ESSAY ON INFLATION

Inflation is the decline of purchasing power of a given currency over time. A quantitative estimate of the rate at which the decline in purchasing power occurs can be reflected in the increase of an average price level of a basket of selected goods and services in an economy over some period of time. The rise in the general level of prices, often expressed a a percentage means that a unit of currency effectively buys less than it did in prior periods.

- Inflation is the rate at which the the value of a currency is falling and consequently the general level of prices for goods and services is rising.
- Inflation is sometimes classified into three types: Demand-Pull inflation, Cost-Push inflation, and Built-In inflation.
- Most commonly used inflation indexes are the Consumer Price Index (CPI) and the Wholesale Price Index (WPI).
- Inflation can be viewed positively or negatively depending on the individual viewpoint and rate of change.
- Those with tangible assets, like property or stocked commodities, may like to see some inflation as that raises the value of their assets.
- People holding cash may not like inflation, as it erodes the value of their cash holdings.
- Ideally, an optimum level of inflation is required to promote spending to a certain extent instead of saving, thereby nurturing economic growth.
- Understanding Inflation
- While it is easy to measure the price changes of individual products over time, human needs extend much beyond one or two such products. Individuals need a big and diversified set of products as well as a host of services for living a comfortable life. They include commodities like food grains, metal and fuel, utilities like electricity and transportation, and services like healthcare, entertainment, and labor. Inflation aims to measure the overall impact of price changes for a diversified set of products and services, and allows for a single value representation of the increase in the price level of goods and services in an economy over a period of time.
- As a currency loses value, prices rise and it buys fewer goods and services. This loss of purchasing power impacts the general cost of living for the common public which ultimately leads to a deceleration in economic growth. The consensus view among economists is that sustained inflation occurs when a nation's money supply growth outpaces economic growth.
- To combat this, a country's appropriate monetary authority, like the central bank, then takes the necessary measures to manage the supply of money and credit to keep inflation within permissible limits and keep the economy running smoothly.
- Theoretically, monetarism is a popular theory that explains the relation between inflation and money supply of an economy. For example, following the Spanish conquest of the Aztec and Inca empires, massive amounts of

gold and especially silver flowed into the Spanish and other European economies. Since the money supply had rapidly increased, the value of money fell, contributing to rapidly rising prices.

- Inflation is measured in a variety of ways depending upon the types of goods and services considered and is the opposite of deflation which indicates a general decline occurring in prices for goods and services when the inflation rate falls below 0%.

Causes of Inflation

An increase in the supply of money is the root of inflation, though this can play out through different mechanisms in the economy. Money supply can be increased by the monetary authorities either by printing and giving away more money to the individuals, by legally devaluing (reducing the value of) the legal tender currency, more (most commonly) by loaning new money into existence as reserve account credits through the banking system by purchasing government bonds from banks on the secondary market. In all such cases of money supply increase, the money loses its purchasing power.

Demand-Pull Effect

Demand-pull inflation occurs when an increase in the supply of money and credit stimulates overall demand for goods and services in an economy to increase more rapidly than the economy's production capacity. This increases demand and leads to price rises.

With more money available to individuals, positive consumer sentiment leads to higher spending, and this increased demand pulls prices higher. It creates a demand-supply gap with higher demand and less flexible supply, which results in higher prices.

Cost-push inflation is a result of the increase in prices working through the production process inputs. When additions to the supply of money and credit are channeled into commodity or other asset markets and especially when this is accompanied by a negative economic shock to the supply of key commodity, costs for all kind of intermediate goods rise. These developments lead to higher cost for the finished product or service and work their way into rising consumer prices. For instance, when the an expansion of the money supply creates a speculative boom in oil prices the cost of energy of all sorts of uses can rise and contribute rising consumer prices, which is reflected in various measures of inflation.

Built-in inflation is related to adaptive expectations, the idea that people expect current inflation rates to continue in the future. As the price of goods and services rises, workers and others come to expect that they will continue to rise in the future at a similar rate and demand more costs/wages to maintain their standard of living. Their increased wages result in higher cost of goods and services, and this wage-price spiral continues as one factor induces the other and vice-versa.

