CHAPTER – I

INTRODUCTION AND DESIGN OF THE STUDY

INTRODUCTION

One of the most complicated challenges of our present times is the problem of rising Inflation. Its effect can be felt by each and every person to at least some degree. Inflation makes no partiality in choosing its innocent sufferers. The money does not buy the same amounts of goods and services as before. This is not entirely negative, because inflation allows businesses to offer more employment opportunities. In fact, many economists believe a gradual and stable inflation rate of 2 to 3% per year is a positive factor in maintaining a low unemployment rate, a stable amount of consumer spending, and desirable lending and savings rates. Rapid growth of inflation complicates the economic decision-making process and slows economic growth. In addition, inflation diminishes the value of savings.

Some economists maintain that high rates of inflation and hyperinflation are caused by an excessive growth of the money supply, while others take the view that under the conditions of a liquidity trap, large injections are “pushing on a string” and cannot cause significantly higher inflation. Views on which factors determine low to moderate rates of inflation are more varied. Low or moderate inflation may be attributed to fluctuations in real demand for goods and services, or changes in available supplies such as during scarcities, as well as to changes in the velocity of money supply measures. However, the consensus view is that a long sustained period of inflation is caused by money supply growing faster than the rate of economic growth.
Today, most economists favor a low and steady rate of inflation. Low (as opposed to zero or negative) inflation reduces the severity of economic recessions by enabling the labor market to adjust more quickly in a downturn, and reduces the risk that a liquidity trap prevents monetary policy from stabilizing the economy. The task of keeping the rate of inflation low and stable is usually given to monetary authorities. Generally, these monetary authorities are the central banks that control monetary policy through the setting of interest rates, through open market operations, and through the setting of banking reserve requirements.

The prices of commodities fluctuate, responding to the pulls and pushes of demand and supply. A failure of a particular crop or trend for a certain kind of clothing can cause the price of that crop and the cost of that kind of clothing to rise, just as an unexpected surplus in the production of onions will cause the price of onions to fall.

Inflation, on the other hand, has little to do with these changes in relative prices of goods and services. It refers, instead, to a significant rise in the general price level in a country over a long period of time. It is the opposite of price stability. In economics, price stability is not used in a rigid sense to mean price fixity. A modest increase of 2 to 3 per cent per annum in the price level is a compatible, sometimes even desirable, in the context of economic development. However, when the general price rise appreciates (say in double-digit figure) and experienced over a long period of time, it gets the dreaded name inflation. For the common person, there is something threatening about the phenomenon

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of inflation, especially on those occasions when the rise in prices of goods is not matched by an equivalent increase in the prices of labour\(^3\).

Then what should be the tolerable limit of price rise. There is no clear-cut answer to this question because it all depends upon the economic circumstances prevailing in a country at a particular time. The Indian Committee to Review the Working of the Monetary System (S. Chakravarty Committee) recommended, as a general guideline, an increase in price of not more than 4 per cent\(^4\). Rangarajan regarded 6 per cent of inflation to be the outer limit. Tarapore Committee recommended 3 per cent level of inflation rate. Thus the acceptable range of inflation rate in India lies between 3-7 per cent\(^5\).

**Factors for rising prices\(^6\):** In general, the following factors are attributed to rise in prices:

1. Area and production, which is dependent on weather and technology.
2. Minimum Support Price
3. Government policies
4. Substitute product
5. Demand/consumption
6. Seasonal Cycles
7. International prices

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\(^3\) Occasional Paper by Kaushik Basu, *op.cit.*

\(^4\) Indian Economy – A Performance Review, *op.cit.*, p. 88

\(^5\) Inflationary Trends in India by Aparna Bhardwaj and Rajesh Kumar, 2011, pp. xvi-xvii

Effects of Inflation

The distortionary effects of inflation are injurious to the smooth functioning of an economy:

1. Rising prices adversely affect the economic conditions of fixed-income groups, particularly wage earners. When prices are high, the value of money is low and vice versa. There is always a lag between price rise and money wage adjustment. Poor people in the unorganised sector are hit the worst because their incomes are not linked with price index. However, business firms gain during price rise because the money value of goods in their stock rises continually.

