ECONOMICS

GEN COM COE

Module 1 ; Class 2

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INFLATION

For a layman inflation is just price rise. It becomes a matter of everyday discussion if the price of daily or weekly items start rising. In developing countries inflation may take an ugly turn and lead to a political crisis

INFLATION

Inflation refers to a sustained/continuous rise in the general price level of goods and services in an economy over a period of time.

n Inflation is a situation of "too much money chasing too few goods" .

n At the time of inflation value of money falls.

n When the price of one good has gone up, it is not considered as inflation, it is inflation only if the prices of most of the goods have gone up.

Following factors are also responsible for inflation.

- Increase in money supply
- Cheap monetary policy
- Deficit financing
- Increase in disposable income
- Increase in consumers spending
- Shortage of factors of production
- Natural calamities etc.

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Demand-pull inflation

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When price rises because aggregate demand in an economy is greater than the aggregate supply of goods and services is called demand-pull inflation.

It is constructive to a faster rate of economic growth, since excess demand is favorable to market condition which stimulates investment and expansion.

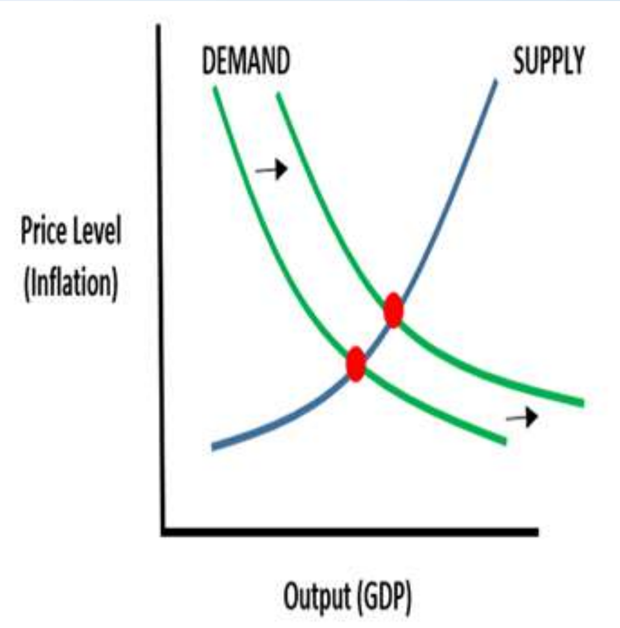
Following factors can be held responsible for demand-pull inflation :

DD > SS ⇒ P↑

1. Rise in population.
2. Black money.
3. Rise in income.
4. Excessive government expenditure.

L> Purchasing power

⇒ EMP↑ ⇒ UEMP↓

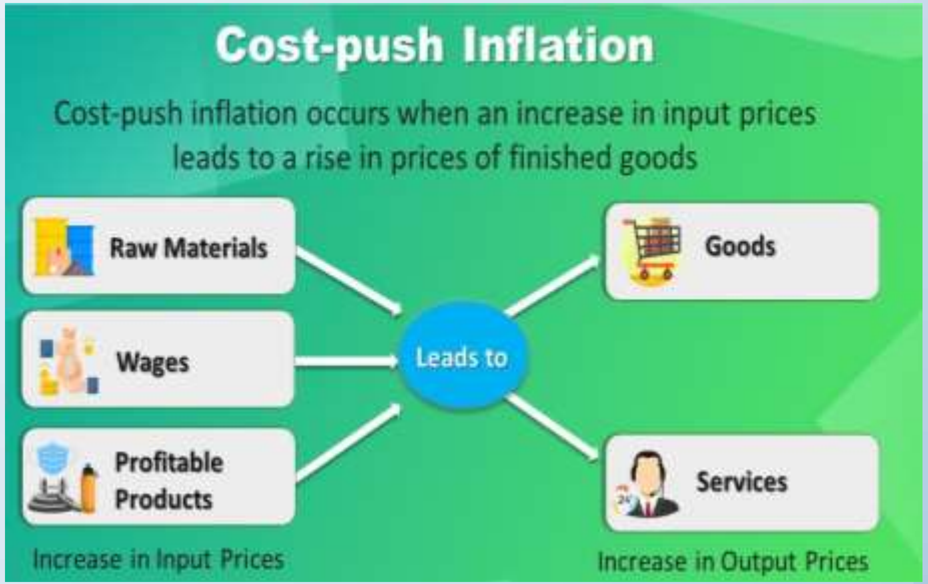


Cost-push inflation

When price of goods and services rise because aggregate supply in an economy is lower than the aggregate demand due to rise in production cost.

