# UPSC Civil Services Examination

## UPSC Notes [GS-III]

## Topic: Inflation - UPSC Economy Notes

Inflation can be defined as a calculated surge in the average prices of goods and services for a longer duration in the economy. It is a macro concept, wherein the effect of inflation is seen over a large basket of goods. The ultimate effect of inflation is that the value of money is reduced i.e., the purchasing power of money is reduced.

## Types of Inflation

The different types of inflation in an economy can be explained as follows:

### Demand-Pull Inflation

This type of inflation is caused due to an increase in aggregate demand in the economy.

Major reasons to support the statement are stated below:

- A growing economy or increase in the supply of money – When consumers feel confident, they spend more and take on more debt. This leads to a steady increase in demand, which means higher prices.
- Asset inflation or Increase in Forex reserves- A sudden rise in exports forces a depreciation of the currencies involved.
- Government spending or Deficit financing by the government – When the government spends more freely, prices go up.
- Due to fiscal stimulus
- Increased borrowing
- Depreciation of rupee

### Cost-Push Inflation

This type of inflation is caused due to various reasons such as:

- Increase in price of inputs
- Hoarding and Speculation of commodities
- Defective Supply chain
- Increase in indirect taxes
- Depreciation of Currency

- Crude oil price fluctuation
- Defective food supply chain
- Low growth of Agricultural sector
- Food Inflation (growth agriculture sector has been averaging at 3.5%)
- Interest rates were increased by RBI

Cost pull inflation is considered bad among the two types of inflation. Because the National Income is reduced along with the reduction in supply in Cost-push type of inflation.

## Built-in Inflation

This type of inflation involves a high demand for wages by the workers which the firms address by increasing the cost of goods and services for the customers.

## Remedies

The different remedies to solve issues related to inflation can be stated as:

- **Monetary Policy (Contractionary policy)**

The monetary policy of the Reserve Bank of India is aimed at managing the quantity of money in order to meet the requirements of different sectors of the economy and to boost economic growth.

This contractionary policy is manifested by decreasing bond prices and increasing interest rates. This helps in reducing expenses during inflation which ultimately helps halt economic growth and, in turn, the rate of inflation.

- **Fiscal Policy**
    - Monetary policy is often seen separate from the fiscal policy which deals with taxation, spending by government and borrowing. Monetary policy is either contractionary or expansionary.
    - When the total money supply is increased rapidly than normal, it is called an expansionary policy while a slower increase or even a decrease of the same refers to a contractionary policy.
    - It deals with the Revenue and Expenditure policy of the government.

**Tools of fiscal policy**

Direct and Indirect taxes (Direct taxes should be increased and indirect taxes should be reduced).

Public Expenditure should be decreased (should borrow less from RBI and more from other financial institutions)

To know more about Fiscal policy in India, refer to the linked article.

- **Supply Management measures**
    - Import commodities which are in short supply

- Decrease exports
- Governmentt may put a check on hoarding and speculation
- Distribution through PDS

## Measurement of Inflation

1. Wholesale Price Index (WPI) – It is estimated by Min of Industry and Commerce and measured on a monthly basis, but with a lag of 14 days.
2. Consumer Price Indices – It is calculated by taking price changes for each item in the predetermined lot of goods and averaging them
    1. 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. The base year for all the three CPI's is
       2010.
3. Producer Price Indices – It is a measure of the average change in the selling prices over time received by domestic producers for their output.
4. Commodity Price Indices – It is a fixed-weight index or (weighted) average of selected commodity prices, which may be based on spot or futures price
5. Core Price Indices – It measures the prices paid by consumers for goods and services without the volatility caused by movements in food and energy prices. It is a way to measure the underlying inflation trends.
6. GDP deflator – It is a measure of general price inflation.

Know more about Cash reserve ratio in this article.

## Effect of Inflation on the Economy

The effect of inflation on the economy can be stated as:

- The effect of inflation is not distributed evenly in the economy. There are chances of hidden costs for different goods and services in the economy.
- Sudden or unpredictable inflation rates are harmful to an overall economy. They lead to market instability and thereby make it difficult for companies to plan a budget for the long-term.
- Inflation can act as a drag on productivity as companies are forced to mobilize resources away from products and services to handle the situations of profit and losses from inflation.
- Moderate inflation enables labour markets to reach equilibrium at a faster pace.

## Terms related to Inflation

1. Disinflation: Reduction in the rate of inflation
2. Deflation: Persistent decrease in price level (negative inflation)
3. Reflation: Price level increases when economy recovers from recession Based on value of inflation
4. Creeping inflation – If rate of inflation is low (upto 3%)
5. Walking/Trotting inflation – Rate of inflation is moderate (3-7%)
6. Running/Galloping inflation – Rate of inflation is high (>10%)
7. Runaway/Hyper Inflation – Rate of inflation is extreme
8. Stagflation: Inflation + Recession (Unemployment)
9. Misery index: Rate of inflation + Rate of unemployment
10. Inflationary gap: Aggregate demand > Aggregate supply (at full employment level)
11. Deflationary gap: Aggregate supply > Aggregate demand (at full employment level)
12. Suppressed / Repressed inflation: Aggregate demand > Aggregate supply. Here governmentt will not allow rising of prices.
13. Open inflation: Situation where price level rises without any price control measures by the government.
14. Core inflation: Based on those items whose prices are non-volatile.
15. Structural inflation: Due to structural problems like infrastructural bottlenecks.