TYPES OF INFLATION

CREEPING INFLATION VERY SLOW AND ESSENTIAL <3%

WALKING INFLATION MODERATE 3% TO 7 % OR <10%; WARNING

RUNNING INFLATION 10% TO 20%

GALLOPING INFLATION 20% TO 100%

BOTTLE NECK INFLATION SUPPLY FALLS DRASTICALLY AND DEMAND REMAINS THE SAME

HEADLINE INFLATION PRICE RISE IN ALL SECTORS

CORE INFLATION

PRICE RISE IN ALL SECTORS EXCEPT FOOD AND ENERGY

INFLATION GAP SPENDING ABOVE NATIONAL INCOME

DEFLATION GAP SPENDING BELOW NATIONAL INCOME

INFLATION SPIRAL BOTH PRICE AND WAGE GOES UP DUE TO INFLATION

INFLATION PREMIUM THE BONUS BROUGHT BY INFLATION TO THE BORROWERS

EFFECTS

GAINER **DEBTORS PRODUCERS FLEXIBLE INCOME GROUPEQUITY HOLDERS EXPORTERS**

LOOSER CREDITORS CONSUMERS FIXED INCOME GROUP

DEBENTURERS / BOND HOLDERS IMPORTERS

TO CONTROL INFLATION

CENTRAL BANK INCREASES RATES WHICH IS CALLED DEAR MONETARY POLICY OR CONTRACTIONARY

TO CONTROL DEFLATION IT DECREASE RATES WHICH IS CALLED CHEAP MONETARY POLICY OR EXPANSIONARY POLICY

Types of Price Indexes

Depending upon the selected set of goods and services used, multiple types of baskets of goods are calculated and tracked as price indexes. Most commonly used price indexes are the Consumer Price Index (CPI) and the Wholesale Price Index (WPI).

Wholesale Price Index (WPI) and Consumer Price Index (CPI) are two commonly used measures that are effective in determining the inflation in the country.

WPI or Wholesale Price Index is an indicator that is used to determine the changes in the price occurring in case of goods available for wholesale in the market.

WPI is useful in calculating the change in commodity prices that occur at selected stages before it reaches retailers.

In India, WPI is used to measure the changes occurring in the price of commodities available for trading in the wholesale market.

Consumer Price Index or CPI is another price index that focuses on the sum of money that a consumer has to shell out in order to purchase a basket of goods and services over a period of time. CPI measures the price that consumers pay to retailers. the number of items will also increase from 437 to 448 in the rural basket and from 450 to 460 in the urban basket. It has 8 Groups Education,Communication.ransportation,Recreation,apparel, foods and beverage, housing and medical care.

CPI is used by the Reserve Bank of India as an important tool for determining inflation, which is useful for framing the credit and monetary policy in the country.

WPI has 3 groups, Primary articles, Fuel and Power and Manufacturing.

Total 697 articles

PRIMARY 117-22.62%

FUEL AND POWER 16 13.15%

MANUFACTURING GOODS 564 64.13%

Let us discuss some points of difference between the Wholesale Price Index and Consumer Price Index

Wholesale Price Index	**Consumer Price Index**
Definition	
Wholesale Price Index is a measure of the average change in the price of goods at a	Consumer Price Index is another price index that calculates price changes of goods

wholesale level or in the wholesale market.	and services that a consumer has to pay for consuming a basket of goods.
Published by	
Office of Economic Advisor	Central Statistics Office
Stage involved	
It measures the initial or first stage of a transaction	It is the final or last stage of a transaction
Scope	
It covers only goods	It covers goods and services
Area of Focus	
It focuses on goods that are traded only between wholesalers or businesses	It focuses on goods that are being purchased by consumers.
Reference year for Calculation	
It uses Financial Year as a reference	It uses the calendar year as a reference

The Producer Price Index

The producer price index is a family of indexes that measures the average change in selling prices received by domestic producers of intermediate goods and services over time. The PPI measures price changes from the perspective of the seller and differs from the CPI which measures price changes from the perspective of the buyer

In all such variants, it is possible that the rise in the price of one component (say oil) cancels out the price decline in another (say wheat) to a certain extent. Overall, each index represents the average weighted price change for the given constituents which may apply at the overall economy, sector, or commodity leve

<u>Pros and Cons of Inflation</u>

Inflation can be construed as either a good or a bad thing, depending upon which side one takes, and how rapidly the change occurs.

For example, individuals with tangible assets that are *priced* in currency, like property or stocked commodities, may like to see some inflation as that raises the price of their assets which they can sell at a higher rate. However, the buyers of such assets may not be happy with inflation, as they will be required to shell out more money. Inflation-indexed bonds are another popular option for investors to profit from inflation.

On the other hand people holding assets *denominated* in currency, such as cash or bonds, may also not like inflation, as it erodes the real value of their holdings. Investors looking to protect their portfolios from inflation should consider inflation-hedged asset classes, such as gold, commodities, and Real Estate Investment Trusts (REITs).

