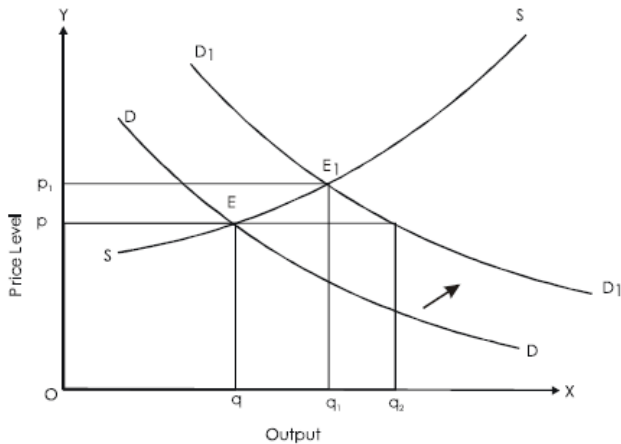


## INFLATION

Inflation arises when price level of an economy goes on rising continuously. According to classical economists inflation is a situation when too much money chases too few goods. It is an imbalance between money supply and Gross Domestic Product. As per Keynes, inflation is an imbalance between aggregate demand and aggregate supply. In an economy, if the aggregate demand for goods and services exceeds aggregate supply, then prices will go on rising.



### Primary causes:

1. When demand for a commodity in the market exceeds its supply, the excess demand will push up the price – **demand-pull inflation**.
2. When factor prices rise, costs of production rise – **cost-push inflation**

### Various causes that may bring about inflation:

1. **Increase in public spending:** Government's spending is an important part of total spending in any modern economy. It is an important determinant of aggregate demand. In less developed economies, Government expenditure has shown an upward trend. This has created inflationary pressure on the economy.
2. **Deficit financing of Government spending:** Government spending increases beyond what can be financed by taxation. In order to be able to incur the extra expenditure, the Government resorts to deficit financing. For instance, it prints money and spends it. This adds to the pressure of inflation.
3. **Increased velocity of circulation:** Total use of money = money supply by the Government × velocity of circulation of money. In boom phase, people spend money at a faster rate. The velocity of circulation of money is increases.
4. **Population growth:** It increases total demand in the market. The pressure of excess demand will create inflation.
5. **Hoarding:** Excess demand is sometimes artificially created by hoarders. They stockpile commodities They do not release them to the market. This leads to excess demand and inflation.
6. **Genuine shortage:** If the factors of production are in short supply, production will be affected. Supply will be less than demand, prices will rise.
7. **Exports:** If the total output of a commodity is not sufficient to meet both domestic and foreign demand. Then exports will create inflation in the domestic economy.

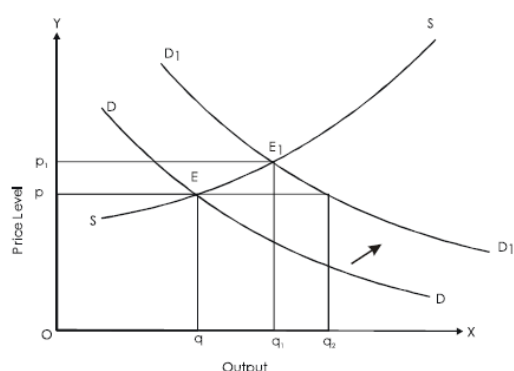
- 8. Trade unions:** By demanding an increase in the wage rate, they increase the cost of production.
- 9. Tax reduction:** Governments sometimes reduce taxes to gain popularity. This leaves more money in people's hands. This leads to inflation if there is no corresponding increase in production.
- 10. Imposition of indirect taxes:** Government may impose indirect taxes (such as excise duty, value-added tax etc.). Then producers or sellers raise the product prices to keep their profits unchanged.
- 11. Price-rise in international market:** The imported price of some commodities or factors of production may rise in the world market. It would lead to inflation in the domestic market.
- 12. Non-economic reasons:** For instance, at times of natural calamities (flood) crops are destroyed, reducing the supply of agricultural products. Prices of these commodities tend to increase.

### Types of Inflation:

1. Open inflation: The continuous rise in price level is visible in the naked eye. One can see the annual rate of increase in the price level.
2. Repressed inflation: There is excess demand. The excess demand is prevented from increasing price level by some repressive measures. The measures taken by the government like price control, rationing etc.
3. Hyper inflation: The price level goes on rising at a very fast rate. Often there happens daily/hourly increase in price level. It often leads to demonetization.
4. Creeping inflation: The price level increases very slowly over a period of time.
5. Moderate inflation: The rise in price level is neither too fast nor too slow.

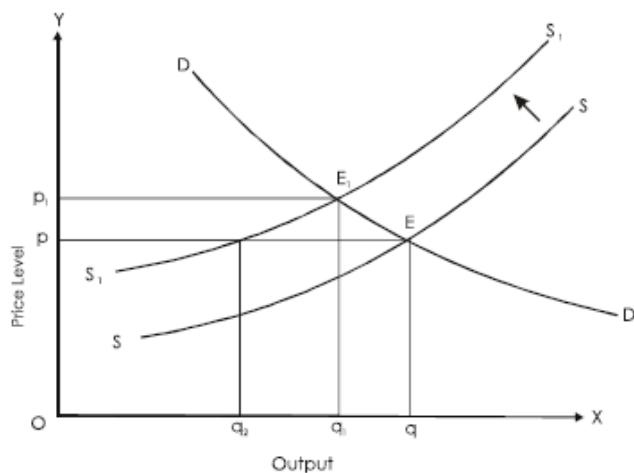
### Forms of Inflation

1. **Demand Pull Inflation:** When in an economy aggregate demand exceeds aggregate supply. Aggregate demand may increase due to an increase in money supply, or money income or public expenditure. The idea of demand inflation is associated with full employment when supply cannot be altered.



