

Inflation

What is inflation?

Why is everybody worried about it?

How does it eat into your money?

We all talk about inflation all the time. Let's try and understand this a little more.

Inflation is an economic concept. Inflation means a rise in an index consisting of many goods that have weights attached to them. The index always has a base year. If a particular item has a higher weight and its price rises, it will have a greater effect on the inflation rate. At the end of the day it depends on how much weight a particular item is assigned. Most countries use a consumer price index (CPI) while India has a wholesale price index (WPI).

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 & Communication |
| 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

In short, Inflation is the price increase over a period of time.

Some examples:-

1. A movie ticket was for a few paise in my dad's time. Now it is worth Rs.150.
2. My dad's first salary for the month was Rs.400 and over the years it has now become Rs.95, 000.

This is what inflation is, the price of everything goes up. Because the price goes up, the salaries go up. Thus inflation reduces the value of money over time requiring more money for the same goods. For example 30 years back a cinema ticket cost Rs 3 whereas today it could cost Rs 250.

Hence if one were to save money in the cupboard for many years, the money saved would lose its buying power. The Rs 3 saved in the year 1970 would not even fetch a “paan” at the stall near the movie theatre.

Thus inflation teaches us:

1. Never keep money stagnant (in the safe, in the cupboard etc.)
2. Always invest the money

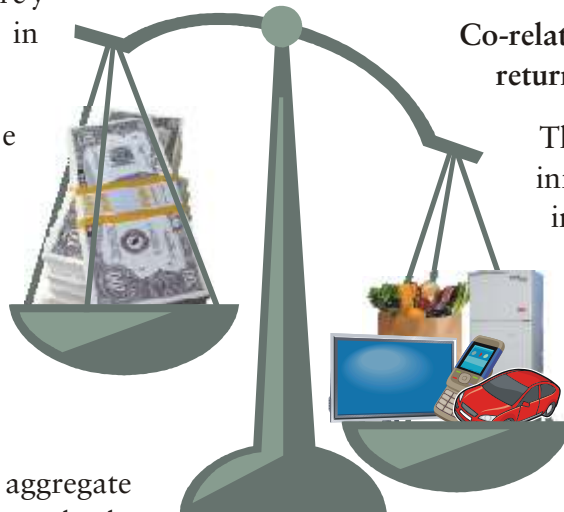
Now that we know how inflation affects us lets see what causes inflation.

Demand-pull inflation:

This is basically when the aggregate demand in an economy exceeds the aggregate supply. It is also defined as 'too much money chasing too few goods'. In other words it means that a country is capable of producing only 100 items but the demand is for 105 items.

Cost-push inflation:

This is caused when there is a supply shock. The best example to describe cost-push inflation is the oil shock in the 1970s. When OPEC was formed, it squeezed the supply of oil and this caused oil prices to rise, contributing to higher inflation. This is similar to what has happened recently when the oil price hike increased inflation in many countries.



Built-in inflation:

It involves workers trying to keep their wages up (gross wages have to increase above the CPI rate to net to CPI after-tax) with prices and then employers passing higher costs on to consumers as higher prices as part of a "vicious circle."

Co-relation between the rate of inflation and rate of return

The rate at which the prices of goods in the inflation basket go up is called the "rate of inflation". For example, if the price of one item was Rs.100 last year and Rs.104 this year then the rate of inflation would be 4%.

In our county India, for the year 2005-2006 the rate of inflation was 4%. This rate keeps changing every year. The finance minister generally gives the official statement on the inflation rate of the country for a particular year.

The rate of return is how much you make on an investment. Suppose you invest Rs.100 in the market and over a year, you make Rs.120, then your rate of return is 20%. This is called the nominal rate of return.

However, if the rate of inflation during this period was 5%, your real rate of return would be 15% (20% - 5%). This is known as the real rate of return.

So, when you make an investment, make sure that your rate of return on the investment is higher than the rate of inflation in your country.