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INFLATION

CAUSES & TYPES

For RBI Grade B, SEBI Grade A & NABARD Exams

What Is Inflation?

Inflation is a quantitative measure of the rate at which the average price level of a basket of selected goods and services in an economy increases over some period of time.

It is the rise in the general level of prices where a unit of currency effectively buys less than it did in prior periods.

Often expressed as a percentage, inflation thus indicates a decrease in the purchasing power of a nation's currency.

Causes of Inflation

Rising prices are the roots of inflation, though this can be attributed to different factors.

In the context of causes, inflation is classified into three types:

1. Demand-Pull inflation,
2. Cost-Push inflation, and
3. Built-In inflation.

1. Demand-Pull Effect

Demand-pull inflation occurs when the overall demand for goods and services in an economy increases more rapidly than the economy's production capacity. It creates a demand-supply gap with higher demand and lower supply, which results in higher prices.

For instance, when the oil producing nations decide to cut down on oil production, the supply diminishes. This lower supply for existing demand leads to a rise in price and contributes to inflation.

Additionally, an increase in money supply in an economy also leads to inflation. With more money available to individuals, positive consumer sentiment leads to higher spending. This increases demand and leads to price rises.

Money supply can be increased by the monetary authorities either by printing and giving away more money to the individuals, or by devaluing (reducing the value of) the currency. In all such cases of demand increase, the money loses its purchasing power.

2. Cost-Push Effect

Cost-push inflation is a result of the increase in the prices of production process inputs. Examples include an increase in labour costs to manufacture a good or offer a service or increase in the cost of raw material. These developments lead to higher cost for the finished product or service and contribute to inflation.

3. Built-In Inflation

Built-in inflation is the third because that links to adaptive expectations. As the price of goods and services rises, labour expects and demands more costs/wages to maintain their cost 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 Indexes

Depending upon the selected set of goods and services used, multiple types of inflation values are calculated and tracked as inflation indexes.

Most commonly used inflation indexes are the **Consumer Price Index (CPI)** and the **Wholesale Price Index (WPI).**

1. The Consumer Price Index

The CPI is a measure that examines the weighted average of prices of a basket of goods and services which are of primary consumer needs. They include transportation, food, and medical care.

CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them based on their relative weight in the whole basket.

The prices in consideration are the retail prices of each item, as available for purchase by the individual citizens.

Changes in the CPI are used to assess price changes associated with the cost of living, making it one of the most frequently used statistics for identifying periods of inflation or deflation.

2. The Wholesale Price Index

The WPI is another popular measure of inflation, which measures and tracks the changes in the price of goods in the stages before the retail level.

While WPI items vary from one country to other, they mostly include items at the producer or wholesale level.

For example, it includes cotton prices for raw cotton, cotton yarn, cotton gray goods, and cotton clothing.

3. 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 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.

Source: Investopedia

Types of Inflation

There are different types inflation which are explained below:

1. Creeping Inflation

This is also known as mild inflation or moderate inflation. This type of inflation occurs when the price level persistently rises over a period of time at a mild rate. When the rate of inflation is less than 10% annually, or it is a single digit inflation rate, it is considered to be a moderate inflation.

This kind of mild inflation makes consumers expect that prices will keep going up. That boosts demand. Consumers buy now to beat higher future prices. That is how mild inflation drives economic expansion.

2. Walking Inflation

This strong, or destructive, inflation is between 3-10% a year. It is harmful to the economy because it heats-up economic growth too fast. People start to buy more than they need to avoid tomorrow's much higher prices.

This increased buying drives demand even further so that suppliers cannot keep up. More important, neither can wages. As a result, common goods and services are priced out of the reach of most people.

3. Galloping Inflation

If mild inflation is not checked and if it is uncontrollable, it may assume the character of galloping inflation. Inflation in the double- or triple-digit range of 20, 100 or 200 percent a year is called galloping inflation. Many Latin American countries such as Argentina, Brazil had inflation rates of 50 to 700 percent per year in the 1970s and 1980s.

Money loses value so fast that business and employee income cannot keep up with costs and prices. Foreign investors avoid the country, depriving it of needed capital. The economy becomes unstable, and government leaders lose credibility.

4. Hyperinflation

It is a stage of very high rate of inflation. While economies seem to survive under galloping inflation, a third and deadly strain takes hold when the cancer of hyperinflation strikes.

Nothing good can be said about a market economy in which prices are rising a million or even a trillion percent per year.

Hyperinflation occurs when the prices go out of control and the monetary authorities are unable to impose any check on it. Germany had witnessed hyperinflation in 1920's.

In fact, most examples of hyperinflation occur when governments print money to pay for wars.

5. Stagflation

It is an economic situation in which inflation and economic stagnation, or recession occur simultaneously and remain unchecked for a period of time. Stagflation was witnessed by developed countries in 1970s, when world oil prices rose dramatically.

Stagflation is when economic growth is stagnant, but there still is price inflation.3 This combination seems contradictory, if not impossible. Why would prices go up when there is not enough demand to stoke economic growth?

6. Deflation

Deflation is the reverse of inflation. It refers to a sustained decline in the price level of goods and services.

It occurs when the annual inflation rate falls below zero percent (a negative inflation rate), resulting in an increase in the real value of money. Japan suffered from deflation for almost a decade in 1990s. It is when prices fall. It is caused when an asset bubble bursts.

7. Core Inflation:

The core inflation rate measures rising prices in everything except food and energy.

Source: Investopedia & Indiainfoline

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