In this graph SS and DD are aggregate supply and demand curves.  $O_p$  and  $O_q$  are equilibrium price and equilibrium output. Due to exogenous causes demand curves shift right-wards to  $D_1$ . At the current price  $O_p$ , demand increases by  $qq_2$ . But supply is  $O_q$ . Excess demand  $qq_2$  puts pressure on price, which gradually rises from  $O_p$  to  $O_{p1}$ . At this price a new equilibrium is achieved where Demand = Supply. The excess demand is eliminated by fall in demand and rise in supply arising out of rise in price.

2. **Cost Push Inflation:** Inflation may originate from supply side also. Aggregate demand remaining unchanged, a fall in aggregate supply due to exogenous cause, may lead to increase in price level.



In this graph, the starting point is the equilibrium price ( $O_p$ ) and output ( $O_q$ ). If aggregate supply has fallen, the SS curve shifts left ward to  $S_1S_1$ . At price  $O_p$  now supply will be  $O_{q2}$  but demand  $O_q$ . This will push prices high till a new equilibrium is reached at  $O_{p1}$ . At the new price there will be no excess demand. Inflation is thus a self limiting phenomenon.

## Impacts of Inflation

Inflationary pressure in an economy generate good effects on the economy, particularly in case of 'creeping' or 'walking' inflation.

### Favorable impacts :

1. **Higher profits** : Profits of the producers are generally favorably affected by inflation, because they can sell their products at higher prices.
2. **Higher investment** : The entrepreneurs and investors get added incentives to invest in productive activities during inflation, since they can earn higher prices.
3. **Higher production** : If productive investment grows during inflation, it would lead to higher production of various goods and services in the economy.
4. **Higher employment and income** : Increase in the output of different goods during inflation would also mean increasing demand for various factors of production. So, it is expected that employment and income opportunities will also increase during inflation.
5. **Possibility of higher income for the shareholders** : During inflationary periods, if the companies earn higher profits, they can declare dividends for their share-holders. Hence, the dividend income of the shareholders may also rise during inflation.
6. **Gain for the borrowers** : Inflation means a decrease in the value or purchasing power of money. If the rate of interest to be paid by the borrower is less than the inflation rate, the borrower will gain since the real value of the money returned by the borrower is actually less than that of the money borrowed earlier.

### Unfavorable Impacts :

1. **Fall in the real income of fixed-income groups** : Real income means purchasing power of money income [Real income = (money income) / (price level).] Given the money income of the fixed income groups, the real income will fall during inflation. Hence, inflation affects workers, salaried people and pension-earners adversely.
2. **Inequality in the distribution of income** : The profit incomes of businessmen and entrepreneurs increasing during inflation while the real income of the common salaried people declines. So, inequality in the distribution of income become acute during inflation.
3. **Upsets the planning process** : When prices of goods, materials, and factor services increase continuously, then more money has to be spent for the completion of any investment project taken up during any planning period. If more financial resources cannot be raised by the Government (through savings or taxation), plan targets are to be curtailed.
4. **Increase in speculative investment** : If the price level rises at a fast rate, speculative investment (say, purchasing shares, land, gems, etc., just for speculative purposes) may increase in the economy for earning quick profits. These types of investments do not help in the creation of productive capital in the economy.

5. **Harmful impact on capital accumulation :** If the price-rise becomes chronic, people prefer goods to money (because the real value of money will fall in future). They also prefer immediate consumption to consumption in future. So, their desire to save is reduced. When both ability and willingness to save become less, a smaller amount of fund becomes available for further investment. As a result, it creates a harmful impact on capital accumulation, since capital accumulation in an economy depends on the growth of investment.
6. **Lenders will lose :** We have already indicated that borrowers will gain during inflation. For this same reason, lenders will lose during inflation. Because, they are actually receiving an amount having lower value (or purchasing power) than before.
7. **Harmful impact on export income :** If the prices of export items also increase during inflation, their demand in the foreign market may fall. This leads to a fall in the export income of a country. This may lead to increase in price level.

## Control of Inflation

|   |                          |   |
|---|--------------------------|---|
| <b>To control demand-pull inflation</b> | <b>Monetary measures</b> | <ul style="list-style-type: none"> <li>• If the supply of money in the economy can be decreased, prices will fall.</li> <li>• If the government withdraws paper notes and coins from circulation, the money supply will decrease.</li> <li>• The lion's share of the total money supply is bank deposits or bank credit.</li> <li>• If we can reduce the rate of lending by banks, we can reduce the total supply of money significantly.</li> <li>• The Central bank of a country can reduce the lending of commercial banks by raising the bank rate and reserve requirements of banks, by open market sales of securities, etc.</li> </ul> |
|   | <b>Fiscal policy</b>     | <ul style="list-style-type: none"> <li>• The policy of changing tax rates or the rate of Government expenditure.</li> <li>• An inflationary gap arises when aggregate demand exceeds the maximum potential supply in an economy.</li> <li>• To overcome, the following types of fiscal measures can be undertaken —<br/> A decrease in the Government expenditure; or,<br/> A decrease in the Government transfer payments; or<br/> An increase in taxes imposed by the Government; or,<br/> A combination of all these measures</li> </ul> <p>These are regarded as contractionary fiscal policies.</p>                                      |
| <b>To control cost-push inflation</b>   | <b>Direct control</b>    | Measures as wage freeze, putting upper limits on the prices of such important inputs as electricity, coal, steel, etc.  |
| <b>Other measures</b>                   |                          | <p>These measures are:</p> <ul style="list-style-type: none"> <li>• augmenting the supplies of commodities in the domestic market by increasing imports.</li> <li>• increasing domestic production, etc.</li> </ul>   |