Social Cost of Inflation

An economy which is experiencing inflation has to bear many costs (disadvantages). Economists, Policy maker and Politician have to make arrangements and take steps to curb (control) inflation because of public pressure. There are different types of social costs. Firstly, we have to categories inflation in two parts:

a) Perfectly anticipated Inflation : Where actual inflation rate must be equal to inflation rate which was anticipated.

b) Imperfectly anticipated Inflation : Where actual inflation rate not be equal to inflation rate which was anticipated.

$$i = \overbrace{r}^{\text{constant}} + \pi$$

$$8\% = 2\% + 6\%$$

constant

$$i = \boxed{r} + \pi$$

$$8\% = \boxed{2\%} + 6\%$$

$$10\% = \boxed{2\%} + 8\%$$

$$\pi \uparrow \rightarrow i \uparrow$$

i		π
↑ 8		6 ↑
10	+ve	8

Perfectly anticipated Inflation

Social Cost under this are:

$\pi \uparrow \rightarrow i \uparrow$

a) Shoe – leather Cost : When people hold money in their hands, they sacrifice their interest from bank. When inflation rises, nominal interest rate also rises, as a result people hold less cash in hand, because they deposit their most of the money in Bank. If they want money, they must make more frequent trips to the bank to withdraw money. The inconvenience of reducing money holding is called the shoe-leather cost of inflation.

a) Menu Cost : Inflation also arises because high inflation causes firms to bring changes in their prices printed in menu cards more often. This procedure is costly as it requires print and distribution of a new catalog. These costs arose due to high inflation are called menu costs, because the firms often revise the price list in their menu cards whenever the rate of inflation is high.

c) Relative Price variability : A third cost of inflation arises because firms don't want to change prices on menu card frequently. thus, the higher the rate of inflation, the greater the variability (change) in relative price. Since market economics rely on relative prices to allocate resources efficiently, inflation leads to microeconomic inefficiencies.

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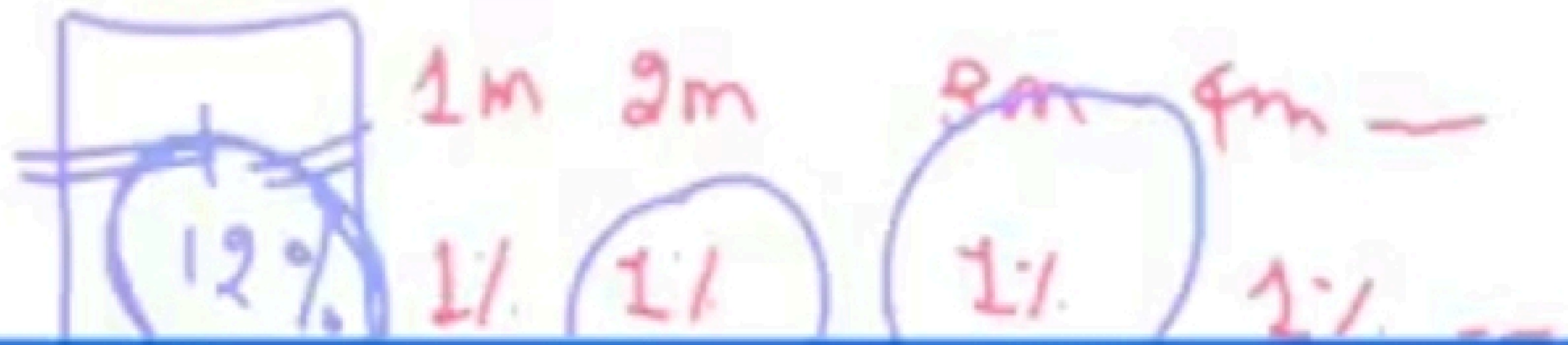
d) Inconvenience: Another cost of inflation is the inconvenience of living in a world where prices are changing and brings changes in the value of rupee. Money is used as a yardstick for measuring economic transactions and therefore, when an economy experiences inflation, that yardstick is changing in length.