Inflation **promotes speculation**, both by businesses in risky projects and by individuals in stocks of companies, as they expect better returns than inflation. **An optimum level of inflation is often promoted to encourage spending to a certain extent instead of saving**. If the purchasing power of money falls over time the, then there may be a greater incentive to spend now instead of saving and spending later. It may increase spending, which may boost economic activities in a country. A balanced approach is thought to keep the inflation value in an optimum and desirable range.

High and variable rates of inflation can impose **major costs on an economy**. Businesses, workers, and consumers must all account for the effects of generally rising prices in their buying, selling, and planning decisions. This introduces an additional source of uncertainty into the economy, because they may guess wrong about the rate of future inflation. Time and resources expended on researching, estimating, and adjusting economic behavior around expected rise in the general level of prices, rather than real economic fundamentals, inevitably represents a cost to the economy as a whole.

Even a low, stable, and easily predictable rate of inflation, which some consider otherwise optimal, may lead to serious problems in the economy, because of how, **where, and when the new money enters** the economy. Whenever new money and credit enters the economy it is always into the hands of specific individuals or business firms, and the process of price level adjustment to the new money supply proceeds as they then spend the new money and it circulates from hand to hand and account to account through the economy.

Along the way, it drives up some prices first and later drives up other prices. This sequential change in purchasing power and prices (known as the Cantillon effect) means that the process of inflation not only increases the general price level over time, but it also distorts relative prices, wages, and rates of return along the way. Economists in general understand that distortions of relative prices away from their economic equilibrium is not good for the economy, and Austrian economists even believe this process to be a major driver of cycles of recession in the the economy.

Controlling Inflation

A country's financial regulator shoulders the important responsibility of keeping inflation in check. It is done by implementing measures through monetary policy, which refers to the actions of a central bank or other committees that determine the size and rate of growth of the money supply.

Price stability—or a relatively constant level of inflation—allows businesses to plan for the future since they know what to expect. The Fed believes that this will promote maximum employment, which is determined by non-monetary factors that fluctuate over time and are therefore subject to change. For this reason, the Fed doesn't set a specific goal for maximum employment, and it is largely determined by employers' assessments. Maximum employment does not mean zero unemployment, as at any given time there is a certain level of volatility as people vacate and start new jobs.

Monetary authorities also take exceptional measures in extreme conditions of the economy. For instance, following the 2008 financial crisis, the U.S. Fed has kept the interest rates near zero and pursued a bond-buying program called quantitative easing.[4] Some critics of the program alleged it would cause a spike in inflation in the U.S. dollar, but inflation peaked in 2007 and declined steadily over the next eight years. There are many complex reasons why QE didn't lead to inflation or hyperinflation, though the simplest explanation is that the recession itself was a very prominent deflationary environment, and quantitative easing supported its effects.

Hedging Against Inflation

Stocks are considered to be the best hedge against inflation, as the rise in stock prices are inclusive of the effects of inflation. Since additions to the money supply in virtually all modern economies occur as bank credit injections through the financial system, much of the immediate effect on prices happens financial assets that are priced in currency, such as stocks.

Additionally, special financial instruments exist which one can use to safeguard investments against inflation. They include Treasury Inflation Protected Securities (TIPS), low-risk treasury security that is indexed to inflation where the principal amount invested is increased by the percentage of inflation. One can also opt for a TIPS mutual fund or TIPS-based exchange traded fund (ETFs). To get access to stocks, ETFs and other funds that can help to avoid the dangers of inflation, you'll likely need a brokerage account. Choosing a stockbroker can be a tedious process due to the variety among them.

Too much inflation is generally considered bad for an economy, while too little inflation is also considered harmful. Many economists advocate for a middle-ground of low to moderate inflation, of around 2% per year. Generally speaking, higher inflation harms savers because it erodes the purchasing power of the money they have saved. However, it can benefit borrowers because the inflation-adjusted value of their outstanding debts shrinks over time.

What are the effects of inflation?

Inflation can affect the economy in several ways. For example, if inflation causes a nation’s currency to decline, this can benefit exporters by making their goods more affordable when priced in the currency of foreign nations. On the other hand, this could harm importers by making foreign-made goods more expensive. Higher inflation can also encourage spending, as consumers will aim to purchase goods quickly before their prices rise further. Savers, on the other hand, could see the real value of their savings erode, limiting their ability to spend or invest in the future.