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Rajasthan Administrative Services

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Volume - 7

Economy of India

SIERRA INNOVATIONS

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Economy of India

3 CHAPTER Inflation

PREVIOUS YEAR QUESTIONS

Q1. Consider the following statements regarding inflation: (2023)

Statement (A): Head-line inflation refers to the rate of change in the Consumer Price Index Number, a measure of the average price of a standard basket of goods and services consumed by a typical family.

Statement (B): Core inflation measures the change in average consumer prices after excluding from the Consumer Price Index certain items of volatile prices such as food and fuel.

Of these statements,

(1) Neither (A) nor (B) is correct.
(2) Both (A) and (B) are correct.
(3) Only (B) is correct.
(4) Only (A) is correct.
(5) Question not attempted

Q2. What is not included in the Index of Industrial Production (IIP), which is the measure of Industrial activities in the Indian Economy? (2021)

(1) Gas and water supply
(2) Electricity
(3) Manufacturing
(4) Mining

Q3. Assertion (A): Cost push inflation is caused by shift in aggregate supply curve. (2018)
Reason (R): Shift in aggregate supply curve takes place because of increase in wages.

(1) Both (A) and (R) are true and (R) is the correct explanation of (A).
(2) Both (A) and (R) are true, but (R) is not the correct explanation of (A).
(3) (A) is true, but (R) is false.
(4) (A) is false, but (R) is true.

Q4. Inflation rate based on consumer price index increases if (2016)

(1) Bank rate is decreased
(2) Reverse repo rate is decreased
(3) Statutory Liquidity ratio is increased
(4) Repo rate is increased

Analysis- This chapter covers both concepts and facts, as previous RPSC questions have addressed both aspects. Therefore, the chapter is comprehensively presented to ensure thorough understanding.

Inflation

Inflation refers to persistence rise or a tendency towards persistence rise in the general price level. Inflation is a macroeconomic phenomenon and is not concerned with rise in price of particular commodities or a small group of commodities. With inflation, the price level goes up. So, with the same level of money income, the household could consume a smaller amount of commodities than it was consuming earlier.

For eg - a household has a monthly income of ₹100 and buys a commodity A that costs ₹4, allowing them to purchase 25 units. If the price of commodity A rises to ₹5, they can only buy 20 units with the same ₹100. This shows that inflation reduces their purchasing power, meaning they can buy less with the same amount of money.

Types of Inflation

Moderate inflation- *When the general price level rises slowly but steadily, it is called moderate inflation.*

1. ***Galloping inflation*** *- steady and fairly high rate of increases in the general price level, the rate of inflation runs into two digits and sometimes even as high as three digits. Eg- Latin American nations had experienced inflation rates of over 100 per cent in the 1970s.*
2. **Hyperinflation** *- when the rate of inflation is very high. Eg - In Zimbabwe during 2008-09, where prices almost doubled every single day and the functions of money such as 'a store of value' and 'a medium of exchange' were no longer valid.*
3. **Stagflation** *- when inflation grows very slowly or at zero rate (stagnant) and prices keep rising. The side effects of stagflation are rise in unemployment accompanied by inflation. This happened in the 1970s, when crude oil prices rose dramatically, fuelling sharp inflation in developed economies.*
4. **Skewflation** *- when prices rise unevenly across different sectors, causing inflation in some areas while others remain stable or decline.*
5. **Deflation** *- consistent decline in price level.*
6. **Core Inflation Vs Headline Inflation**

Core Inflation	Headline Inflation
➢ Food and energy items are not included in our estimate of inflation as their prices are significantly more unpredictable. ➢ The consumer price index (CPI): Most commonly used to calculate it. ➢ Measure of long-term inflationary trend.	➢ Food and energy prices (e.g., oil and gas), which are far more volatile and prone to inflationary surges are included in this estimate of total inflation. ➢ Sector-specific inflationary surges are unlikely to endure. ➢ Headline inflation may not accurately reflect an economy's inflationary trend.

