UNIT 4 INFLATION

NOTES

Structure

4.0 INTRODUCTION

According to the public understanding, inflation means a condition which produces a rising trend in the general price level in the economy. Inflation may, however, be present in the economy if the sustained price rise, which would have otherwise occurred, is prevented from occurring by imposing the price and physical controls in the economy. Such a situation is called 'suppressed inflation'. Inflation is not amenable to any one definition.

According to the Chambers' Twentieth Century Dictionary, inflation is an 'undue increase in quantity of money in proportion to buying power, as on an excessive issue of fiduciary money.' Gardner Ackley has defined inflation 'as a persistent and appreciable rise in the general level or average of prices.' According to this definition, a sporadic price spurt or an imperceptible rise in prices will not be inflation. Elaborating further, Ackley has stated: 'We define inflation as rising prices, not as 'high' prices. In some sense, then inflation is a disequilibrium state; it must be analysed dynamically rather than with the tools of statics.' According to Crowther, 'inflation is a state in which the value of money is falling, i.e., prices are rising.' According to Pigou, inflation exists 'when money income is expanding relatively to the output of work done by the productive agents for which it is the payment.' In general, inflation may, therefore, be defined as a sustained rise in the general price level brought about by high rates of expansion in the aggregate money supply although in the contemporary discussions on inflation it is defined as a sustained rise in the general price level, howsoever generated. All these definitions have a common feature of stressing the point that inflation is a process of rising prices and not a state of high prices, showing a state of disequilibrium between the aggregate supply and the aggregate demand at the existing or current prices necessitating a rise in the general price level in the economy.

In this unit, you will learn about the concept of inflation, its causes and effects. This unit will also discus the measures used for controlling inflation.

4.1 UNIT OBJECTIVES

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After going through this unit, you will be able to:

- Define the concept of inflation and its various forms
- Identify the various causes of inflation
- List the effects of inflation on various classes
- Explain the measures for controlling inflation

4.2 CAUSES OF INFLATION

Inflation is a persistent rise in the general price level rather than a once-for-all rise in it. It should be noted that most economists all around the world have assumed that price stability is the main objective of economic policies.

The value of money can be divided into four parts, which are as follows:

- Inflation
- Deflation
- Reflation
- Disinflation

Forms of Inflation

In economic life there are several forms of inflation. Some of them are as follows:

- **Production inflation:** Sometimes the production of goods and services decrease, that time the disequilibrium between the demand and the supply exist. At the time of lower level of production, the demand exceeds the supply; this situation is known as inflation. Production inflation can also exist when the production is fixed and the money income of the consumers increases.
- **Currency inflation:** As it is clear from the name, the inflation due to increase in the currency is known as currency inflation. When the government or the central bank of a country increases the money supply in a high volume, it will increase the general price level. This inflation is known as currency inflation. Normally, in the case of war or in some economic difficulties, central bank increases the money supply in a high volume.
- **Credit money:** The total money stock of a country is the sum of high power money (money supply by the central bank), and the credit creation by the commercial banks. In today's world, credit money has a significant value in the monetary system.

Inflation on the basis of motion

On the basis of motion, inflation can be divided into four parts:

- **Creeping inflation:** When there is a slow increase in the general price level due to inflation, then it is known as creeping inflation. The rate of increase in this inflation is not more than 2 per cent in a year. According to Keynes, it is a must for the development of an economy.

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- **Walking inflation**: When the government and other monetary authorities are not able to control the creeping inflation, it takes the form of walking inflation. The rate of increase in the inflation is more in walking inflation, in comparison with creeping inflation. It affects the people adversely. According to Keynes, this is the form of real inflation.
- **Running inflation:** In running inflation, the rate of increase in the inflation increases at a higher rate. It affects the fixed income group adversely.
- **Galloping inflation:** It is the worst form of inflation, which is possible in any country after the failure of central bank, and other monetary authorities. In this situation, the increase in price affects people very badly and the prices became uncontrollable. According to Keynes, 'this condition of inflation is possible only after the point of full employment.'

