INFLATION

What is Inflation?

1) Inflation refers to a continuous rise in general price level which reduces the value of money or purchasing power over a period of time.

2) Statistically speaking, inflation is measured in terms of a percentage rise in the price index (i.e. percentage rate per unit time) usually for an annum (a year) or for 30-31 days (a month).

Definition of Inflation

According to **Crowther**, "Inflation is a state in which the value of money is failing i.e. the prices are rising." According to **Coulbourn**, "Inflation is too much of money chasing too few goods."

Features of Inflation

The characteristics or features of inflation are as follows :-

1. Inflation involves a process of the persistent rise in prices. It involves rising trend in price level.
2. Inflation is a state of disequilibrium.
3. Inflation is scarcity oriented.
4. Inflation is dynamic in nature.
5. Inflationary price rise is persistent and irreversible.
6. Inflation is caused by excess demand in relation to supply of all types of goods and services.
7. Inflation is a purely monetary phenomenon.
8. Inflation is a post full employment phenomenon.
9. Inflation is a long-term process.

Types of Inflation on Rising Prices

Types of inflation on the basis of rising prices or rate of inflation:-

1. **Creeping Inflation** : When prices are gently rising, it is referred as Creeping Inflation. It is the mildest form of inflation and also known as a **Mild** Inflation or **Low** Inflation. According to **R.P. Kent**, when prices rise by not more than (upto) 3% per annum (year), it is called Creeping Inflation.
2. **Chronic Inflation** : If creeping inflation persist (continues to increase) for a longer period of time then it is often called as Chronic or **Secular** Inflation. Chronic Creeping Inflation can be either Continuous (which remains consistent without any downward

movement) or Intermittent (which occurs at regular intervals). It is called chronic because if an inflation rate continues to grow for a longer period without any downturn, then it possibly leads to Hyperinflation.

3. **Walking Inflation** : When the rate of rising prices is more than the Creeping Inflation, it is known as Walking Inflation. When prices rise by more than 3% but less than 10% per annum (i.e between 3% and 10% per annum), it is called as Walking Inflation. According to some economists, walking inflation must be taken seriously as it gives a cautionary signal for the occurrence of Running inflation. Furthermore, if walking inflation is not checked in due time it can eventually result in Galloping inflation.

4. **Moderate Inflation** : Prof. Samuelson clubbed together concept of Crepping and Walking inflation into Moderate Inflation. When prices rise by less than 10% per annum (single digit inflation rate), it is known as Moderate Inflation. According to Prof. **Samuelson**, it is a stable inflation and not a serious economic problem.

5. **Running Inflation** : A rapid acceleration in the rate of rising prices is referred as Running Inflation. When prices rise by more than 10% per annum, running inflation occurs. Though economists have not suggested a fixed range for measuring running inflation, we may consider price rise between 10% to 20% per annum (double digit inflation rate) as a running inflation.

6. **Galloping Inflation** : According to Prof. Samuelson, if prices rise by double or triple digit inflation rates like 30% or 400% or 999% per annum, then the situation can be termed as Galloping Inflation. When prices rise by more than 20% but less than 1000% per annum (i.e. between 20% to 1000% per annum), galloping inflation occurs. It is also referred as **Jumping** inflation. India has been witnessing galloping inflation since the second five year plan period.

7. **Hyperinflation** : Hyperinflation refers to a situation where the prices rise at an alarming high rate. The prices rise so fast that it becomes very difficult to measure its magnitude. However, in quantitative terms, when prices rise above 1000% per annum (quadruple or four digit inflation rate), it is termed as Hyperinflation. During a worst case scenario of hyperinflation, value of national currency (money) of an affected country reduces almost to zero. Paper money becomes worthless and people start trading either in gold and silver or sometimes even use the old barter system of commerce. Two worst examples of hyperinflation recorded in world history are of those experienced by **Hungary** in year 1946 and **Zimbabwe** during 2004-2009 under **Robert Mugabe**'s regime.

Types of Inflation on Expectation

Types of inflation on the basis of expectation or predictability:-

1. **Anticipated Inflation** : If the rate of inflation corresponds to what the majority of people are expecting or predicting, then is called Anticipated Inflation. It is also referred as **Expected** Inflation.