Causes of Inflation

Demand Pull Inflation	➢ Factors which increase Aggregate Demand while there is no increase in aggregate supply can cause demand side inflation.	➢ Increased consumer spending ➢ Increased government spending ➢ Increased exports ➢ Expansionary monetary policy ➢ Consumer Confidence ➢ Population Growth ↓ **Increased Demands** ↓ **Demand Pull Inflation** ↓ **Supply Didn't Grow**
Cost Push Inflation	➢ Increases in cost of labour, raw materials, transportation, and other inputs which are supply side factors causes cost push inflation. ➢ It is also called wage-push inflation as wages constitute a substantial part of total costs of production. ➢ Eg- Oil price shocks in the 1970s were cost push inflation because they increased the cost of production.	➢ Increased Production Cost ➢ Rising Wages ➢ Supply Chain Disruptions ➢ Decreased Supply ↓ **Cost Push Inflation** ↓ **Cost Pushed Up**
Monetary Inflation	➢ A continuous growth in a country's money supply is referred to as monetary inflation. ➢ Inflation is caused by RBI issuing more money (deficit financing).	
Structural Inflation (Bottleneck Inflation)	➢ Inflation due to structural rigidities like the resource gap (i.e. saving is less than investment), food shortages (resulting from rainfed agriculture), foreign exchange scarcity and poor infrastructural facilities. ➢ This types of inflation is usually found more in developing nations.	
Built-in Inflation	➢ Built-in inflation is when prices keep going up because people expect them to rise, often due to wages increasing and businesses passing those costs onto customers.	

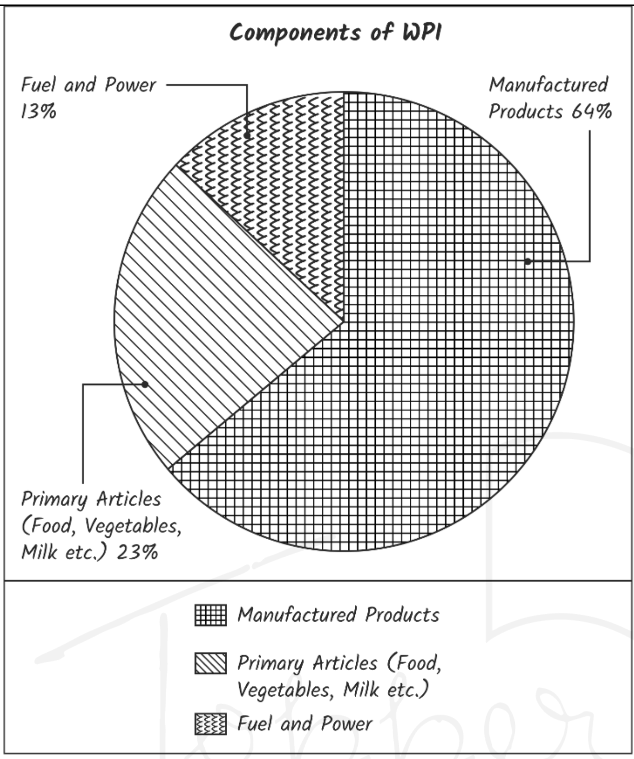
Measurement of Inflation

Inflation can be measured at three levels – producer, wholesaler, and retailer (consumer). Prices generally rise at each level till the commodity finally reaches the hand of the consumer.

1. Measurement at Producer Level: Producer Price Index (PPI)

- Producer Price Index (PPI) reflects the overall change in prices of goods and services at the producer level. (Measures Inflation level at the point of Production).
- The Producer Price Index has not yet been used in India, but NITI Aayog has developed a plan to implement it soon.