Inflationary and Deflationary Gap

It should be noted that equilibrium cannot be on the full employment level. It should be considered that the equilibrium level may involve much unemployment and waste of natural resources. It means that the only level of equilibrium that can be considered desirable is that which provides the near full employment.

Inflationary Gap

The concept of inflationary gap has been propounded by Keynes. According to Keynes, inflationary gap arises when consumption and investment spending together are greater than the full employment gross national product level.

In other words, it is a gap between money incomes of the community and the available supply of output of goods and services. In this situation, more goods will be demanded than the economic system can produce. The result will be that the prices will begin to rise and an inflationary situation will emerge.

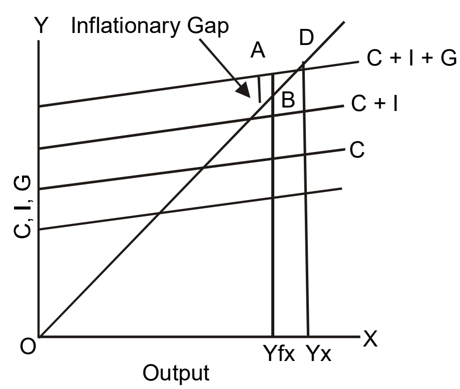

Fig. 4.1 *Inflationary Gap*

In Figure 4.1, the inflationary gap has been shown. C, I, G stand for the consumption, Investment and the Government Expenditure. (C+I+G), shows the total expenditure on demand in the economy. At this level Yx is the total real output. Yfx shows a full employment limit on real output Yfx. Real income of the economy cannot reach Yx, so the total demand (C+I+G), exceeds total output, leaving a gap AB, which is known as inflationary gap.

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Deflationary Gap

Similarly, you can show the deflationary gap with the help of a graph. This would come into existence, if total aggregate demand is insufficient to create the full employment. Yx is the total output at full employment. Let us assume that the total demand is (C+I+G)' which cuts the 45° line at B, with real output Y'x. AB is the deflationary gap.

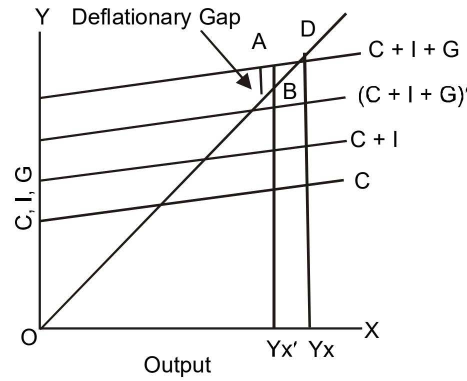

Fig. 4.2 Deflationary Gap

In figure 4.2, the deflationary gap has been shown. The output has been assumed on X axis, on the other hand consumption, investment and the government expenditure have been shown on the Y axis. The deflationary gap has been shown in the graph as AB.

Demand Pull Inflation

This represents the situation where the basic factor at work is the increase in the aggregate demand for output either from the government or the entrepreneur or the households. The result is that the pressure of demand is such that it cannot be met by the currently supply of output.

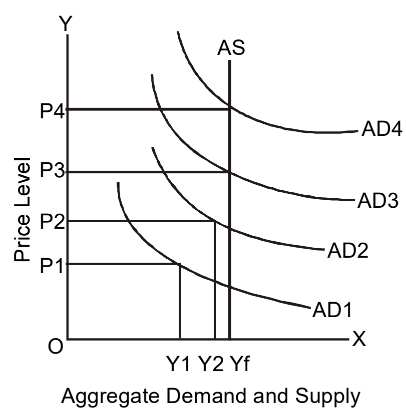

Fig. 4.3 Demand Pull Inflation

It should be noted that Keynes has propounded the concept of demand pull inflation in his booklet, *How to Pay for war*, and it is surprising that it was published during the Second World War. In this theory, Keynes has explained the inflation in terms of excess demand for goods to the aggregate supply of their output.

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In Figure 4.3, you have assumed the aggregate demand and aggregate supply on the X axis; on the other hand you have assumed the price level on the Y axis. Aggregate supply curve is upward in the beginning but became vertical after the full employment level. According to the figure when it intersects the AD3, it becomes vertical, because after the full employment, the supply of output cannot be increased.