2. Inflation encourages hoarding of essential commodities, leading to speculation and generation of black money.

3. Fluctuating prices generate opposite effects on debtors and creditors. Rising prices prove beneficial for debtors at the expense of creditors. Thus, inflation discouarge people to invest in financial assets. Conversely, falling prices make it difficult for debtors to meet their obligations\(^7\).

4. Price stability is a prime concern of the governments the world over.

Measurement of Inflation

Changes in the level of prices are measured by means of index numbers. The index of prices includes a wide variety of goods and services which are essential for life\(^8\). In India here are five indices for measuring changes in the price level. Four of these are the Consumer Price Indices (CPIs), which are specific to a group, or class of

\(^7\) Indian Economy – A Performance Review, *op.cit*, pp. 89-90

\(^8\) *Ibid*, p. 88
consumers and the one Wholesale Price Index (WPI), which has an economy wide coverage and a higher frequency.

The current series of WPI at base 2004-05 constitutes 676 commodities. There are three consumer price indices (CPIs) traditionally released at the national level to reflect the fluctuations in retail prices of goods and services pertaining to specific segments of population in the country. The basket of CPI for Industrial Workers (CPI-IW) based on 2001 included 120-360 items, CPI for Agriculture Labourers (CPI-AL) and CPI for Rural Labourers (CPI-RL) both with base year 1986-87 included 260 items. In addition, there is now the new series of CPI-(U+R) based on the year 2010 for both rural and urban areas and also combined has been introduced from January 2011 and includes 456 items\(^9\).

According to the International Monetary Fund (IMF) statistics, 24 countries use WPI as the official measure to track inflation, whereas 157 countries use CPI for the same purpose.

WPI is considered as most preferred measure of inflation in India due to its wider coverage, scope and frequency. WPI is compiled and released by Department of Industrial Policy and Promotion on monthly basis and weekly basis for primary articles\(^10\).

**SIGNIFICANCE OF THE STUDY**

The study analyses the WPI and CPI methods of inflation calculations in India and the fluctuation in inflation Rate.

\(^9\) Lok Sabha Starred Question No. 347 dated 26.08.2011
\(^10\) Rajya Sabha Starred Question No. 25 dated 2.08.2011
In economics, inflation is a rise in the general level of prices of goods and services in an economy over a period of time. When the general price level rises, each unit of currency buys fewer goods and services. Consequently, inflation reflects a reduction in the purchasing power per unit of money – a loss of real value in the medium of exchange and unit of account within the economy. A chief measure of price inflation is the inflation rate, the annualized percentage change in a general price index (normally the consumer price index) over time.

This study covers the aspects of the calculation of inflation rate based on WPI and CPI from 2010 to 2014. It highlights the effect of the calculation of inflation rate on agriculture labor, industrial labor and also rural labor. The analysis of this study helps to understand a suitable methodology of calculating inflation rate in various contexts. An analysis of price moment by commodity groups and their contribution inflations is also made considering the WPI and CPI.

Inflation is the periodical (Usually one year) increase in prices of goods (Food items, consumer durables and whatnot) and services (Airlines, IT, Telecom and whatnot) in an economy. Simply speaking, the WPI inflation talks about prices of various products in the wholesale market. On the other hand, the CPI inflation talks about prices of products in the retail market. A layman would think that CPI is obviously closer to the reality - because that's the inflation which the real consumer has to actually face in the market. That layman wouldn't be wrong.

But there is a reason why WPI was actually preferred over CPI. The thing about WPI is that it gives a more accurate feedback, and it
gives a more **quick feedback**. There you have it - accuracy and quickness.

This is because it does not take much time for price changes to pass on to the wholesale market. However, it takes time for those effects to trickle down to the retail market. As a result, retail market will reflect those changes over a longer period of time, as a result of which CPI wouldn't be as reliable. Today, most of the countries for CPI as considered as the best method of exhibiting the real inflation of the exonomy.

