Inflation

HS 301

Definition

- Persistent increase in the general price level leading to decline in purchasing power of money.
- Statistically measured in terms of percentage increase in the price index per unit of time (usually in a year or a month).

"*State in which the value of money is falling, i.e., prices are rising*."

"*Inflation is always and everywhere a monetary phenomenon*."

"*Too much money chasing too few goods*."

Features of Inflation

- Inflation is always accompanied by a rise in the price level. It is a process of uninterrupted increase in prices.
- Inflation is a monetary phenomenon and is generally caused by excessive money supply.
- Inflation is essentially an economic phenomenon as it originates in the economic system and is a result of action and interaction of economic forces.
- Inflation is a dynamic process as observed over the long period.
- A cyclical movement of prices is not inflation.
- Pure inflation starts after full employment.
- Inflation may be demand pull or cost push.
- Excess demand in relation to the supply of everything is the essence of inflation.

Causes of inflation

Factors causing increase in demand

- Increase in money supply.
- Increase in government expenditure.
- Increase in private expenditure – both consumption and investment.
- Reduction in taxes.
- Increase in exports.
- Increase in population.
- Paying of public debt by the government resulting in increase in purchasing power of public.
- Black money spent on conspicuous consumption.

Causes cont.

Factors causing decrease in supply:

- Scarcity of factors of production.
- Hoarding by traders and businessmen.
- Trade union activities e.g., strikes, wage increase.
- Natural calamities.
- Increase in exports.
- Law of diminishing returns (additions to output due to a unit increase in one factor of production falls as the other factor is held constant, i.e., assuming a production function of the form $Q = f(L|K)$, $\frac{dQ}{dL} > 0\ but\ \frac{d^2Q}{dL^2} < 0$).
- War
- International causes, e.g., increase in price of petrol.

Effects of Inflation

Effects on Production:

- Disrupts price system.
- Reduces savings.
- Discourages foreign capital inflow.
- Encourages hoarding.
- Encourages speculation activities.
- Affects pattern of production by diverting resources from the production of essential items to luxury goods.
- Quality falls.

Effects cont.

Effects on Distribution:

- Debtors gain and creditors lose.
- Wage and salary earners lose.
- Fixed income groups, e.g., persons living on past savings, pensioners, interest and rent earners suffer losses.
- Business community i.e., producers, traders, entrepreneurs, speculators gain because prices rise at a faster rate than the cost of production, prices of inventories go up resulting in increased profits.
- Investors investing in equities gain because of rising profits. Investors investing in fixed income bearing securities/ bonds lose.

Control of inflation

Monetary Policy

- Increasing bank rate – the rate at which central bank lends money to the commercial bank.
- Sale of government securities.
- Higher reserve ratio.
- Selective credit control.

Fiscal Policy

- Increase in taxation.
- Reduction in public expenditure.
- Public borrowing through savings bonds.
- Control of deficit financing.

Control of Inflation cont.

Direct controls

- Direct controls on prices.
- Rationing .

Other Measures

- Expansion of output.
- Proper wage policy.
- Encouragement to savings.
- Overvaluation of domestic currency.
- Population control.

Demand Pull Inflation

- Occurs when aggregate demand for goods and services is greater than the available supply at the existing price level.
- 2 theories – Monetarist and Keynesian.
- Monetarist theory – increased quantity of money in circulation, given full employment will pull up prices.
- Keynesian Theory – when aggregate demand exceeds the aggregate supply at full (or near full) employment level.

Cost Push Inflation

- True source of inflation is the cost of production.
- Increase in cost of production is independent of demand conditions.
- Push forces operate through important cost components, e.g., wages, profits or material costs.
- **Wage push inflation** – trade unions succeeding in raising wages. Wage rise due to excess demand for labour, due to increased cost of living, due to productivity increases, are not a part of wage push inflation.
- **Profit push inflation** – business houses having monopoly power succeed in raising prices.
- **Material push inflation** – increase in prices of some key inputs in production such as steel, basic chemicals, oil etc.

Demand–cum–Cost Inflation

- Inflation is a combination of both demand-pull and cost-push rise in prices.
- Demand pull inflation leading to cost push inflation – rise in prices due to excess aggregate demand leads to increase in demand for wages by workers.
- Cost push inflation leading to demand pull inflation – when wages rise workers demand more goods and services.
- Actual mechanism of inflationary process (demand-cost-price spiral): $AD \uparrow \rightarrow P \uparrow \rightarrow w \uparrow \rightarrow AD \uparrow \rightarrow P \uparrow$

Deflation

- Phenomenon of falling prices and corresponding rise in value of money.
- Should be accompanied by unemployment, overproduction and fall in the economic activity.
- Deflation is different from disinflation which is process of reverse inflation without creating unemployment or reduction in output. Disinflation aims to reduce prices when they are abnormally high.
- Deflation may be due to natural causes or it may be result of a deliberate policy of the government, but disinflation is always the deliberate policy of the government.
- Prices can be brought down to normal level with the help of disinflation, but deflation reduces the prices even below the normal level.

Inflation is better than Deflation

- Inflation does not reduce national income. Deflation does.
- Inflation is post-full employment phenomenon. With deflation problem of unemployment becomes more and more acute.
- Mild inflation is better than deflation from the point of view of economic development.
- Inflation makes it increasingly difficult for the people to earn a good livelihood. Deflation deprives the people of their livelihood by rendering them unemployed.

Stagflation

- Stagflation occurs when a period of high inflation coincides with a stagnant economy and elevated unemployment.
- The term coined by British politician Ian Macleod in the Parliament in 1965.
- High prices in the economy should be accompanied by high unemployment.
- The economy is not growing but the prices are growing.

Inflationary/ Deflationary Gap

- Inflationary gap occurs when aggregate demand (AD) exceeds aggregate supply (AS) at full employment level of output. Inflationary gap continues to prevail until either AD contracts to the level consistent with the full employment level, or AS is expanded through economic growth.
- Deflationary gap occurs when AD is less than AS at full employment level of output. It depicts the unemployment situation attributable to the fact that at full employment level of output AD < AS. It will continue until higher AD consistent with full employment output is achieved.

Stimulating Effects of Inflation: Inflation promotes Economic Development

- Increases investible profits – redistributes income in favor of entrepreneurial classes with high marginal propensity to save.
- Creates optimistic conditions – profit margins of businessmen go up as costs rise less rapidly than prices.
- Fuller utilization of resources through inflationary increase in aggregate demand.
- A necessary cost – inflation and economic growth go together, at least in the initial stages of development of a country.