When the aggregate demand was AD1, the equilibrium is at the level less than full employment and the price decided is P1. When the aggregate demand increased from AD1 to AD2, the price level also increased from P1 to P2. it should be noticed in this case the aggregate output supplied also increased from OY1 to OY2. If the aggregate demand further increased to AD3, the price level rises to P3, and the output increased to OYf.

If the aggregate demand further increases, say to AD4, only price level rises to OP4 , and the output remains constant at Yf. OYf is the full employment level of output and aggregate supply curve is perfectly inelastic at Yf.

Factors that Increase or Decrease Aggregate Demand

Aggregate demand can increase or decrease depending on several factors. These factors cause upward or downward shifts in the aggregate demand curve. These are as follows:

Exchange Rates: When the exchange rate increases, this results in a decrease in net exports. Thus, aggregate expenditure will go down at all prices, that is, aggregate demand will decrease.

Distribution of Income: When the real wages of people increase, they have more money to spend and consume. This results in an increase in the consumption expenditures to increase.

Expectations: Consumers adjust their spending in accordance with their expectations of the economy. If they expect the economy to not do so well in the future, savings would increase thus overall expenditures will decrease. Rising price levels will cause aggregate demand to increase. If consumers foresee the price level to rise in the near future, they might just go out and buy that good now, increasing the consumption expenditures in aggregate demand.

Monetary and Fiscal Policies: Government policies have an effect on aggregate demand. Government spending or increase in taxes influence how consumers spend or save. An expansionary fiscal policy of the government causes aggregate demand to increase, while a contractionary monetary policy causes it to decrease.

Cost Push Inflation

In the early theories of inflation, the emphasis was given only on the inflation created by the demand. In the classical quantity theory of money and also in the Keynesian theory of money, both suggested that the reason of inflation is the excess of aggregate demand over the supply. However, after 1950, a new theory came into existence, the cost push inflation or in other words new inflation theory. The theory explains that inflation occurs because of the rise in the cost of goods by an increase in the cost of production.

Some economists have found nothing new in the new inflation theory as Martin Bronfenbrenner and F. D. Holzman stated. cost inflation has been the layman's instinctive explanation of general price increase, since the dawn of the monetary system.

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The cost push inflation can be divided into three parts, such as follows:

- Wage push inflation
- Profit push inflation
- Increase in prices raw materials, like crude oil prices and energy prices

Wage Push Inflation

In today's world, trade unions are very strong, and they push the producers for higher wages. In this theory, it has been discussed that mainly the trade unions are responsible for wage push inflation. When trade unions push for higher wages, which are not justifiable either on the grounds of a prior rise in productivity or of cost of living, they produce a cost push effect.

In the above situation, the employer is bound to increase the wages, because of the competition in the labour market. Employers also like to think that they can pass on these cost to the consumers in the form of hike in prices. This situation is known as wage push inflation. Wage push inflation is a major cause of cost push inflation. Cost push inflation tell us that even if the aggregate demand is not increasing, prices may be able to rise, because of the increase in the cost of production.

It should be noted that with the increase in the wages, the aggregate supply curve shifts towards left, with a given aggregate demand curve. This results in higher prices of output.

Profit Push Inflation

The profit push inflation is one of the causes of cost push inflation; firms operating under the monopoly market or in oligopolistic market can charge a higher price to increase their profits. In the above case because of the increase in wages of the employees, the cost push inflation exists. However, in this case, the cause of cost push inflation is the increase of profit. Also, in this case the aggregate supply curve shifts towards left with the fixed aggregate demand curve, and the result is increase in price (Figure 4.4).

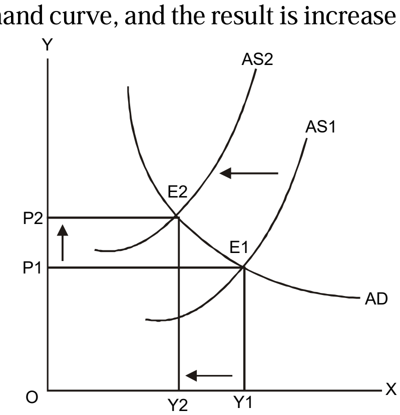

Fig. 4.4 *Cost Pull Inflation*

Rise in Raw Material Prices

In addition to the rise in wage rate of labour and increase in profit margins, you have one more reason of cost push inflation, and that is the rise of raw material prices. The same happened in the seventies, when the OPEC increased the price of crude oils. As a result, the aggregate supply decreased, resulting in cost push inflation.