Following factors can cause cost-push inflation:

1. Infrastructure bottlenecks which leads a rise in production and distribution costs.
2. Rise in international prices.
3. Hoarding and black marketing.
4. Rise in indirect taxes.



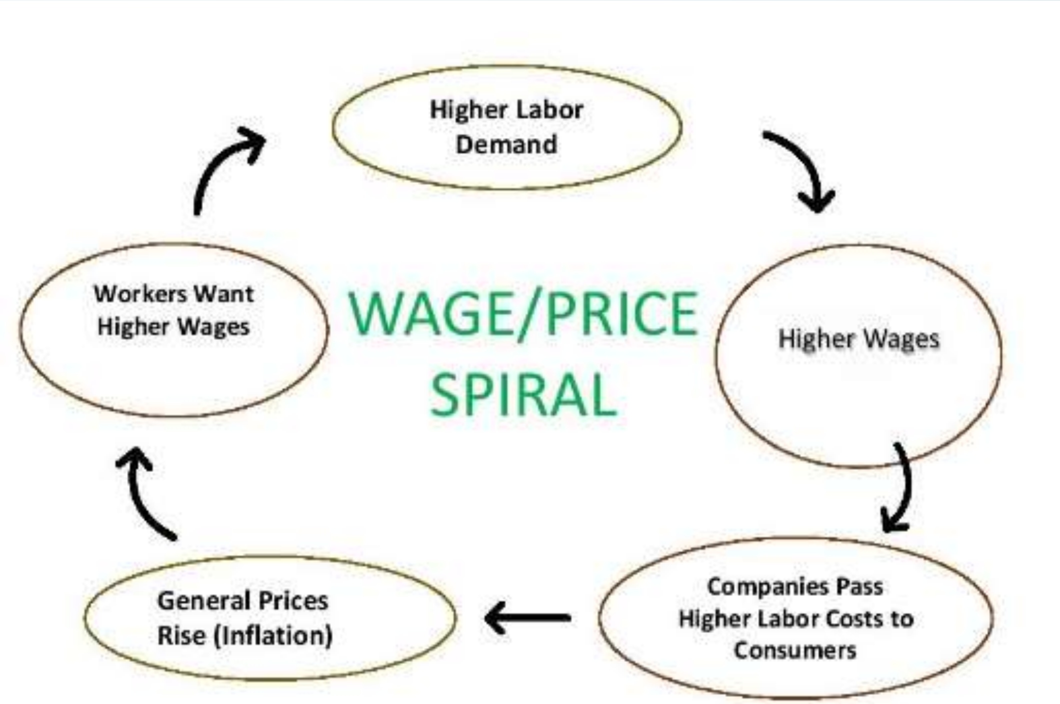
Spiral Inflation

W↑ P↑

W↑ P↑

W↑ P↑

When wage pushes prices up and price pushes wages up is called spiral or built in inflation.
It involves workers trying to keep their wages up with prices and firms passing those higher labour cost on their customers. This nature is based on adaptive expectation.



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Effects of inflation:

- Everybody thinks inflation is evil but necessarily not so. If inflation is anticipated then it can be compensated.
- Inflation redistributes wealth from creditors to debtors i.e- lenders suffer and borrowers benefit out of inflation.
- Usually higher inflation suggests producers to increase their production as it is generally considered as an indication of higher demand in the economy.

