

Eye for Inflation

What is Inflation?

Inflation basically means the rise in prices of goods and services. Since price rise affects each and every individual and can drastically affect lives, especially of the poor, most governments set their primary goal to control inflation. In other words, success in tempering inflation is seen as a measure of good governance.

Since inflation is related to price increases, we need to understand the various forces at play that affect prices.

Types of Inflation

There are basically two main types of Inflation.

- Cost-push Inflation
- Demand Inflation (or Supply demand mismatch)

Cost-push inflation

It is defined as persistently rising general price levels, brought about by rising input costs. In general, there are three factors that could contribute to cost-push inflation: rising wages, increase in corporate taxes and imported inflation (when imported raw or partly-finished goods become more expensive, often as a result of currency depreciation). For inflation to be cost-push in nature, increases in input prices must affect a large proportion of the country's producers, so as to be able to push up the general price level.

In history, an ideal example of cost-push inflation would be the oil crisis of the 1970s, which some

economists see as a classic example of imported inflation experienced in the Western world in that decade wherein price increases of a key imported constituent impacted the prices of goods across industries.

Demand pull inflation

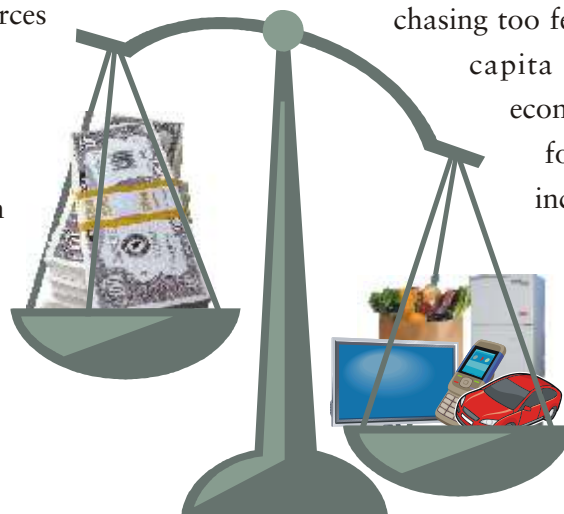
Demand-pull inflation arises when the aggregate demand in an economy outpaces aggregate supply. This is commonly described as "too much money chasing too few goods". With increasing per capita income seen in emerging economies, this aggregate demand for goods and services has been increasing.

How is Inflation measured?

There are two main indices used to measure inflation. The first is the Consumer Price Index (CPI). The CPI is a measure of the price of a set of goods and services. The "bundle,"

as the group is known, contains items such as food, clothing, edible oils etc. The amount of inflation is measured by the change in the cost of the bundle: if it costs 5% more to purchase the bundle this year as compared to last year, we could say inflation has been 5% based on CPI.

The second measure of inflation is the wholesale Price Index (WPI). While the CPI indicates the change in the purchasing power of a consumer, the WPI is a measure of change in the prices charged to intermediaries. The WPI measures the price at which a good is sold to other businesses before the good is sold to a consumer. The WPI actually



combines a series of smaller indices that cross many industries and measure the prices for three types of goods: crude, intermediate and finished.

Generally, the markets are most concerned with the finished goods because these are a strong indicator of what will happen with future CPI reports.

Though the CPI is a more popular measure of inflation than the WPI, investors watch both closely. The weekly inflation numbers that are released are based on WPI.

Inflation and Your Investments

Inflation is feared by investors as it grinds away the value of their investments.

The rate of inflation is important as it represents the rate at which the real value of an investment is eroded and the loss in spending power over time.

It is crucial to include measures of expected inflation when calculating your expected return on investment. As the most basic example, if you invest Rs.1000 in a 1-year FD that will return 5%

Inflation Baskets

FOOD, BEVERAGES & TOBACCO

- a. Cereals
- b. Pulses
- c. Oils & Fats
- d. Meat, Fish etc.
- e. Milk & Milk Products
- f. Condiment, Spices etc.
- g. Vegetables
- h. Fruits
- i. Sugar, Honey etc.
- j. Non-alc Beverages
- k. Prep. Meals etc.
- l. Pan, Supari, Tobacco etc.

II FUEL & LIGHT

III HOUSING

IV CLOTHING, BEDDING & FOOT-WEAR etc.

- a. Clothing & Bedding
- b. Foot-wear

V MISCELLANEOUS

- a. Medical care
- b. Education
- c. Recreation & Amusement
- d. Transport & Communicaton
- e. Personal Care & Effect
- f. Household Requisites
- g. Others



CPI

- Electricity for Railway Traction,
- Purified Terephthalic Acid(PTA),
- Injection Moulded Plastic Items,
- Oxygen Gas in Cylinder,
- Railway Sleepers (Cement product),
- Thinner,
- MS/SS Ingots,
- Cold Rolled Sheets,
- LPG Cylinder,
- Jelly Filled Telephone Cables,
- Colour TV Sets,
- Computer and Computer based Systems.
- Light products,
- Power, Lubricants...etc.

Total 453 items



WPI

over that year, you will be giving up Rs.1000 right now for Rs.1050 in 1 year. If over the course of that year, the inflation is 6%, the purchasing power of Rs.1000 has decreased by Rs.60, and you have actually made a loss of 1%.

What it means is that if you had spent that Rs.1000 instead of investing it, you would have been able to purchase a larger bundle of goods than was possible with the Rs.1050 you earned a year later. However, this is not a suggestion that you spend your money instead of saving it. This only highlights the fact that your investment decision should account for the expected inflation. The rate which one arrives at after taking inflation into account is known as the real rate of return.

This real rate of return = Rate of expected returns - Rate of expected inflation.

The description above explains why investors follow CPI and WPI reports so closely. In addition to being aware of the current rate of inflation, it is crucial to be aware of the inflation rate which the experts are anticipating. Both the value of current investments and the attractiveness of future investments will change depending on the outlook for inflation.

Hedging against inflation

Although inflation can erode the value of cash investments, such as stocks, bonds and FDs, some people believe that investments in real goods, such as a home, gold are protected from inflation. This is because the value of a real good is determined to a large extent by its intrinsic nature, as opposed to money, which is valued only for what you can trade it for. If inflation is high, the price of a home or gold may simply increase at a similar rate, insulating it from price erosion.

During inflationary times, one should avoid investing in longer-dated debt investments. This is because inflation is usually countered by central banks by raising interest rates. When rates are raised, issuing banks/institutions raise the coupon rates on their offerings. Investors in existing securities witness a fall in their investment value, while fresh investors will get the opportunity to earn a higher coupon rate.

So when it appears that interest rates could rise, invest in short-term deposits/debt funds so as to be sufficiently liquid. This way when interest rates do rise, you will be in a better position to benefit from the situation.

Long on Equity

If you have the appetite for risk, then equities/stocks is a must-have in your investment portfolio if you want to successfully counter inflation. It has been proven time and again how, over the long-term, equities can be an effective foil for inflation.

Sample this - over the last 10 years, the BSE Sensex has appreciated by 14.7 per cent CAGR (compounded annualised growth rate). On the other hand, inflation has averaged about 5.6 per cent CAGR.

In effect, by investing in the BSE Sensex over 10 years you would have outperformed inflation by a significant margin (9.1 per cent CAGR).

Of course, investing in equities is easier said than done. More than the money, it involves 'investing' a lot of time and effort, which is beyond most lay investors.

Help is at hand, for such individuals in the form of equity funds. Investing in equity funds not only saves you time and effort, but also reduces the risk of investing in equities through superior diversification.