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It should be noted that an important feature of cost push inflation is that this not only causes rise in price level, but brings about a fall in aggregate output.

Generally speaking, the cost push inflation in the economy occurs as a result of the combination of all the factors discussed above: wage push inflation, profit push inflation and the rise in the price on raw materials. According to those who feel that prices are pushed up by rising costs rather than by the demand pull forces, some control in the form of prices and incomes policy is necessary to bring the spiral of rising prices to a halt.

Both the demand pull and the cost push inflations are closely related, and intertwined with the now widely held view that the problem of inflation is more sociological than economic in nature.

Check Your Progress

1. List some of the forms of inflation.
2. What do you understand by creeping inflation?

4.3 EFFECTS AND CONTROL OF INFLATION

The future of the governments and the political parties depend on how they tackle the problem of inflation. Many aspects of our everyday activities are in some way influenced by the level of and changes in the rate on inflation.

A high rate of inflation makes the life of the poor very miserable. During mild inflation, consumers generally cut their spending on luxurious goods, corporate profits increases sharply due to the increase in price and they build up new inventories. Also in government sector, the tax collected from indirect tax also rises. It also affects the income distribution of the economy.

We can divide the effects of inflation into six parts, as given below:

1. Effects of inflation on producers and traders class
2. Effects of inflation on investors class
3. Effects of inflation on laboures and other fixed income groups
4. Effects of inflation on consumers class
5. Effects of inflation on debtors and creditors class
6. Other effects of inflation

Before discussing the effects of inflation on different classes of the economy, this section will discuss the concepts of anticipated and unanticipated inflation.

Anticipated Inflation

If the people know that in the coming time period the rate of inflation is going to increase, this inflation is known as anticipated inflation. If rate of inflation is anticipated, people take steps to make suitable adjustment in their contracts to avoid the adverse effects which inflation could bring to them.

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For instance, a worker correctly anticipates that in the coming year the rate of inflation will be 15 per cent. Suppose, his income in the existing year is ₹ 10,000, then he can make a contract with his employer to increase the wage by 15 per cent in next year, so he will get ₹ 11,500 in the next year. This way he will not be affected by the rise in the inflation rate.

Unanticipated Inflation

Suppose, a worker is not able to anticipate the inflation rate, it means in next year he will also get the same wage, i.e., 10,000. However, in real term, his real income was decreased by 15 per cent, due to the increase in the rate of inflation.

Effects of Inflation on Producers and Traders Class

From the view point of producers and traders, inflation is always very useful, in the period of inflation they earn much profit and soon they became financially strong. There are many reasons for this such as follows:

- In the period of inflation, the cost of production and price both increase, but the rate of increase in price is much higher than the increase in the cost of production. That's why a lower cost of production producer charges a higher price and earns a higher rate of profit.
- In the period of inflation, the demand is much higher even at a higher price; the result is same as above, a higher rate of profit.
- In the period of inflation the liquidity increases. That's why people can purchase more, so the demand of the consumer increases. The producer can sell all the goods easily even at a higher price.

Effects of Inflation on Investor's Class

Here, the meaning of investor class is those people who invest their capital in the industry. On the basis of investment, investor class can be divided into two parts, (i) investors of fixed income and (ii) investors of variable income.

Investors of Fixed Income

Those investors received fixed return from their investment, like investment in the debentures; they receive a fixed income for their investment. In the period of inflation this type of investors are in loss, because their real income decreases.

Investors of Variable Income

The incomes of the investors of variable income depend on the change in the value of money and on the business. They usually invest into the shares of a company. Because they earn in the period of inflation and they earn their share through increase in the price of the share.