4%

U.L = 6%

L.L = 2%

lender

borrower

P↑

→ DD > SS

→ P.P↑

→ EMP↑

→ UBMPV

Effects of inflation

v.v.Imp

- In the flexible currency regime, due to inflation domestic currency of the economy depreciates.
- People living off a fixed income group such as retirees experience a decline in their purchasing power and consequently their standard of living.
- If the inflation is greater than that of other countries, domestic products become less competitive

dividend (part of π)

In summary

- Gainers from inflation: **Debtors, equity holders, businessman etc.**
- Loser's from inflation: **Creditors, salaried person, pensioners , bond holders,**

fixed 'r'.

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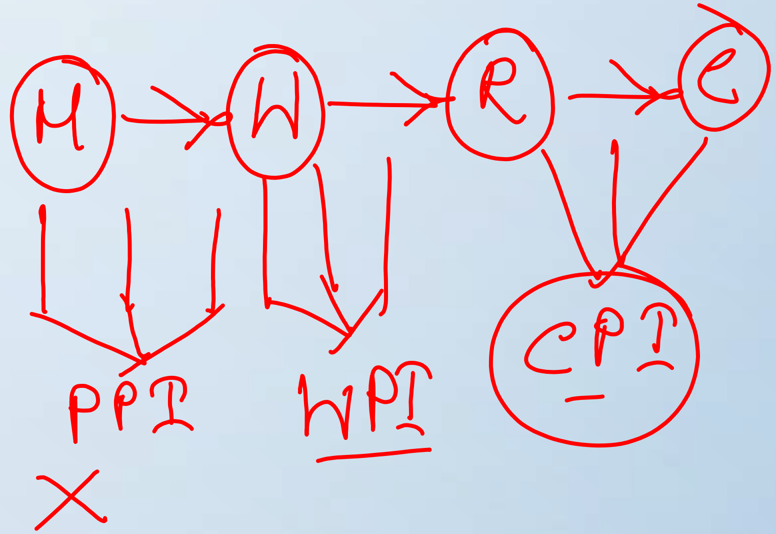
Measuring Inflation

- The rate of inflation is the rate of change of general price level which is measured by using any price index. A price index is a weighted average of the price of a number of goods and services.

- Inflation can be measured at three levels – production, wholesale and retail (consumer). Prices generally rise in each level till the commodity finally reaches the hand of consumer.



Producer Price Index (PPI)

- PPI measures the arrange change in price received by the producer. PPI is calculated on the basis supply of inputs.
- As of now in India, there is no index to measure inflation at producer level.

Wholesale Price Index (WPI)

- It represents the price of goods at a wholesale stage i.e. goods are sold in bulk and traded between organisations instead of consumers.

- The index basket of the WPI covers commodities falling under the three major groups, namely primary article, fuel and power and manufactured products.
- A representative commodity basket in WPI comprises 697 items including 117 items for Primary and food articles (weightage- 22.62%), 16 items for Fuel & Power (weightage 13.15%) and 564 items for Manufactured Products (weightage 64.23%).

- The WPI index is available on a monthly basis with a lag of fortnight.

- One of the major limitations of WPI is that it does not include services such as the health, IT, Education, transport etc.

Consumer Price Index (CPI)

- It is designed to measure the changes over time in the level of retail prices of a fixed set of goods and services consumed by an average family of a defined population group in a given area with reference to a base year.

- Note that, in CPI, the price data is collected periodically, and thus, it is used to calculate the inflation levels in an economy. This can be further used to compute the cost of living.

- Reserve Bank of India (RBI) had adopted the new Consumer Price Index (CPI) (combined) as the key measure of inflation.
- The new CPI is meant to measure retail inflation.
- This index will combine urban and rural CPIs, to be released simultaneously.
- The unified new CPI will usher in a fundamental shift in the way the Reserve Bank of India (RBI) targets inflation.