2. Measurement at Wholesaler Level: Wholesale Price Index (WPI)



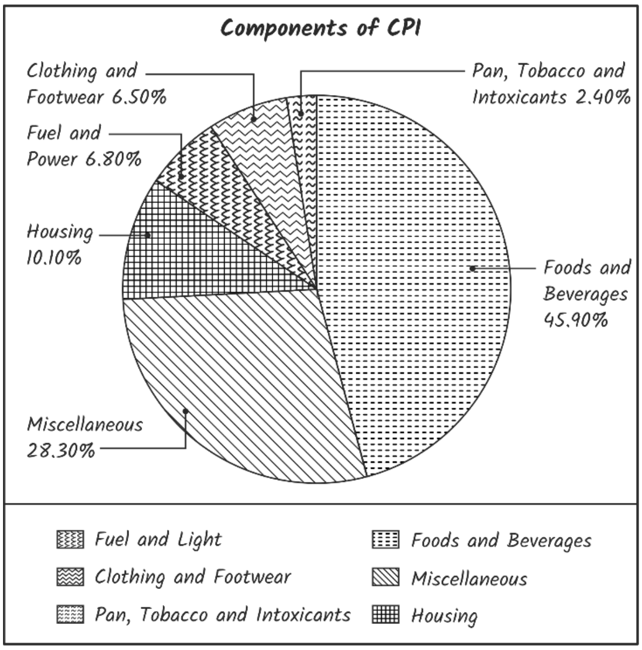
- WPI is the price of a representative basket of wholesale goods. The wholesale price index number indicates the change in the general price level.
- WPI's current base year is 2011-12.
- Covers only goods.
- Manufactured products (64%) > Primary Articles (23%) > Fuel and Power (13%).
  - ✓ Published by Office of Economic Adviser (OEA), Ministry of Commerce and Industry.
- Indirect taxes are not included in WPI.
- The WPI basket contains 697 items.

3. Measurement at Retailer/Consumer Level: Consumer Price Index (CPI)

- The Consumer Price Index (CPI) determines the average change in retail prices.

$$CPI = \frac{\text{Cost of the Market Basket in a given year}}{\text{Cost of the Market Basket in a Base year}} \times 100\%$$

- Also known as 'Cost of Living Index'.
- It measures the Price fluctuations at the consumer level.
- Its current base year is - 2012.
- Ever since the RBI introduced inflation targeting, the CPI(C) has been used as a nominal anchor for the implementation of monetary policy in India.
- According to the Monetary Policy Committee, the CPI(C) must be maintained between 2% and 6%.
- If the bank rate is decreased then CPI increases.



Types of CPI

Type of CPI	Compiled by	Base Year
CPI for Industrial Workers (IW)	Labour Bureau in the Ministry of Labour and Employment (published monthly)	2016
CPI for Agricultural Labourer (AL)	Labour Bureau in the Ministry of Labour and Employment	1986-87
CPI for Rural Labourer (RL)	Labour Bureau in the Ministry of Labour and Employment	1986-87
CPI (Rural/Urban/Combined)	NSO in the Ministry of Statistics and Programme Implementation	2012

Other Indices

Index of Industrial Production (IIP)

- The Index of Industrial Production (IIP) measures short-term changes in industrial production across various sectors, indicating the overall industrial performance of an economy.
- It includes three main sectors: mining, manufacturing, and electricity, reflecting their contribution to industrial output.
- It serves as a vital economic indicator for policymakers, investors, and analysts, guiding decisions and policy formulation based on industrial trends.
- A rising IIP indicates industrial growth and a robust economy, while a declining IIP can signal an economic slowdown or challenges in specific sectors.
- Compiled and published by National Statistical Office (NSO), Ministry of Statistics and Programme Implementation.
- Base year -2011-2012

> **NOTE:- Eight Core Sectors**: These comprise 40.27% of the weight of items included in the Index of Industrial Production (IIP). The eight core sector industries in decreasing order of their weightage: Refinery Products> Electricity> Steel> Coal> Crude Oil> Natural Gas> Cement> Fertilizers.

Effects of inflation

I. Debtors and Creditors

a. When the price rises, the value of money falls. Though debtors return the same amount of money but since the value of money is less than when they were borrowed the money. The burden of debt is reduced and debtors gain.

b. Creditors, on the other hand, lose although they receive the same amount of money but in real terms the value of money has fallen.

2. **Fixed Income group**
    a. Persons with fixed salary are at a loss when there is inflation because salaries are slow to adjust when prices are rising.
3. **Traders and investors**
    a. Producers and traders gain as when prices are rising the value of their inventories rise in the same proportion. So, their profits go up as their sales go up.
    b. The owners of real estates are gainers during inflation because the prices of landed property usually increase faster than the general price level.
4. **Agriculturists**
    a. Landlords lose during rising prices because they get fixed rents.
    b. Peasants proprietors who own and cultivate their farms gain.
    c. Landless agricultural workers are hit hard as inflation impacts prices of farm products more than the cost of production (wage rate and land revenue).
5. **Government**
    a. The government as a debtor gains at the expense of households who are its principal creditors. This is because interest rates on government bonds are fixed and are not raised to offset expected rise in prices.
    b. The households however stand to gain as tax payers. As the taxes are paid with a lag, on income earned during the year and real value of taxes is reduced because of inflation.