Effects of Inflation on Labourers and other Fixed Income Groups

Generally, this sector includes the service sector; the persons who sell their services like, agricultural labour, industrial worker, teachers all come under this group. Because they belong to fixed income group, it means in the period of inflation the purchasing power of this group decreased. It is also true that they can have more new job offers in the period of inflation, and the employers also pay the dearness allowances for this inflation, but that dearness allowance cannot off-set the inflation, that's why the labourer's do the strikes.

Effects of Inflation on Consumer Class

Every person in this world is a consumer. No matter he is a producer or the supplier of the factors of production. From the view point of a consumer inflation is always bad.

Effects of Inflation on Debtors and Creditors Class

In the period of inflation the purchasing power of the money decrease. That's why the real burden of the tax decreases. In other words, in the period of inflation the payment of debt is not a tough task; in this period the debtor is in a better position than the creditor. For example, you lend ₹ 20,000 to a person at a rate of 5 per cent per annum, after one year you will receive ₹ 21,000. However, if there will be 4 per cent rate of inflation then your 4 per cent of income will be offset by the rise in prices, and effectively you will get only 1 per cent real rate of interest.

Other Effects of Inflation

The following are the other effects of inflation.

- **Unequal distribution of wealth:** Because of the inflation, there can be a centralization of the economic power, producers and the traders earn a higher profit and persons who belong to the fixed income group have to bear the loss. As a result, there will be unequal distribution of income and wealth.
- **Increase in taxation:** In the period of taxation, governments generally revise the old taxes and it also implements new taxes, to decrease the purchasing power of the consumers.
- **Increase in immorality:** This effect can be understand with the help of some definitions. According to Michael Levy; many people lose their health and happiness trying to accumulate money and that makes it most expensive thing on earth.

Effect of Inflation on Growth of Banking Sector

In the period of inflation, the monetary income of the people increase very fast. Hence, the insurance and the banking sector have changed completely.

Effect of Inflation on Balance of Payment (BOP)

Because of the inflation the balance of payment of any country can be adverse. Inflation leads to the increase in the price level, it affects the export very badly on the other hand it attracts the imports. As a result the balance of payment became negative or in other words adverse.

Adverse Effect on Savings

In the time period of inflation, the purchasing power of the consumers decrease, they have to pay more for the same amount of commodities. That's why they have to decrease the amount of savings. In other words, inflation affects the rate of savings adversely.

Control of Inflation

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With the help of above discussion, you can conclude that the inflation is very bad from the view point of economy, it can affect the economic and social structure of the economy adversely. There are several measures to check the inflation; some of them are as follows:

- Monetary measures
- Fiscal measures

Monetary Measures

In monetary measures the government of a country tries to control the inflation through the central bank of that country. The central bank follows a strict monetary policy, through which central bank takes the excess money supply from the economy.

Instruments of Money Control

There are many instruments to control the money supply in the economy. Some of the main instruments of money control are as follows:

1. **Open market operation**: The term open market operation means the purchase and sale of government securities by the RBI from and to the public and also from and to the banks. When there is a situation of inflation in the economy, that time government can sell the government securities to the public and also to the bank to soak the excess liquidity interms of excess money supply from the economy.

   As you know that because of excess money supply, price of the goods and services increase, because of increase in demand for goods and services. With the sale of government securities to the public and to the bank, government takes back the excess money supply from the economy. Through this process government can check the inflation by using this instrument of money control.

   On the other hand, if there is a recession in economy. In this situation, government can correct the situation by purchasing the government securities from the public and from the banks. In recession, aggregate demand for the goods and the services decrease and because of this the production also decrease and consequently the employment.

   To correct the condition of unemployment, decrease in aggregate demand of goods and services government purchase the government securities from the public and from the banks. By the help of this process, the government injects liquidity into the economy, and it corrects the situation of recession. In most of the developing countries open market operation is regarded as the most efficient instrument of the monetary policy.

