Inflation

Inflation is defined as a situation where there is sustained, unchecked increase in the general price level and a fall in the purchasing power of money. Thus, inflation is a condition of price rise.
The reason for price rise are :
(1) Increase in demand : eg during festival times there is increase in demand which results in hike in prices
(2) Reduced supply: e.g. during covid times there was a problem of logistics which resulted in reduced supply of goods. This resulted in a hike of prices.

Lets understand with an example.
On 24th may the price of rice was 10Rs per kg but on 30th may the price of rice was 20Rs per kg.
The price rise of 10 is called inflation.

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

Inflation at Producer Level
As of now in India, there is no index to measure inflation at producer level. A Producer Price Index (PPI) is proposed, but so far this type of inflation calculation has not started in India. There are two types:

- In the case where the goods leave the production place, it is known as Output PPI.
- Similarly, Input PPI is when goods enter the production process.

Inflation at Wholesale Level
The index used to calculated wholesale inflation is known as Wholesale Price Index (WPI). This inflation rate is often known as headline inflation.
Though RBI used WPI for most of its policy decisions before 2014. But WPI based inflation calculation was not foolproof. WPI shows the combined price of a commodity basket comprising 676 items. But WPI does not include services, and it neither reflects the bottlenecks between producer and wholesaler nor between wholesaler and retailer (consumer).Hence from 2014, as part of the reforms initiated by RBI governor Raghu Ram Rajan, RBI shifted to CPI for policy decisions.

- Published by the Office of Economic Adviser, Ministry of Commerce and Industry.
- It is the most widely used inflation indicator in India.
- Major criticism for this index is that the general public does not buy products at wholesale price.
- The base year of All-India WPI has been revised from 2004-05 to 2011-12 in 2017.

Inflation at Consumer Level
Consumer often directly buys from retailer. So the inflation experienced at retail shops is the actual reflection of the price rise in the country. It also shows the cost of living better.
In India, the index which shows the inflation rate at retail level is known as Consumer Price Index (CPI). CPI is based on 260 commodities, but includes certain services too. There were four Consumer Price Indices covering different socio-economic groups in the economy.

1. Consumer Price Index for Industrial Workers (CPI-IW);
2. Consumer Price Index for Agricultural Labourers (CPI-AL);
3. Consumer Price Index for Rural Labourers (CPI -RL) and
4. Consumer Price Index for Urban Non-Manual Employees (CPI-UNME).

CPI is now using a new series on the base 2012=100 for all-India and States/UTs separately for rural, urban and combined. The Central Statistics Office (CSO), Ministry of Statistics and Program Implementation releases Consumer Price Indices (CPI). CPI is based on retail prices and this index is used to calculate the Dearness Allowance (DA) for government employees.

Other important terms:

Core Inflation (Underline Inflation or Non-food Inflation)

Core inflation is also a term used to denote the extend of inflation in an economy. But Core inflation does not consider the inflation in food and fuel. This is a concept derived from headline inflation. There is no index for direct measurement of core inflation and now it is measured by excluding food and fuel items from Wholesale Price Index (WPI) or Consumer Price Index (CPI).

Shrinkflation

It is the practice of reducing the size of a product while maintaining its sticker price. Raising the price per given amount is a strategy employed by companies, mainly in the food and beverage industries, to stealthily boost profit margins or maintain them in the face of rising input costs. Shrinkflation is also referred to as package downsizing in business and academic research. A less common usage of this term may refer to a macroeconomic situation where the economy is contracting while also experiencing a rising price level.

Demand-pull inflation

This occurs when the economy grows quickly and starts to 'overheat' – Aggregate demand (AD) will be increasing faster than aggregate supply (LRAS).

Cost-push inflation

This occurs when there is a rise in the price of raw materials, higher taxes, e.t.c

Disinflation – a falling rate of inflation is called Disinflation
Creeping inflation –Inflation rate is low, but consistently creeping up.
Walking/moderate inflation – When inflation rate is between (2-10%)
Running inflation : When inflation rate is between(10-20%)

Wage Inflation: Rising wages tend to cause inflation. In effect, this is a combination of demand-pull and cost-push inflation. Rising wages increase costs for firms, and so these are passed onto consumers in the form of higher prices. Also rising wages give consumers greater disposable income and therefore cause increased consumption and AD. In the 1970s, trades unions were powerful in the UK. This helped cause rising nominal wages; this was a significant factor in causing inflation of the 1970s.

Imported Inflation:A depreciation in the exchange rate will make imports more expensive. Therefore, the prices will increase solely due to this exchange rate effect. A depreciation will also make exports more competitive so will increase demand.