

Inflation

1. Meaning of Inflation

- **Inflation:** Sustained rise in the **general price level** of goods and services.
- Measured as a **percentage change** in a price index.
- Indicates a **decline in the purchasing power** of currency.
- Opposite situation: **Deflation** (persistent fall in price level).

2. Types of Inflation

A. Demand-Pull Inflation

Occurs when **Aggregate Demand (AD) > Aggregate Supply (AS)**.

Causes:

- Increase in money supply
- Rise in exports (currency undervaluation)
- Excess consumption demand
- Government deficit spending

Mechanism:

Higher demand → Demand-supply gap → Rise in prices

B. Cost-Push Inflation

Occurs when the **cost of production increases**, reducing aggregate supply.

Causes:

- Rise in wages
- Increase in raw material prices (e.g., crude oil)
- Supply bottlenecks
- Hoarding / artificial scarcity
- Increase in freight costs
- Exchange rate depreciation

Mechanism:

Higher input cost → Reduced supply → Higher prices

3. Factors Causing Inflation

Demand Side Factors

- Excess money supply
- Credit expansion
- Increase in exports
- Government deficit
- Rise in disposable income

Supply Side Factors

- Shortage of labour, land, and capital
- Increase in global commodity prices
- Poor agricultural output
- Hoarding and black marketing
- External shocks

4. Measurement of Inflation in India

Inflation is measured through **price indices**.

A. Consumer Price Index (CPI)

- Measures retail-level price changes.
- Includes:
 - Food
 - Medical care
 - Education
 - Housing
 - Transport
- Reflects the **cost of living**
- Used by RBI for inflation targeting.

B. Wholesale Price Index (WPI)

- Measures wholesale-level prices.
- Captures goods sold between businesses.
- Does not include services.

In India, both CPI and WPI are used.

5. Effects of Inflation on the Economy

Negative Effects

- Decline in purchasing power
- Increase in the cost of living
- Reduced savings value
- Loss of international competitiveness
- Economic uncertainty
- Lower investment
- Slower economic growth

Positive Effects (Moderate Inflation)

- Encourages spending
- Discourages hoarding
- Promotes production and investment

6. Inflation Targeting in India

Institutional Framework

- Inflation is measured by the **Ministry of Statistics and Programme Implementation (MoSPI)**
- Controlled by **RBI through the Monetary Policy Committee (MPC)**

Target

- CPI inflation target: **4%**
- Tolerance band: **2%–6%**
- Introduced in **2016**

RBI uses:

- Repo rate
- Reverse repo rate
- Bank rate
- Open Market Operations (OMO)

7. Pros and Cons of Inflation Targeting

Pros

- Transparency and accountability
- Anchors inflation expectations
- Avoids boom-bust cycles
- Encourages macroeconomic stability
- Reduces uncertainty

Cons

- May ignore unemployment
- Less policy flexibility
- Cannot solve supply shocks
- Cannot fix structural bottlenecks
- Growth may slow in the short run

8. Methods to Control Inflation

A. Monetary Policy

- Increase repo rate
- Reduce the money supply
- Open Market Operations
- Increase CRR/SLR

Used mainly for demand-pull inflation.

B. Fiscal Policy

- Increase taxes
- Reduce public expenditure
- Cut the fiscal deficit

Limits private spending.

C. Price Control

- Fixing maximum prices
- Short-term relief only

D. Supply-Side Measures

- Increase MSP to boost production
- Buffer stock operations
- Price Stabilization Fund
- Control hoarding (Essential Commodities Act)
- Import essential goods

9. Government Steps to Control Inflation

- Action against hoarding and black marketing
- Enforcement of the Essential Commodities Act
- Creation of buffer stock (e.g., pulses)
- Price Stabilization Fund
- Stock limits on onions
- Market intervention schemes
- Regular price monitoring committees

Quick Revision Pointers

- CPI is used for inflation targeting.
- Inflation target = $4\% \pm 2\%$.
- WPI does not include services.
- Demand-pull: Aggregate Demand > Aggregate Supply.
- Cost-push: Increase in production cost.
- Moderate inflation is desirable.
- Deflation is rare and dangerous.

- Inflation reduces the real value of savings.

Aspire with Ram IAS