**STATEMENT OF THE PROBLEM**

Rising inflation was the most recent ticklish political issue that hit the government. There is Inflation due to rising of price in essential commodities and also the method we follow in calculating the Inflation. Some economists state that India's method of calculating inflation is to be reviewed. Although Government announces that there is reduction in Inflation Rate the corresponding effect on the price of the commodity is not realized by the citizens. The very dangerous economical setback in the Indian economy is inflation which hinders economical power of the people. Most of the people are still suffering due to inflation in India. Government and economists should generate better policies for the development of nation. The above observation stimulates the researcher to do the research. Therefore an attempt is made to undertake "**An analytical study on the effect of computation of inflation rate based on WPI and CPI in India**".
OBJECTIVES OF THE STUDY

1. To find the level of fluctuations in the inflation rate computed based on WPI over previous years.
2. To know the level of fluctuation in the inflation rate computed based on CPI.
3. To evaluate the deviation or fluctuation in inflation rate by comparing WPI and CPI over previous year.
4. To analysis the effect of computation of inflation rate based on WPI and CPI on the economy of the country.
5. To offer suggestions for the improved methodologies for the calculation of Inflation Rate.

HYPOTHESES OF THE STUDY

1. There is no significant relationship between inflation rate based on WPI and CPI in relation to industrial Worker.
2. There is no significant relationship between inflation rate based on WPI and CPI in relation to Agricultural Labour.
3. There is no significant relationship between inflation rate based on WPI and CPI in relation to Rural Labour.
4. Control measure of RBI on inflation has no direct bearing when inflation is calculated under WPI.
5. Control measure of RBI on inflation has no direct bearing when inflation is calculated on the CPI in relation to Industrial Workers.
6. Control measure of RBI on inflation has direct bearing when inflation is calculated on the CPI in relation to Agriculture labours.
7. Control measure of RBI on inflation has no direct bearing when inflation is calculated on the CPI under Rural labours.

**METHODOLOGY OF THE STUDY**

The present study is purely based on secondary data collected from the various source such as research study, survey report, RBI bulletin, Records of Labour bureau of Government of India and Ministry of statistics, various financial reports, magazines, daily newspapers, journals, RBI financial reports and from RBI authorized website and books, with the help of inquiring schedule. A process of cross checking was highly established to ensure the authenticity and reliability of data. The nature of the present study is analytical, deals with the assessment and analyses of inflation in India from 2010 to 2014.

**STATISTICAL TOOLS USED FOR ANALYSES OF DATA**

Trend percentage Analysis, Karl Person correlation and Two Way ANOVA test were the statistical tools applied for analysis and interpretation of data.

**SCOPE OF THE STUDY**

The deviation or fluctuation in inflation rate by comparing WPI and CPI give the variants. Historically the retail and wholesale price measures tended to move broadly in a similar fashion, barring short horizons where the divergence was wide. Of late, however, there has been considerable divergence in inflation rates between the CPIs and WPI, leading to heated debates on factors driving the divergence and their policy implications. In this context, this research study attempts to have a detailed analysis on the CPIs and WPI in India particularly on
the method of compilation, distributional properties and measures of underlying inflation.

The present study also examines the effect of computation of inflation rate based on WPI and CPI in India and WPI Inflation Trend, CPI Inflation Trend, deviation between WPI and CPI Inflation and RBI credit control Measures on inflation are revealed clearly. The control measures of inflation in WPI, CPI and RBI Credit control trends in India and variants of WPI are analytically evaluated.

LIMITATIONS OF THE STUDY:

1. The result of the analysis of this study can not substantiated beyond India.
2. The study is restricted to the period from 2010 to 2014.

CHAPTER SCHEME

The research report is divided into five chapters as described below.

Chapter – I: INTRODUCTION AND DESIGN OF THE STUDY

The first chapter presents the introduction, signification of the study, statement of the problem, objectives, hypotheses, methodology, Scope, limitations of the study and organization of the thesis.

Chapter – II: CONCEPTS AND REVIEW OF LITERATURE

The Second chapter deals with the concepts and review of literature related to inflation, methods of inflation calculation in India and other countries are outlined.
Chapter – III: WPI, CPI AND RBI CREDIT CONTROL MEASURES TRENDS IN INDIA

WPI, CPI and RBI Credit control trends in India are reveals and Analysis in this chapter. Variants of WPI are analytically evaluated.

Chapter – IV: ANALYSIS AND INTERPRETATION OF INFLATION TREND UNDER WPI AND CPI

WPI Inflation Trend, CPI Inflation Trend, deviation between WPI and CPI Inflation and RBI credit control Measures on inflation are reveals clearly.

Chapter – V: SUMMARY OF THE FINDINGS, RECOMMENDATIONS AND CONCLUSION.

Summary of Findings, Suggestion and Conclusion are presented in this chapter.

The next chapter deals with the concepts and review of related literature.