12% Inflation Rate

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1m 2m 3m 4m —

12% Inflation Rate

12%

1% 1% 1% 1%

Imperfectly anticipated Inflation

Social Cost under this are:

a) Distribution of wealth among individuals: Loan agreements have an interest rate, taken inflation into consideration. If inflation is higher than expected, the borrower (Debtor) is better off because he/she is repaying the fixed loan with less valuable rupees and the Lender (Creditor) is worst off. The opposite situation is true if inflation is lower than expected.

b) Hurts individuals on fixed pensions and those bound by fixed contracts- Similar to the borrower/lender example, unexpectedly high or low inflation can hurt one party in a fixed long term contract or payment system.

1,00,000 $i = 10\%$

10,000 $i = 10\%$

$\pi^e = 6\%$

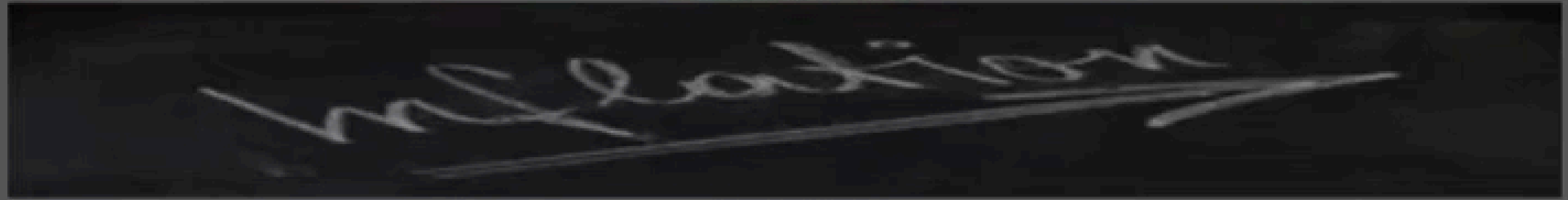
$\pi = 8\%$

And $r = 4\%$

$r = 2\%$

Advantages of inflation

1- Increase in demand of goods and services due to fear of inflation ..



increase in demand cause more production of goods which cause companies to earn more capital
when companies earn more they expand their business and hire new employee ,,,, and economy grow faster,,

2- Ease of returning loan

when you get loan from someone suppose one lac and you have to return it after one year ..after one or two year you

Will return it very easily because the purchasing power decrease to some extent

3- *Decrease in unemployement*

there is inverse relation between inflation and unemployement and direct relation between employement and inflation ,,

increase in employement mean increase money in economy which cause more demands and result in high inflation so more employement mean more inflation

5- investment in companies and real estate

Some people invest in companies and real estate like plots of lands and in other commodities

Like storing of different kinds of material and then waiting for their prize to go high ,,,

These people get a lot of benefit from inflation ..

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5- Saving Money in bank

Before keeping money in bank you should check the inflation rate of last many years to see that how much low is the Inflation rate from interest rate ,,if the difference is high then it's ok otherwise invest in other places to earn high .

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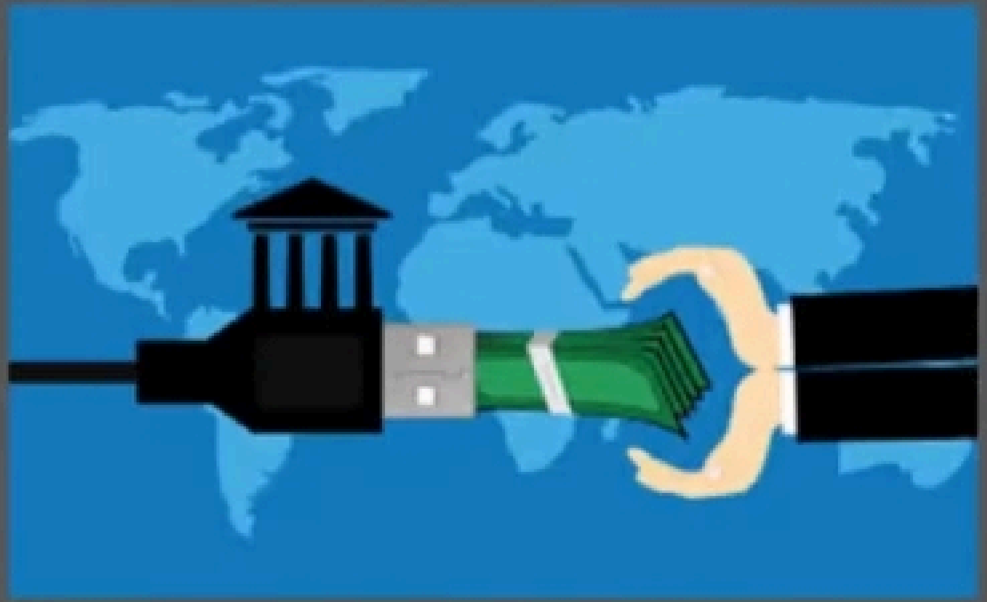
3- force people to invest money