2. **Variation in reserve requirement:** Banks have to keep certain proportion of their assets in the form of cash. It is for two reasons. The first reason of holding the cash is to meet their daily transactions and the second reason of holding the cash reserve is statutory reserve requirement. Balance with the RBI is known as reserve requirement. This reserve requirement is known as CRR. According to the RBI Act 1956, the RBI can impose the CRR between 3 to 15 per cent on their net demand and time liabilities. The working of CRR can be explained with the help of two conditions of the economy. In the condition of inflation, when there is an excess money supply in the economy, RBI increases the CRR. With the increase

in CRR, the lending power of the commercial banks decrease, the availability of the credit to the public also decrease.

On the other hand, if there is a condition of recession in the economy. In this condition RBI decreases the CRR, so that the lending power of the commercial banks increase, and also the availability of credit to the public. By increasing and decreasing the rate of the CRR, RBI can affect the availability of the credit to the public.

3. **Bank rate policy:** The instrument of bank rate also plays a crucial role in money control. Bank rate is a rate at which RBI should be prepares to buy or rediscount eligible bills of exchange and other commercial papers. The bill market in India is not well developed in comparison with other developed countries, that's why RBI has to makes advances to banks mainly in other forms.
4. **Working of bank rate:** An increase in the bank rate raises the cost of borrowed reserves by the commercial banks, and subsequently the commercial banks increase the PLR (prime lending rate), which discourages the public to take loans from banks. By increasing bank rate, RBI can decrease the money supply in the economy.

   On the other hand, a decrease in bank rate decreases the cost of borrowed reserves by the commercial banks, and subsequently the commercial banks decrease the PLR. Hence, people can avail loans at a lower interest rate. By decreasing the bank rate, RBI can increase the money supply in to the economy.
5. **Statutory liquidity ratio:** Statutory liquidity ratio is another instrument of money control. According to this instrument each and every commercial bank has to require statutory to maintain a minimum proportion of their daily total demand and time liabilities in the form of liquid assets.

   Liquid assets can be as follows:
   - Other approved securities
   - Current-account balances with other banks

By increasing and decreasing of statutory liquidity ratio the RBI can increase or decrease the money supply in to the economy.

In the condition of excess money supply, RBI increases the statutory liquidity ratio, to decrease the lending power of the banks. In controlling the money supply, statutory liquidity ratio works indirectly rather than directly.

Moral Suasion

Moral suasion is a combination of persuasion and pressures. The central bank of any country is always in a position to use this on commercial banks. In this instrument, the bank uses discussions, letters and speeches. The RBI issues letters to banks making clear its policy and urging banks to fall in line.

Selective Credit Control

Normally selective credit control is used in western countries. The working of this instrument is very simple; the availability of bank finance for purchasing and holding some commodities is restricted. In India, the holding of food grains, agricultural raw material and other essential commodities is restricted to control the undue rise in their prices.

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Fiscal Measures

The fiscal policy is prepared by the union finance minister. The first goal of the fiscal policy is to increase tax revenue as well as non-tax revenue. On the other hand, the other goals of fiscal policy are to maintain public services like food, shelter, safe drinking water, to bridge the gap between rich and poor, to control the money in circulation, full employment and to increase the rate of saving and rate of investment.

The fiscal policy is a projected balance sheet of the nation or a country. It is a study of allocation of the resources and generating those resources. The Finance Minister implements the fiscal policy through the budget. The budget is a future statement of revenue and expenditure of the state or a nation. According to Harvey and Johnson changes in government expenditure and taxation are designed to influence the patterns and level of activity.

With the help of fiscal policy, a government tries to bridge the gap in income levels, which affects the development of the country. With the equal distribution of income and wealth, a country can perform well in all the sectors. According to Otto Eckstein, changes in taxes and expenditure which aim at short-run goals of full employment, price level and stability.

Meaning of Budget

Budget has an important role in the economy of any country. It is the central point of the financial administration. The government can affect the economic activities of the country with the help of budget in terms of allocation and administration of the available resources. The budget is vertically divided into two parts: revenue and expenditure. Horizontally, it is divided into two part revenue account and capital account.

Objectives of Fiscal Policy

The major objectives of the fiscal policy are as follows.