2. **Unanticipated Inflation** : If the rate of inflation corresponds to what the majority of people are not expecting or predicting, then is called Unanticipated Inflation. It is also referred as **Unexpected** Inflation.

Causes & Types of Inflation

Main Causes of Inflation

1) Cost Push Inflation

Cost-push inflation occurs when businesses respond to rising **production costs**, by raising prices in order to maintain their profit margins. Higher costs shift a firms supply curve upwards and lead to an increase in price. There are many reasons why costs might rise:

- **Rising imported raw materials costs** perhaps caused by inflation in countries that are heavily dependent on exports of these commodities or alternative by a fall in the value of the Rs in the foreign exchange markets which increases the price of imported inputs
- **Rising labour costs** - caused by wage increases which exceed any improvement in productivity. This cause is important in those industries, which are labour-intensive. If labour costs amount for example to 25% of a firms total costs then a 10% increase in the total wage bill will cause the firms total costs to rise by 2.5%.
- **Higher indirect taxes imposed by the government** for example a rise in the specific duty on alcohol and cigarettes, an increase in fuel duties or perhaps a rise in the standard rate of Value Added Tax or an extension to the range of products to which VAT is applied. These taxes are levied on producers who, depending on the price elasticity of demand and supply for their products can opt to pass on the burden of the tax onto consumers. For example, if the government was to choose to levy a new tax on aviation fuel, then this would contribute to a rise in cost-push inflation.

2) Demand Pull Inflation

Demand-pull inflation is likely when there is full employment of resources and short run aggregate supply is inelastic. In these circumstances an increase in AD will lead to a general increase in prices. AD might rise for a number of reasons some of which occur together at the same moment of the economic cycle

 A depreciation of the exchange rate, which increases the price of imports and reduces the foreign price of UK exports. If consumers buy fewer imports, while foreigners buy more exports, Aggregate demand will rise. If the economy is already at full employment, prices are pulled upwards.

 A reduction in direct or indirect taxation. If direct taxes are reduced consumers have more disposable income causing demand to rise. A reduction in indirect taxes will mean that a given amount of income will now buy a greater real volume of goods and services. Both factors can take aggregate demand and real GDP higher and beyond potential GDP.

 The rapid growth of the money supply perhaps as a consequence of increased bank and building society borrowing if interest rates are low and consumer confidence is high. Monetarist economists believe that the root causes of inflation are monetary in particular when the monetary authorities permit an excessive growth of the supply of money in circulation beyond that needed to finance the volume of transactions produced in the economy.

 Rising consumer confidence and an increase in the rate of growth of house prices both of which would lead to an increase in total household demand for goods and services

 Faster economic growth in other countries providing a boost to Kenya exports overseas. Remember that export sales provide an extra flow of income and spending into the Kenya circular flow. Exports are counted as an injection of AD.

<u>Effects of Inflation</u>

1. **Impact of Inflation on Savers:** When inflation is high, people may lose confidence in money as the real value of savings is severely reduced. Savers will lose out if interest rates are lower than inflation – leading to negative real interest rates.

2. **Inflation Expectations and Wage Demands:** Price increases lead to higher **wage demands** as people try to maintain their real living standards. This process is known as a 'wage-price spiral'.

3. **Arbitrary Re-Distributions of Income:** Inflation tends to hurt people in jobs with **poor bargaining positions** in the labour market - for example people in low paid jobs with little or no trade union protection may see the real value of their pay fall. Inflation can also favour borrowers at the expense of savers as inflation erodes the real value of existing debts.

4. **Business Planning and Investment:** Inflation can disrupt business planning. Budgeting becomes difficult because of the uncertainty created by rising inflation of both prices and costs - and this may reduce planned investment spending.

5. **Competitiveness and Unemployment:** Inflation is a possible cause of higher unemployment in the medium term if one country experiences a much higher rate of inflation than another, leading to a **loss of international competitiveness** and a subsequent worsening of their trade performance.

Benefits of inflation

1. **Higher revenues and profits**: A low stable rate of inflation of say between 1% and 3% allows businesses to raise their prices, revenues and profits, whilst at the same time workers can expect to see an increase in their pay packers. This can give psychological boost and might lead to rising investment and productivity.