CPI-C

CPI → R, U

CPI-R
CPI-U

R+U = C

CPI-C

2021-26

Annually 4%
U.L = 6%
Lo.L = 2%

TYPES OF INFLATION

On the basis of speed or intensity inflation can be classified as-

Creeping or mild inflation

- **If the speed of upward thrust in prices is slow but small then we have creeping inflation. To some, a creeping or mild inflation is one when annual price rise varies between 2 p.c. and 3 p.c. If a rate of price rise is kept at this level, it is considered to be helpful for economic development.**

Walking inflation

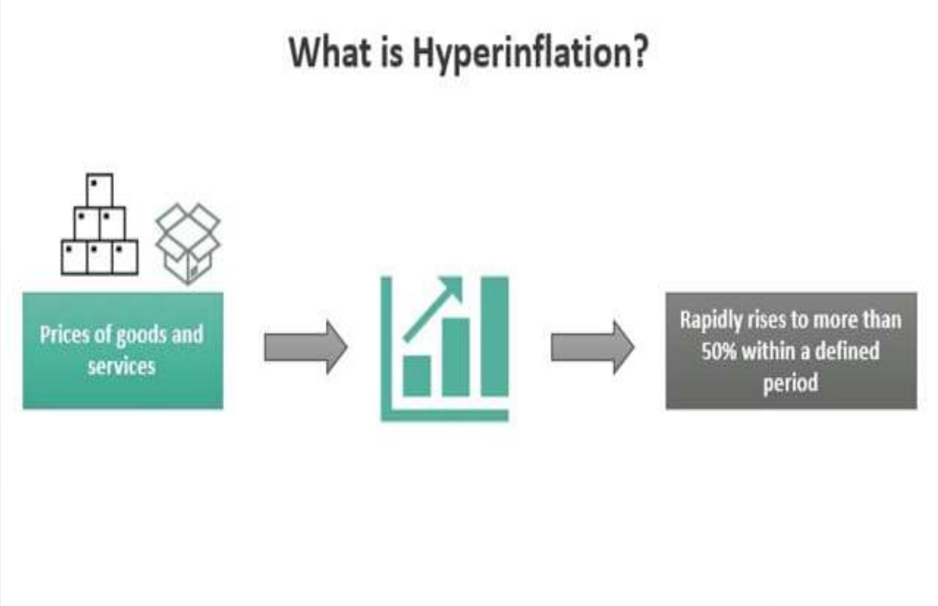
- If the rate of annual price increase lies between 3 p.c. and 4 p.c., then we have a situation of walking inflation. When mild inflation is allowed to fan out, walking inflation appears. These two types of inflation may be described as 'moderate inflation'

Galloping or running inflation

Walking inflation may be converted into running inflation. Running inflation is dangerous. If it is not controlled, it may ultimately be converted to galloping or hyperinflation

Hyperinflation

- Hyperinflation is when the prices of goods and services rise more than 50 percent a month. It is fortunately very rare. In fact, most examples of hyperinflation have occurred when the government printed money recklessly to pay for war.



Inflation Targeting

- The announcement of an official target range for inflation is known as inflation targeting.
- GOI asked RBI to perform this function in the early 1970.
- Inflation target was also mentioned in the report of Urjit Patel Committee in early 2014.
- The Government of India notified inflation target of 4 per cent, with a band of +/- 2 per cent for the period from August 2016 .

Base Effects

The base effect is the distortion in a monthly inflation figure that results from abnormally high or low levels of inflation in the year-ago month. A base effect can make it difficult to accurately assess inflation levels over time.

2011-12

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Reflation

- It is a monetary or fiscal policy by the government and central bank respectively to boost demand and thus increase the level of economic activity and combat deflation which usually occurs after a period of economic uncertainty or a recession.

  Re + Inflation

  fall in general price

- Reflation may also refer to an economic phase after a period of recession – the initial stage of a nation's economic recovery

+4% inflation

-4% Deflation

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Disinflation

8%

4%

4%

Deflation

- Disinflation is a decrease in inflation rates. In simple terms, a decline in the rate of increase in the general price level of goods and services of a country over time is called disinflation.

- Disinflation is not problematic and it is different from deflation. In disinflation, prices do not drop and it does not signal the start of a slowing economy. Deflation is represented as a negative rate of growth, such as. If a central bank wants to enforce a tighter monetary policy, the supply of money in the economy could be limited, causing a disinflationary pressure in the economy.

