Inflation : Definition, WPI, CPI, Measurement and Causes

Inflation is defined as a situation where there is sustained, unchecked increase in the general price level and a fall in the purchasing power of money. Thus, inflation is a condition of price rise. The reason for price rise can be classified under two main heads : (1) Increase in demand (2) Reduced supply.

Inflation explained with an example

Suppose for Rs.100, last week you bought 5 Kg. of rice. This means that the cost of 1Kg of rice was Rs. 20. This week when you approached the same shop-keeper and paid Rs.100 to get rice, he gave only 4 Kg of rice. He also explained that the price of rice has increased, and now it is Rs.25 per Kg.

This example clearly explains the fall in the purchasing power of money. For Rs. 100 you could get 5 Kg rice before, but now only 4 Kg. So purchasing power of money got reduced. *This is inflation*. And let's us calculate the inflation rate (percentage). If price of rice, which was Rs.20 per Kg increased to Rs.25, this corresponds to Rs.5 increase on Rs.20, ie. 25% increase. So the inflation rate is 25%, which is obviously a very high rate.

Problems with Inflation

Having understood what inflation really is, let's ponder what effects can inflation cause in an economy? Is inflation that bad? High rates of inflation is bad because, it can eat up hard-earned money of ordinary people. Life of common man will become tough. His savings will soon be exhausted, unless his investments offer high rate of return than the inflation rate present in the country.

Inflation Rates in India

There are different indices in India like Wholesale Price Index(WPI), Consumer Price Index(CPI) etc which measure inflation rates in India. But what we generally find in headlines as inflation rate in India is Inflation rate based on WPI. In the last 50 years, WPI based inflation rate shows an average inflation rate around 7-8%. The highest inflation rate observed in India was 34.68 Percent in September of 1974. The lowest rate touched was -11.31 Percent in May of 1976 (a case of deflation).

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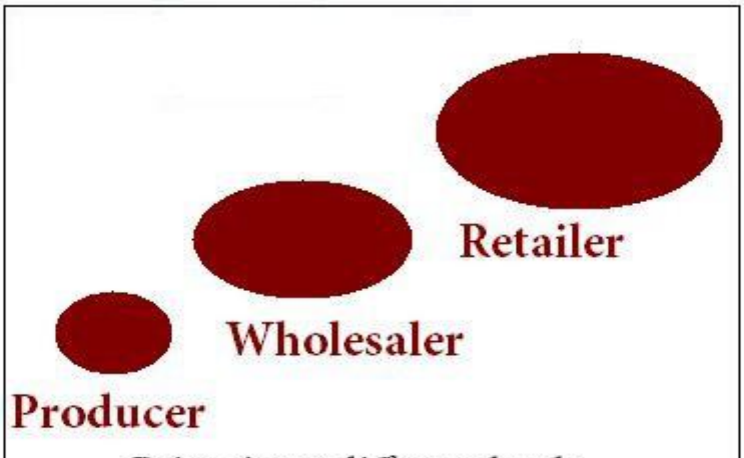

Price rise at different levels

How to measure Inflation rate?

Unchecked inflation can ruin the whole economy. There are many examples from African and South American economies which got shattered by the high inflation rates. But who measures inflation rate in India? And what are they types of Inflation indices in India? Let's study each of them.

Inflation can be measured at three levels – producer, wholesaler and retailer (consumer). Prices generally rise in each level till the commodity finally reach the hand of consumer.

Inflation at Producer Level

As of now in India, there is no index to measure inflation at producer level. A Producer Price Index (PPI) is proposed, but so far this type of inflation calculation has not started in India.

Inflation at Wholesale Level

This is the most popular inflation rate calculation methodology in India. The index used to calculated wholesale inflation is known as Wholesale Price Index (WPI). This inflation rate is often known as headline inflation. WPI is released by the Ministry of Commerce and Industry.

Though RBI used WPI for most of its policy decisions before 2014. But WPI based inflation calculation was not false proof. WPI shows the combined price of a commodity basket comprising 676 items. But WPI does not include services, and it neither reflect the bottlenecks between producer and wholesaler nor between wholesaler and retailer (consumer).

Hence from 2014, as part of the reforms initiated by RBI governor Raghu Ram Rajan, RBI shifted to CPI for policy decisions.

Inflation at Retail Level (Consumer Level)

Consumer often directly buys from retailer. So the inflation experienced at retail shops is the actual reflection of the price rise in the country. It also shows the cost of living better.

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In India, the index which shows the inflation rate at retail level is known as Consumer Price Index (CPI). CPI is based on 260 commodities, but includes certain services too. There were four Consumer Price Indices covering different socio-economic groups in the economy. These four indices were Consumer Price Index for Industrial Workers (CPI-IW); Consumer Price Index for Agricultural Labourers (CPI-AL); Consumer Price Index for Rural Labourers (CPI -RL) and Consumer Price Index for Urban Non-Manual Employees (CPI-UNME). CPI is now using a new series on the base 2010=100 for all-India and States/UTs separately for rural, urban and combined. The Central Statistics Office (CSO), Ministry of Statistics and Program Implementation releases Consumer Price Indices (CPI). CPI is based on retail prices and this index is used to calculate the Dearness Allowance (DA) for government employees.

Headline Inflation vs Core Inflation

Having studied inflation rate measurement at different levels, now let's focus on two terms related to inflation. They are Headline Inflation and Core Inflation.

Headline Inflation

Headline Inflation is the measure of total inflation within an economy. It includes price rise in food, fuel and all other commodities.

The inflation rate expressed in Wholesale Price Index (WPI) usually denotes the headline inflation**.** Though Consumer Price Index (CPI) values are often higher, WPI values traditionally make headlines.

Core Inflation (Underline Inflation or Non-food Inflation)

Core inflation is also a term used to denote the extend of inflation in an economy. But Core inflation does not consider the inflation in food and fuel. This is a concept derived from headline inflation. There is no index for direct measurement of core inflation and now it is measured by excluding food and fuel items from Wholesale Price Index (WPI) or Consumer Price Index (CPI).

Also read: Land reforms in India

Causes of Inflation

There can be two set of factors that can cause inflation in an economy. They are Demand Pull and Cost Push.

Demand Pull Factors

1. Rise in population.
2. Black money.
3. Rise in income.
4. Excessive government expenditure.

Cost Push Factors

1. Infrastructure bottlenecks which lead rise in production and distribution costs.
2. Rise in Minimum Support Price (MSP).
3. Rise in international prices.
4. Hoarding and black marketing.
5. Rise in indirect taxes.

What measures can be taken to address inflation?

Both government and central bank (Reserve Bank) try to tackle inflation with their policies which are known as Fiscal and Monetary Policies respectively. Fiscal policies correspond to tax related measures taken by government to control inflation (money supply). RBI through its various monetary policies limit the money supply by altering rates like CRR, Repo, Reverse Repo etc. Administrative measures taken by government like strengthening of Public Distribution System also plays a crucial role in curbing inflation.

Is inflation always bad for the economy?

Though a high rate of inflation is not good for the economy, a mild inflation, say under 3%, may turn, at times, useful for the economy. As we hinted in the beginning, inflation can occur because of high demand too. High demand on scarce resources will automatically increase prices. This is called demand pull inflation. But demand for a commodity is a good sign from the industry perspective. Industries now will try to produce more commodities to reap the benefit of high prices and demand. More production will trigger GDP growth.