- To finance various developmental projects, mobilization of resources is needed
- To get the maximum utilization of the available resources
- To get full employment
- To decrease regional disparities
- To control the inflationary pressure in the economy
- To reduce the per centage of below poverty line (BPL) population
- To increase the rate of capital formation with the increasing rate of saving and investment

Aspects of Fiscal Policy

There are mainly four aspects of fiscal policy, which are as follows:

1. **Taxation policy:** Taxation policy plays a vital role in the collection of revenue for the government in any country. Government can impose a direct tax and indirect tax. Direct tax is the tax in which impact and incidence of tax burden are on the individual person. In other words, he or she cannot shift the tax burden to others. In indirect tax, shifting of tax burden is possible.

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The main objectives of the tax policy are as follows:

- To mobilize idle resources
- To bridge the gap between rich and poor
- To check the inflation by adopting an anti-inflationary taxation policy
- Public expenditure policy
- Public debt policy
- Deficit financing policy

2. **Public expenditure policy:** In developing countries fiscal policy has a vital role in the economic development of the countries. After collecting the revenue from the public, government engages in public expenditure, which can be developmental or non-developmental expenditure. Developmental expenditures are generally related with developmental activities like roads, hospitals, bridges, infrastructure, railway. Non-developmental expenditures are generally related with maintenance of law and order, defence and so on.
3. **Public debt policy:** Mostly in developing countries, people have a low taxable capacity. They cannot afford a higher rate of tax imposed by the government. To finance the developmental projects governments take loans from the public. It is known as public debt. Public debt helps the government in two ways, firstly it soaks the excess liquidity from the market that creates the inflationary pressure, and secondly it helps the government in financing the developmental projects, which are necessary for the economic development of the country. This debt can be internal or external. Government can also take the loan from the external resources like, World Bank, IMF, IDA etc.
4. **Deficit financing policy:** When the government expenditure exceeds the government revenue, this condition is known as deficit, and to finance that deficit government apply this policy. In this policy government can take the loan from the central bank in the form of issuing the fresh currency to finance the deficit. In the developing countries, where the taxable capacity, as well as rate of saving and the rate of investment are low, deficit financing policy is very useful for the economic development of those countries.
5. **Increase in taxation:** With an increase in the taxation, the disposable income of the consumers decreased, now because the purchasing power of the consumer decreased they can purchase a lesser amount of goods. Both the taxes have the adverse effect on purchasing power, direct tax and indirect tax.

   Direct tax decreased the disposable income of the consumer and on the other hand, indirect tax increased the prices of the commodities. Thus, by increasing the rate of tax, government can control the inflation.
6. **Decrease in the public expenditure:** In the period of inflation, the government should decrease the amount of public expenditure, so that the velocity of the money decreased. The main policy in the period of inflation should be decrease in the unproductive expenditure.
7. **Increase in public debt:** In the period of inflation, the government should take the public debt in larger amount. It affects the inflation in two ways, first it reduces the purchasing power of the consumers and secondly, after collecting the debt from the public, government can invest that into the manufacturing process, so that the output of the economy increased. With an increment in the output government can control the inflation.

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8. **Balanced budget policy:** In the period of inflation, government should follow the balanced budget policy. Government should not prepare the deficit budget in the inflation, because it leads to the inflation.
9. **Control over consumption:** In the period of inflation, the government should control the consumption, especially unproductive and demonstration expenditure.
10. **Encouragement to savings:** In the period of inflation, government should encourage saving, it can be through launching of new saving schemes. Government should also increase the deposit rates.
11. **Overvaluation:** In the period of inflation, government can also over valuate the value of the currency, through over valuation will cause exports to decrease and imports to increase.
12. **Control over investment:** You have seen that in the period of inflation, investment increased in a larger amount. Because of this the profit as well as the inflation both increases. Banks and other financial institutions also provide the loan easily in this time period, the government should control it.

Some other measures to curb inflation are as follows:

- **Increase in production:** The best and the most convenient way to control inflation is to increase the amount of production. In the time period of inflation, the agriculture and the industrial sectors should be promoted through tax relief and subsidy.
- **Proper use of tariffs and quotas:** In the time period of inflation, imports should be promoted and on the other hand, exports should be minimized through proper use of tariffs and quotas.

CHECK YOUR PROGRESS

3. What are the two types of investor class?
4. Name the two measures that can be used to check the inflation.
5. Write any three objectives of fiscal policy.