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Deflation

The opposite of inflation is deflation. It is "a state in which the value of money is rising, i.e. prices are falling." Deflation means persistent fall in the general price level over a period of time compared to base year price level. It is usually associated with falling activity and employment.

100/- 20 units

value of money ↑

100/-

↳ 10 units

Inflation

5 units

Value of Money ↓

Causes of Deflation

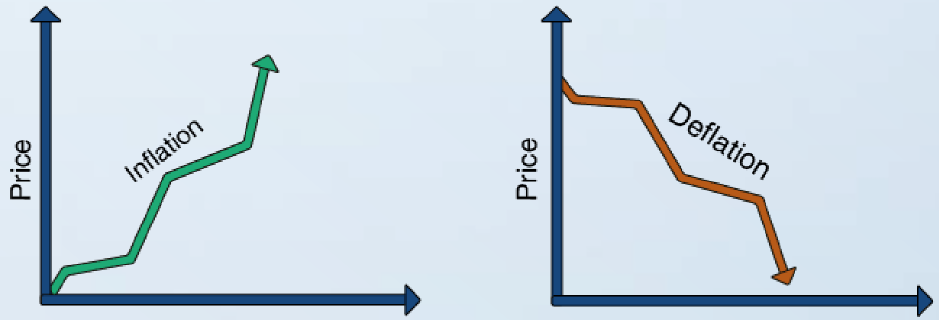
costly

- ❑ Decrease in money supply
- ❑ Dear monetary policy
- ❑ Decrease in disposable income
- ❑ Decrease in public expenditure
- ❑ Decrease in consumer spending etc.

Effects of Deflation

- ❑ Deflation affects different groups differently. Persons with fixed incomes gain because the value of money rises with falling prices.

- ❑ On the other hand, businessman, industrialists, traders, real estate holders and others with variable incomes lose

