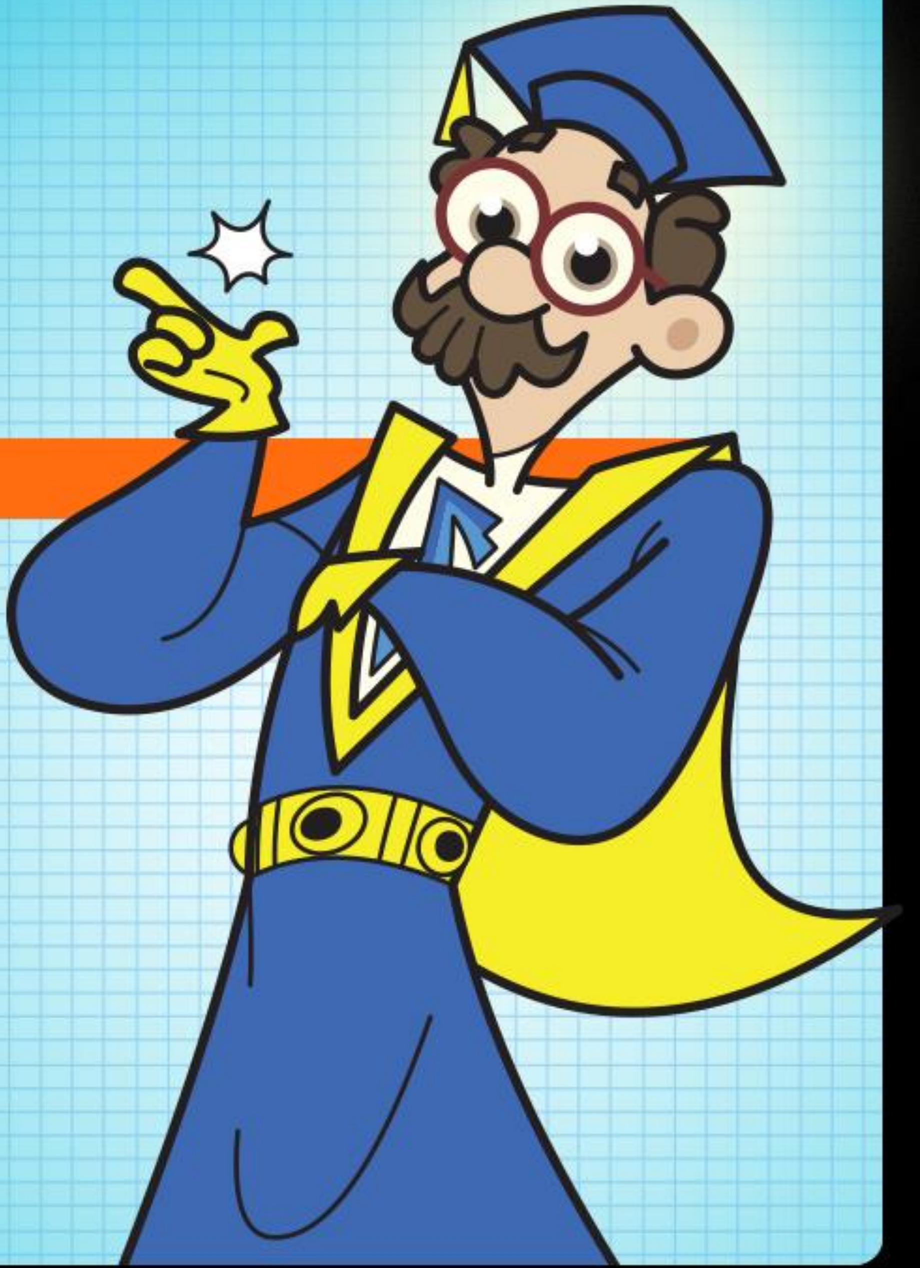
BASE EFFECT



Understanding the concept of

Base Effect

– By Prof. *Simply* Simple™

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BASE EFFECT

The annual Wholesale Price Index-based inflation rate fell in the first week of June, the first time in well over three decades, mainly on account of a statistical base effect.

So what is this base effect?

To understand base effect, we need to revisit Inflation to understand its implication.