Measures to control Inflation

Monetary Measures

- Measures adopted by the Central Bank / RBI
    1. Increase in Bank rate
    2. Sale of Government Securities in the Open Market
    3. Higher Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)
    4. Consumer Credit Control
    5. Higher margin requirements
    6. Higher Repo Rate and Reverse Repo Rate
- The primary goal of monetary policy is to keep prices stable (keeping inflation within the target band of 2% to 6%).

Fiscal Measures

- Fiscal policy adopted by the country's government:
    - ✓ Reduction of Government Expenditure
    - ✓ Reduction in Public Borrowing
    - ✓ Enhancing taxation.

Other Measures

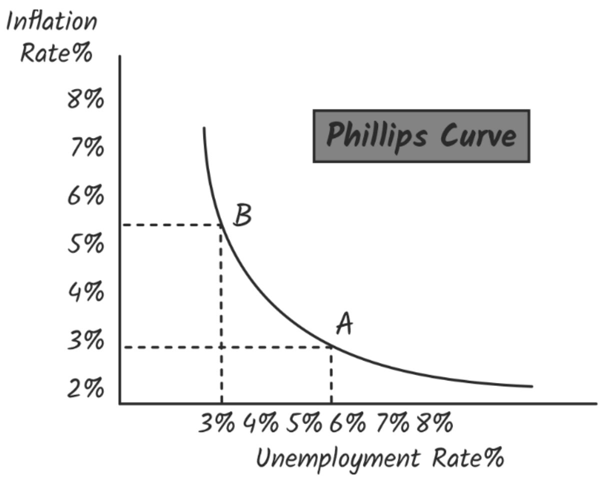
- *These include the use of buffer stocks, imports to supplement domestic supply, a ban on exports, direct price controls, restrictions on speculation and hoarding, and a prohibition on commodity futures trading.*
- *Price Control through Direct Action*
  - ✓ *Drug Price Control Order (DPCO): It seeks to control the cost of prescription drugs.*
  - ✓ *Essential Commodity Act of 1955: It allows the government to designate a good as an essential good to guarantee that it is offered to the general public at fair pricing.*
- *Examine Speculation and Hoarding: Government under the Prevention of Black Marketing & Maintenance of Supplies of Essential Commodities Act, 1980 detain people who engage in price-rigging, stockpiling, and artificially depleting supplies of essential commodities.*
- *Policy on Buffer Stocks*
  - ✓ *The Government of India has maintained buffer stocks of food grains to cover any unforeseen circumstances.*
  - ✓ *Food Corporation of India is the in-charge of purchasing, storing, moving, transporting, distributing, and selling food grains and other food items.*
- *Ban on Exports:*

  The Indian government establishes a Minimum Export Price (MIP) to prevent the export of raw materials and guarantee their supply on domestic markets.
- *Ban on Commodity Futures trading:*

  Governments typically forbid trade in commodities in the future to avoid speculation-driven rate increases. (e.g., the government prohibited future trading in chana, etc.).

Important Terms Related to the Chapter

- ***Disinflation:*** *Process of reversing inflation without generating adverse effects.*
- ***Reflation:*** *It is the act of simulating the economy by raising the money supply or lowering the taxes.*
- ***Phillips curve:*** *Inverse relationship between unemployment and inflation. According to the hypothesis, the lower the unemployment rate, the higher the rate of inflation, and vice versa.*
- ***Inflation Spiral or Wage Price Spiral:*** *The wage-price spiral occurs when rising wages lead to higher production costs, prompting businesses to increase prices. This results in further wage demands from workers, creating a continuous cycle of inflation.*



- **Thalinomics:** *Thalinomics is a term coined by Indian economist Gurcharan Das to describe the economics of the Indian thali (a traditional meal platter). It refers to the study of how food prices and consumption patterns reflect the broader economic conditions in India.*
- **Inflation Targeting**: *Inflation targeting is a monetary policy strategy where a central bank sets a specific inflation rate as its goal and adjusts monetary policy tools, such as interest rates, to achieve and maintain that target.*