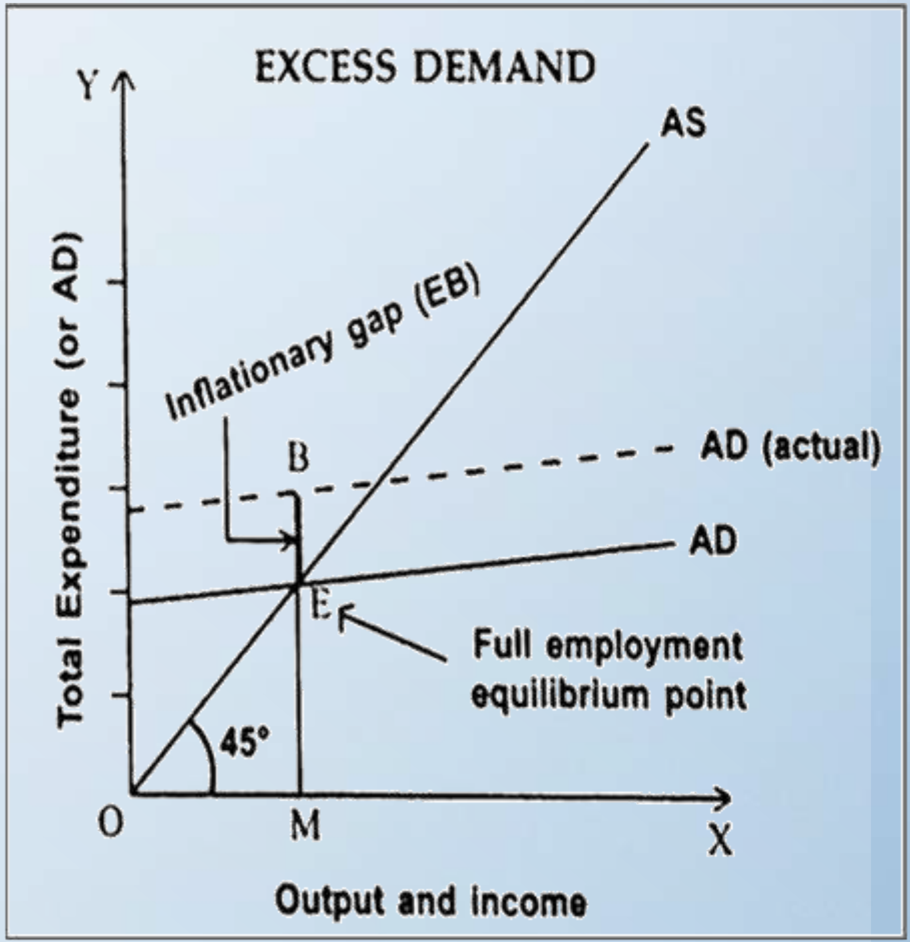


Inflationary Gap

v.v.Imp

- An inflationary gap measures the difference between the current level of real GDP and the GDP that would exist if an economy was operating at full employment.
- The gap to be considered as inflationary when the real GDP must be higher than the potential GDP. Policies that can reduce an inflationary gap include reductions in government spending, tax increases, bond and securities issues, interest rate increases and transfer payment reductions etc.

350 units
↳ Demand
800 units
Supply
DD > SS
↳ P↑



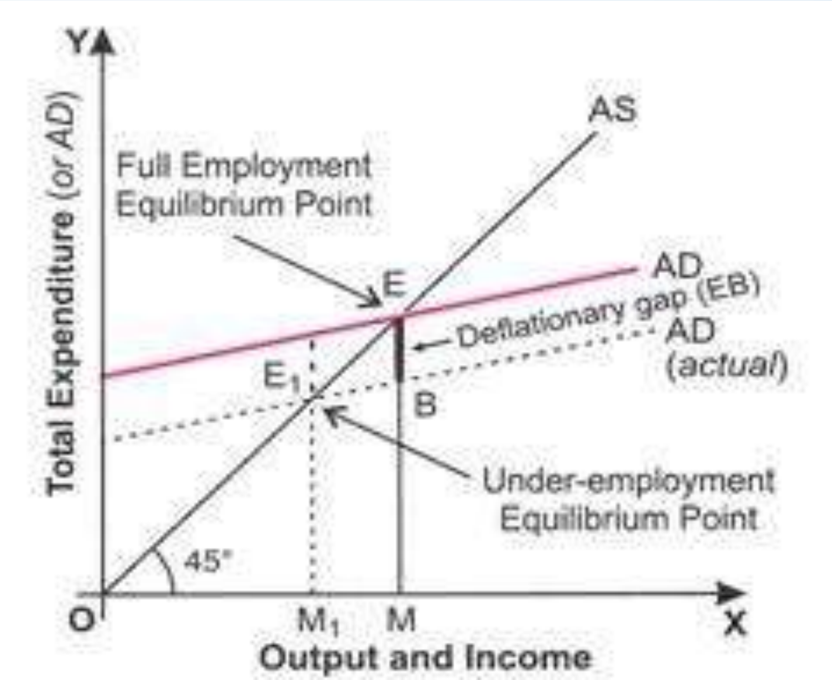
Deflationary Gap

fall BMP (SS)

When the potential GDP is higher than the real GDP, the gap is instead referred to as a deflationary gap