2. **Tax revenues**: The government gains from inflation through what is called '**fiscal drag effects'**. For example many indirect taxes are ad valorem in nature, e.g. VAT at 20% - so as prices rise, so does the amount of tax revenue flowing into the Treasury.

3. **Cutting the real value of debt**: Low stable inflation is also a way of helping to reduce the real value of outstanding debts – there are many home owners with huge mortgages who might benefit from a period of inflation to bring down the real burden of their mortgage loans. The government too might welcome a period of higher inflation given the huge level of public sector debt!

4. **Avoiding deflation**: Perhaps one of the key benefits of positive inflation is that an economy can manage to avoid some of the dangers of a deflationary recession

Measures to control Inflation

The various methods to control inflation are given below however the most common ones are Monetary and Fiscal Policies:

1. Monetary Policy With growth of 3.8%, demand in the economy could be growing faster than capacity can grow to meet it. This leads to inflationary pressures. We can term this demand pull inflation. Therefore, reducing the growth of Aggregate demand, should reduce inflationary pressures.

Monetary policy is the policy of the central bank of the country, which is the supreme monetary and banking authority in a country. The central bank may use such methods as the bank rate, open market operations, the reserve ratio and selective controls in order to control the credit creation operation of commercial banks and thus restrict the amounts of bank deposits in the country. This is known as tight money policy. Monetary policy to control inflation is based on the assumption that a rise in prices is due to a larger demand for goods and services, which is the direct result of expansion of bank credit. To the extent this is true, the central bank's policy will be successful. Monetary policy may not be effective in controlling inflation, if inflation is due to cost-push factors. Monetary policy can only be helpful in controlling inflation due to demand-pull factors. Let us see how increasing the rate can help control inflation A higher interest rate should also lead to higher exchange rate, which helps to reduce inflationary pressure by

- Making imports cheaper.
- Reducing demand for exports and
- Increasing incentive for exporters to cut costs.

NB//Read more on monetary policy

2. Fiscal Policy It is the policy of a government with regard to taxation, expenditure and public borrowing. It has a very important influence on business and economic activity.

Taxes determine the size or the volume of disposable income in the hands of the public. The proper tax policy to control inflation will avoid tax cuts, introduce new taxes and raise the rates of existing taxes. The purpose being to reduce the volume of purchasing power in the hands of the public and thus reduces their demand. A precisely similar effect will be achieved if voluntary or compulsory savings are increased.

Savings will reduce current demand for goods and thus reduce the inflationary rise in prices. As an anti-inflationary measure, government expenditure should be reduced. This indicates that demand for goods and services will be further reduced. This policy of increasing public revenue through taxation and decreasing public expenditure is known as surplus budgeting. However, there is one important difficulty is this policy. It may be easy to increase revenue in times of inflation when people have more money income, but difficult to reduce public expenditure.

During war times as well as during a period of development, it is absolutely impossible to reduce the planned expenditure. If the government has already taken up a scheme or a group of schemes, it is ruinous to give them up in the middle. Therefore, public expenditure cannot be used as an anti-inflationary measure. Lastly, public debt, i.e., the debt of the government may be managed in such a way that the supply of money in the country may be controlled. The government should avoid paying back any of its previous loans during inflation so as to prevent an increase in the circulation of money. Moreover, if the government manages to get a surplus budget, it should be used to cancel public debt held by the central bank. The result will be anti-inflationary since money taken from the public and commercial banks is being cancelled out and is removed from circulation. But the problem is how to get a budget surplus, which is extremely difficult.

3. Price Control and Rationing This is the most important and effective method available during war and other critical times particularly because both monetary and fiscal policies are more or less useless during this period.

Price control implies the establishment to legal upper limits beyond which prices of particular goods should not rise. The purpose of rationing, on the other hand, is to distribute the goods in short supply in an equitable manner among all people, irrespective of their wealth and social status.

Price control and rationing generally go together. The chief objection behind use of this method to fight inflation is that they restrict the freedom of the consumers and thus limit their welfare. Besides, its success depends on administrative efficiency, which in many underdeveloped countries is very low.