## Constraints faced to control Inflation

Constraints in controlling cost push inflation

- Prices of imported commodities – crude oil prices increased
- Depreciation of rupee
- Food inflation because of defective supply chain
- Low growth of agriculture sector
- Increase in interest rates
- Increase in Public Expenditure and Budgetary deficit

Constraints in controlling demand pull

- Foreign investment is increasing
- Depreciation of rupee

**Note**: Out of the two types of Inflation, it is the Cost-Push type of inflation that is hard to control because these are real problems faced by the economy (like droughts, floods, supply chain management problems). On the other hand, Demand-Pull type of inflation can be controlled by controlling money side factors.

## Impact of Inflation

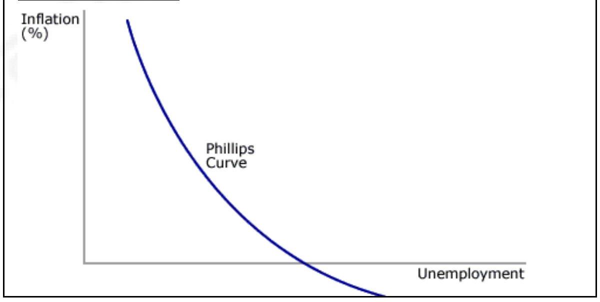
Positive Impact

- Inflation is good for the economy upto reasonable limits. This according to RBI is 5%.
- Moderate inflation stimulates growth.

Negative Impact

- Real income of people would decrease.
- Inflation is regressive in nature.
- Would increase income inequalities.
- Capital formation is adversely affected.
- Interest rates were increased by RBI.
- Distorts Resource allocation.
- Promotes generation of Black Money.
- Standard of living would reduce.
- Promote hoarding and speculation.
- Adversely effects BOP situation.

**Phillips curve**




## Measurement of Inflation

Inflation is measured with the help of Index numbers. Index numbers are numbers that measure change in any variable.

There are two types of Index numbers

- **Wholesale Price Index (WPI)**
  - ✓ Based in 676 commodities
  - ✓ Estimated by Min of Industry and Commerce
  - ✓ Measured on a monthly basis, but with a lag of 14 days.
  - ✓ Base year is 2004-05

| Item Groups | No of Items | Weightage (%) |
|---|---|---|
| Primary articles | 102 | 20.12 |
| Fuel and Power | 19 | 14.91 |
| Manufactured Items | 555 | 64.97 |
| Total | 676 | 100 |

**Note**: WPI was revised in 2010. It was revised on the recommendation of Prof. Abhijit Sen committee. Earlier the base year for WPI was 1993-94.
In India, general rate of inflation is measured by WPI.

Different methods to measure WPI

- ✓ <u>Point to Point inflation</u>
  Inflation is compared between two points in time, usually a month's inflation rate.
- ✓ <u>52 week average method</u>
  Average of previous 52 week's point to point inflation is taken.

- **Consumer Price Index (CPI)**
- ✓ It shows the impact of inflation on a common man (increase in cost of living).
- ✓ CPI is considered to provide Dearness Allowance to Central government employees.
- ✓ CPI is based on retail prices.
- ✓ Is available on a monthly basis.

There are four types of CPI:

- ✓ CPI for Industrial Workers (CPI-IW)
  - Base year: 2001
  - Weightage of food items is 46%
  - Measured by Labour Bureau
  - This is used for the grant of DA

- ✓ CPI for Urban Non-Manual Employees (CPI-UNME)
  - Base year: 1984-85
  - This is used to provide grant by some MNC's

- ✓ CPI for Agricultural Labourers (CPI-AL)
  - Base year: 1986-87
  - Used for the fixation of minimum wages
  - This is used for revision of wages under MNREGA

- ✓ CPI for Rural Labourers (CPI-RL)
  - Base year: 1986-87

**<u>New CPI introduced by CSO</u>**
In 2011, CSO introduced three new CPI's

- CPI – Urban
- CPI – Rural
- CPI – Combined

The reason to introduce these new CPI's was that there was no single CPI that could give the effect of inflation as a common man residing in India would experience. Base year for all the three CPI's is 2010.

Why Inflation is high on CPI as compared to WPI?

- Weightage of food is high in CPI than when compared to WPI.

**Sub-Prime loans**

These are loans that are provided to risky borrowers or in other words, clients who have high probability of defaulting.

**Impact of Sub-prime crisis on Indian Economy**

Banks and Financial Institutions suffered loses as a result withdrawal of money by Financial Institutions. This resulted in demand being reduced. This in turn resulted in inflation decreasing in India.

Remedies: Government provided Fiscal stimulus (taxes reduced, govt expenditure increased), Expansionary monetary policy was adopted by RBI and Support packages was required.

**Terms Related with Inflation**

1. Inflation: Persistent increase in price level
2. Disinflation: Reduction in the rate of inflation
    - Price level decreases
    - No adverse effect on economy
3. Deflation: Persistent decrease in price level (negative inflation)
4. Reflation: Price level increases when economy recovers from recession

**Based on value of inflation**

1. Creeping inflation – If rate of inflation is low (upto 3%)
2. Walking/Trotting inflation – Rate of inflation is moderate (3-7%)
3. Running/Galloping inflation – Rate of inflation is high (>10%)
4. Runaway/Hyper Inflation – Rate of inflation is extreme

**New terms**

1. Stagflation: Inflation + Recession (Unemployment)
2. Misery index: Rate of inflation + Rate of unemployment
3. Inflationary gap: Aggregate demand > Aggregate supply (at full employment level)
4. Deflationary gap: Aggregate supply > Aggregate demand (at full employment level)
5. Suppressed / Repressed inflation: Aggregate demand > Aggregate supply. Here govt will not allow rising of prices.
6. Open inflation: Situation where price level rises without any price control measures by the government.
7. Core inflation: Based on those items whose prices are non-volatile.
8. Headline inflation: All commodities is covered in this.
9. Structural inflation: Due to structural problems like infrastructural bottlenecks.