Syllabus subtopic: Indian Economy and issues relating to Planning, Mobilization of Resources, Growth, Development and Employment.

Prelims and Mains focus: about CPI and its significance; about inflation targeting

News: The RBI governor has stressed the need to review the monetary policy framework. An inflation targeting framework is effective when the measure of inflation is accurate. But there are concerns about CPI’s composition.

What is CPI and how is it computed?

- The consumer price index (CPI) measures the changes in the prices of goods and services that are consumed by households. The rural CPI index is based on the consumption basket of rural India, while urban CPI focuses on the urban basket of consumption.

- The index is a monthly series, which measures inflation in the form of a change compared to the same month in the previous year.

- A simplistic understanding of the computation of CPI would be to consider it as a weighted average of the goods and services that the consumers in a country purchase. The weights are adjusted with changes in consumption patterns.

How are these weights for CPI derived?

- In India, the National Statistical Office conducts the Consumption Expenditure Survey (CES) that helps us understand the consumption basket of various consumers.

- Suppose a consumer spends Rs.10 out of Rs.100 on food, then the share of food in his consumption is 10%. CES gives us these shares for the overall economy. The government has not released the 2017 CES because of...
inconsistencies. Therefore, the weights of the CPI series would not be adjusted using this survey.

- Our current CPI weights are based on the 2011-12 survey and will be updated once we have a new and reliable consumption survey.

Why is it important to update CPI weights?

As our consumption pattern shifts, a CPI based on old weights is likely to underestimate or overestimate inflation. For example, the share of expenditure on transistors, which have become obsolete, has gone down. If prices of transistors increase, old shares would give a higher inflation rate than what consumers experience.

How will this impact inflation targeting?

An inflation targeting regime is as good as the quality of inflation statistics. This is important as several other inflation indicators seem to be below 4%, even as food inflation rose, driven by onion prices. As such, we may be overestimating inflation, but there have been times when we have underestimated it. Recently, some authors argued the need to move to a broader measure of inflation target that could combine the GDP deflator, wholesale price index and CPI to avoid overdependence on a single indicator.

How do we get a right estimate of inflation?

The share of consumption expenditure has changed between the 2011 and 2017 National Accounts Statistics (NAS), with a decline in the share of expenditure on food. The official CPI series could be more sensitive to food inflation. Given that the quality and reliability of the survey data have been questioned over the years, moving towards a CPI derived from the private final consumption data from NAS must be considered.