BASE EFFECT

- Inflation is the ‘rate of change’ of prices.
- If for a certain week, the inflation figure is at 12%, it means the price index is 12% higher as compared to the corresponding week in the previous year.

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BASE EFFECT

Here's an example…

- **To explain base-effect:**

  Week 30 2008 - index was at 100 (100 is just an example).

- **Week 31 2008 - index was at 98.**

  Week 30 2009 - index is at 112.

  Thus, inflation is 12% (denoting a 12% increase in prices).

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BASE EFFECT

Now

- Week 31 2009 - index continues to be at 112.

  So as compared to the base exactly one year ago (week 31 2008) inflation would be at 14.29% [(112 -98)/98]*100

  Now though the index continued to be the same as what it was in week 30 of 2009, the inflation went up as the corresponding base was lower in the previous year.

  So even if the prices of the goods that represent the index did not change as compared with the previous week (i.e. week 31- 2009 over week 30-2009), the inflation figure changed due to the effect of the previous year.
- This is the base-effect for inflation.

BASE EFFECT

Which means..

- **Every reported inflation number is with reference to the inflation number that existed exactly one year back re-based to 100**

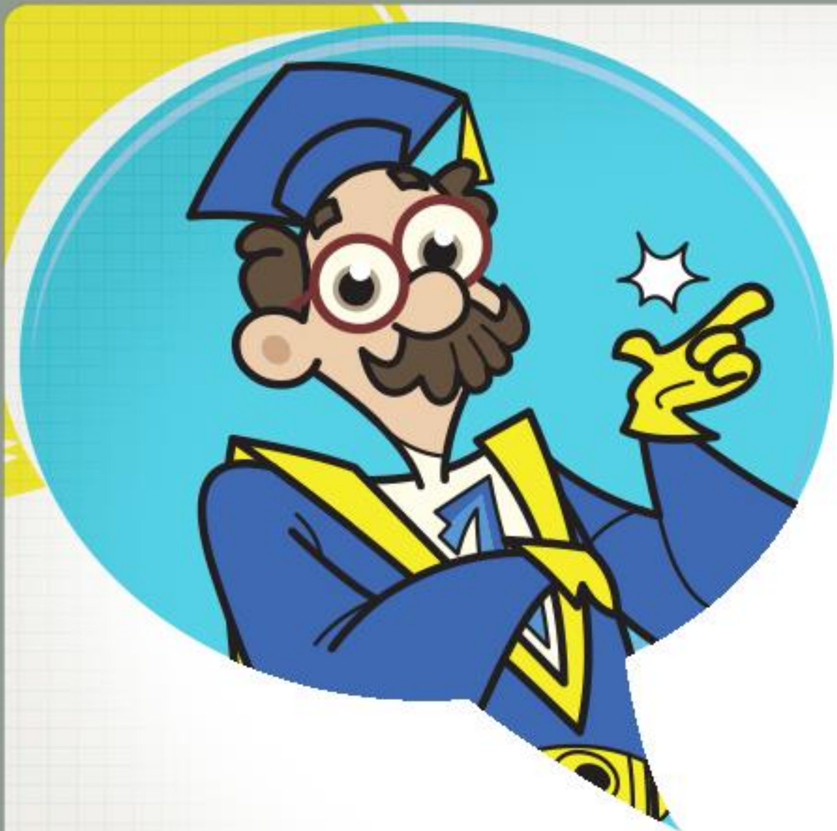
- **To make it more simple, if we say inflation is 5%, it means that if the price of goods comprising the inflation basket was 100 exactly a year back, it is 105 today.**

BASE EFFECT

To sum up

- The base effect relates to inflation in the corresponding period of the previous year:
- Thus if the inflation rate was too low in the corresponding period of the previous year, even a smaller rise in the Price Index will arithmetically give a high rate of inflation now.
- On the other hand, if the inflation rate was too high in the corresponding period of the previous year a large price rise might land up presenting itself as minor rise in inflation due to the base effect.
- Thus the term ‘base effect’ has a lot of impact while ascertaining inflation numbers and can sometimes appear to misrepresent ground realities because it is dependant on a number that existed one year back.

BASE EFFECT



Hope you have now understood the concept of Base Effect

Thinking of Investment

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