People invest money in order to face inflation ,, when they invest economy goes faster ,, suppose if inflation is zero ,,the prize of goods will remain same afters years and people will not invest,

So economy can destroy in this way ,,thatswhy inflation is very important to force will to invest because they know if they donot invest ,,their money will lose its value ..so its important to invest ,,

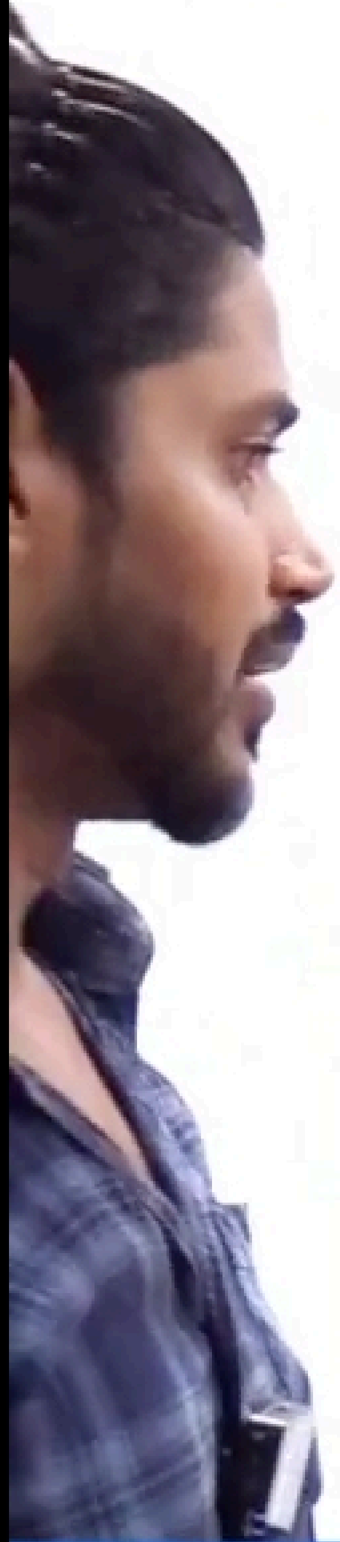


MACRO-ECONOMICS

PART 2

Inflation

Inflation & Interest Rate (Real & Nominal)



inflation → 4% (π)

100₹ → 6% → Nominal Int. (i)

$\boxed{r}$ Real Int $= i - \pi$

$= 6\% - 4\%$

$= 2\%$

Inflation → 4% (π)

100₹ → 6% → Nominal Int. (i)

$\boxed{r}$ Real Int $= i - \pi$

$= 6\% - 4\%$

$= 2\%$

100 → 106

100 → 104

Real 2₹

Inflation & Interest rate

The fisher equation has analyzed the relationship between inflation and interest rate through an equation. The Fisher equation provides the link between nominal and real interest rates. To convert from nominal interest rates to real interest rates, we use the following formula:

Real Interest Rate = Nominal Interest rate – Rate of Inflation

$$r = i - \pi$$

Nominal Interest Rate = Real Interest rate + Rate of Inflation

$$i = r + \pi$$

This equation states that nominal interest rate is the sum of real interest rate and inflation rate.

For example, if a loan has a 12 percent interest rate (Nominal) and the inflation rate is 8 percent, then the real return on that loan is 4 percent (Real).