4.4 SUMMARY

- Inflation is a persistent rise in the general price level rather than a once-for-all rise in it. It should be noted that most economists all around the world have assumed that price stability is the main objective of economic policies.
- The concept of inflationary gap has been propounded by Keynes. According to Keynes, inflationary gap arises when consumption and investment spending together are greater than the full employment gross national product level.
- In today's world trade, unions are very strong, and they push the producers for higher wages. In this theory, it has been discussed that mainly the trade unions are responsible for wage push inflation.
- The profit push inflation is one of the causes of cost push inflation; firms operating under the monopoly market or in oligopolistic market can charge a higher price to increase their profits.

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- Both the demand pull and the cost push inflations are closely related, and intertwined with the now widely held view that the problem of inflation is more sociological than economic in nature.
- The future of the governments and the political parties depend on how they tackle the problem of inflation. Many aspects of our everyday activities are in some way influenced by the level of and changes in the rate on inflation.
- The incomes of the investors of variable income depend on the change in the value of money and on the business. They usually invest into the shares of a company. Because they earn in the period of inflation and they earn their share through increase in the price of the share.
- In the period of inflation, the monetary income of the people increase very fast. Hence, the insurance and the banking sector have changed completely.
- In monetary measures the government of a country tries to control the inflation through the central bank of that country.
- The term open market operation means the purchase and sale of government securities by the RBI from and to the public and also from and to the banks.
- The instrument of bank rate also plays a crucial role in money control. Bank rate is a rate at which RBI should be prepares to buy or rediscount eligible bills of exchange and other commercial papers.
- Statutory liquidity ratio is another instrument of money control. According to this instrument each and every commercial bank has to require statutory to maintain a minimum proportion of their daily total demand and time liabilities in the form of liquid assets.
- The fiscal policy is prepared by the union finance minister. The first goal of the fiscal policy is to increase tax revenue as well as non-tax revenue.
- Budget has an important role in the economy of any country. It is the central point of the financial administration. The government can affect the economic activities of the country with the help of budget in terms of allocation and administration of the available resources.

4.5 KEY TERMS

- **Currency inflation:** The inflation due to increase in the currency is known as currency inflation. When the government or the central bank of a country increases the money supply in a high volume, it will increase the general price level.
- **Running inflation:** In running inflation, the rate of increase in the inflation increases at a higher rate. It affects the fixed income group adversely.
- **Inflationary gap:** An inflationary gap, in economics, is the amount by which the actual gross domestic product exceeds potential full-employment GDP. It is one type of output gap, the other being a recessionary gap.
- **Direct tax:** Direct tax is the tax in which impact and incidence of tax burden are on the individual person.

4.6 ANSWERS TO 'CHECK YOUR PROGRESS'

NOTES

1. In economic life there are several forms of inflation. Some of them are as follows:
    - Production inflation
    - Currency inflation
    - Credit money
2. When there is a slow increase in the general price level due to inflation, then it is known as creeping inflation. The rate of increase in this inflation is not more than 2 per cent in a year. According to Keynes, it is a must for the development of an economy.
3. On the basis of investment, investor class can be divided into two parts, such as follows:
    - Investors of fixed income
    - Investor of variable income
4. The two measures that can be used to check the inflation are monetary and fiscal measures.
5. The three objectives of fiscal policy are as follows:
    - To finance various developmental projects, mobilization of resources is needed
    - To get the maximum utilization of the available resources
    - To get full employment

4.7 QUESTIONS AND EXERCISES

Short-Answer Questions

1. State the main objectives of fiscal policy.
2. What are the effects of inflation and how can inflation be controlled?
3. Write short notes on the following:
    - Cost push inflation
    - Wage push inflation
    - Profit push inflation
4. Differentiate between anticipated and unanticipated inflation.
5. What do you understand by the concept of inflationary gap?

Long-Answer Questions

1. Describe the forms of inflation on the basis of motion.
2. Discuss the effects of inflation on various classes.
3. Explain the various aspects of fiscal policy.
4. List some of the main instruments of money control.

4.8 FURTHER READING

NOTES

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