DD

SS > DD ⇒ P↓



Bottleneck inflation

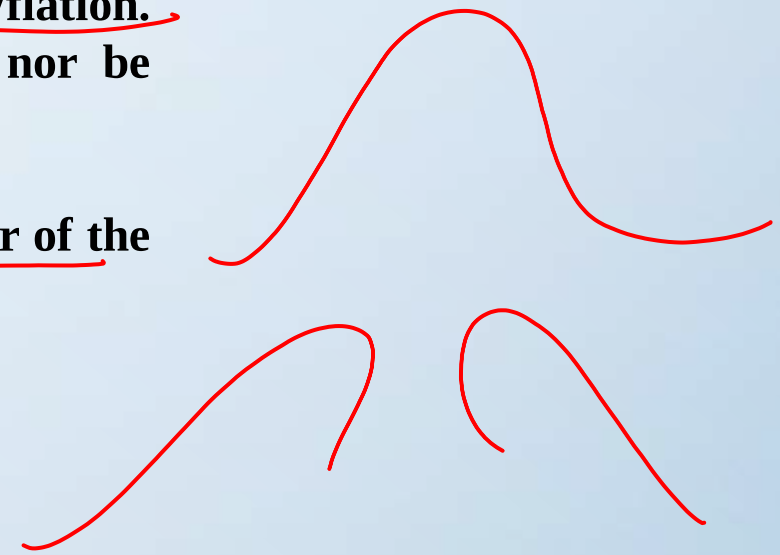
- Inflation takes place when there is a short fall from supply side (due to lack of raw material, Investible capital, mismanagements). It is also known as structural inflation.

- Whenever the government managed to go for higher growths by managing higher investible capital, it had inflationary pressure on the economy and growth was sacrificed.

Skewflation

- A rising price of some set of goods and falling asset price for another set of good together at a time is called skewflation. This situation can neither be defined as inflation nor be defined as deflation.

- In terms of policy, skewflation does not fall into either of the categories of inflation or deflation.



Core inflation

403456

6% - 2%

4%

An inflation measure which excludes transitory or temporary price volatility as in the case of some commodities such as food items, energy products etc. It is calculated using the Consumer Price Index (CPI) by excluding such commodities

Headline inflation

- It is a measure of total inflation. It is not adjusted to remove highly volatile figures, including those that can shift regardless of economic conditions.

- Headline inflation is often closely related to shifts in the cost of living , which provides useful information to consumers within the marketplace

Stagflation

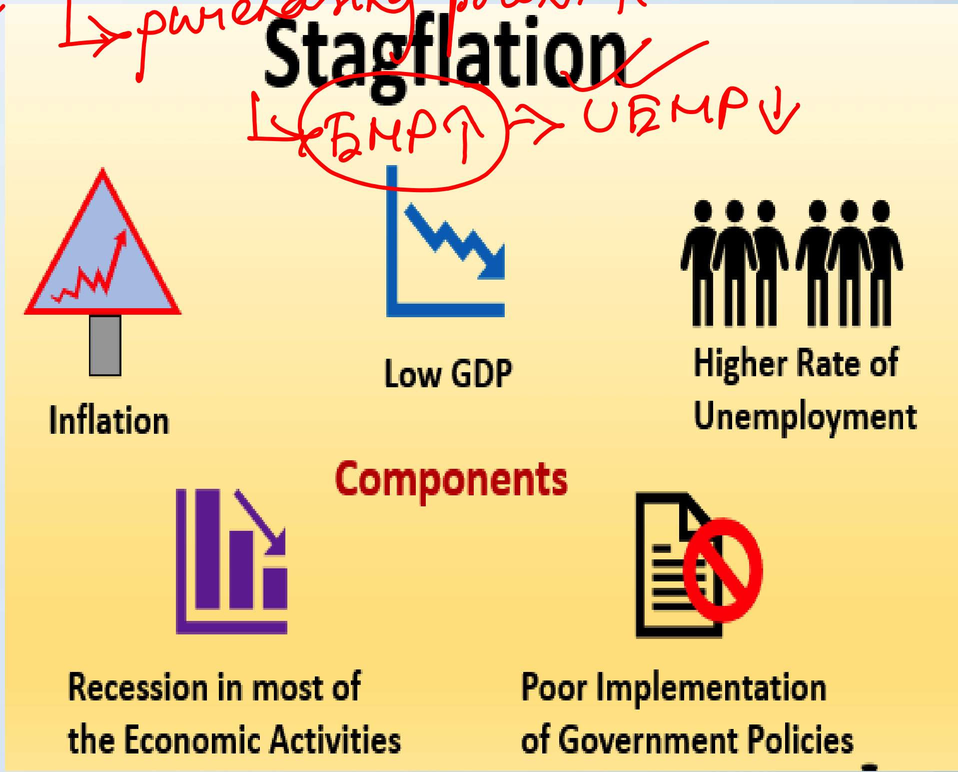
Stagnation + Inflation

P↑ ⇒ DD > SS

↳ purchasing power ↑

↳ EMP↑ ⇒ UEMP↓

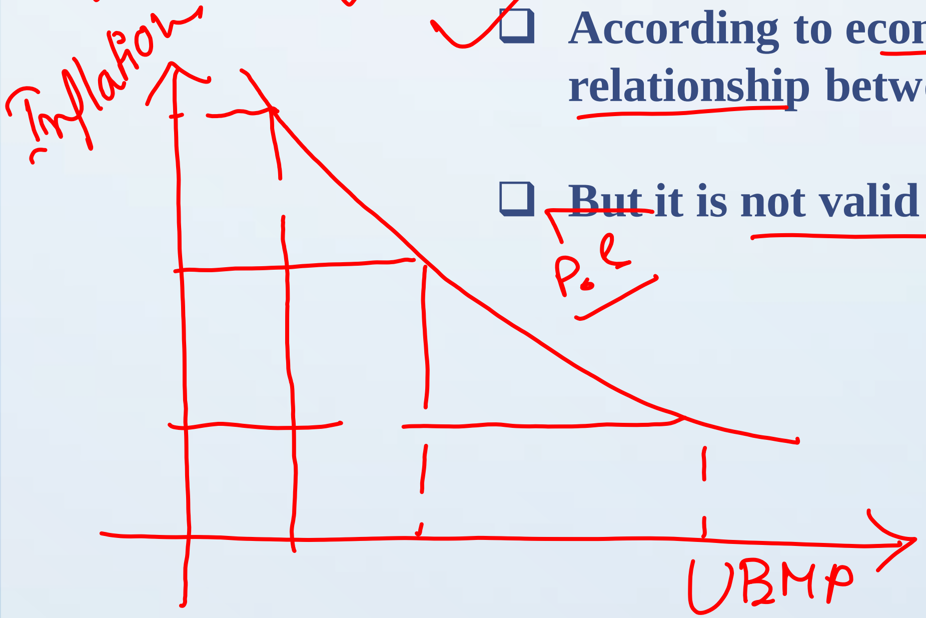
- The term was coined by Iain Macleod, a Conservative Party MP in the United Kingdom, in November 1965.
- Stagflation is said to happen when an economy faces stagnant growth as well as persistently high inflation.
- With stalled economic growth, unemployment tends to rise and existing incomes do not rise fast enough and yet, people have to contend with rising inflation.
- So people find themselves pressurized from both sides as their purchasing power is reduced.



P↑ → DD↑ → SS↑ → EMP↑ → UEMP↓

- The relationship between inflation and unemployment is represented by Phillips curve.
- According to economist Phillips there is an inverse relationship between inflation and unemployment.
- But it is not valid during Stagflation.

P.e



Is Inflation Always Bad For The Economy?

- Though a high rate of inflation is not good for the economy, a mild inflation say under 3% may turn at times useful for the economy.

4%

- High demand on scarce resources will automatically increase prices. But demand for a commodity is a good sign from the industry perspective. Industries now will try to produce more commodities to reap the benefit of high prices and demand. More production will trigger GDP growth.

- In the short run in order to control inflation Government /RBI can go for cutting down the money supply by changing rates and reserve ratio. But in long run, the best way is to increase production with help of the best production practiced

Inflation redistributes income and wealth in favour of: (SSC CGL 1st Sit. 2011)

a)Pensioners
(b) Poor
(c) Middle class
(d) Rich

Ans-D

Forced Savings refer to (SSC CGL 1st Sit. 2013)

a)Compulsory deposits imposed on income tax payers
(b) Provident fund contribution of private sector employees
(c) Reduction of consumption consequent to a rise in prices
(d) Taxes on individual income and wealth

Ans- c

Which among the following term is used for coexistence of inflation and stagnation?

a) Depression

b) Recession

c) Reflation

d) Stagflation

ans- d

THANK YOU