INFLATION (Types and measures to control Inflation)

inflation is a sustained increase in the general price level of goods and services in an economy over a period of time. When the general price level rises, each unit of currency buys fewer goods and services; consequently, inflation reflects a reduction in the purchasing power per unit of money – a loss of real value in the medium of exchange and unit of account within the economy.

Types:1.Demand pull
2.Cost push

1.Demand-pull Inflation:

If aggregate demand (AD) rises faster than productive capacity , then firms will respond by putting up prices, creating inflation.

a) Inflation – a sustained increase in the price level.

b) Demand-pull inflation – inflation caused by AD increasing faster than AS.

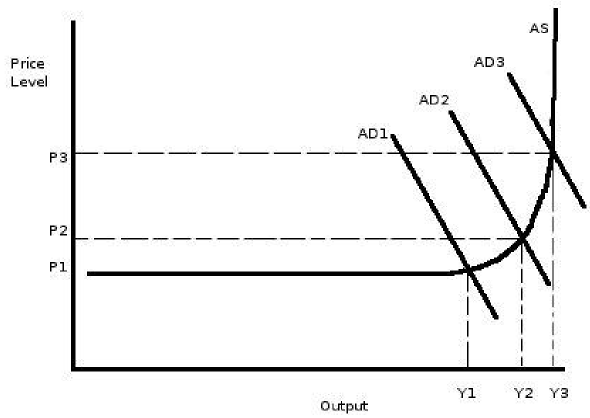
Demand-pull inflation means:

- Excess demand and 'too much money chasing too few goods.'
- The economy is at (or very close to) full employment/full capacity.
- The economy will be growing at a rate faster than the long-run trend rate.
- A falling unemployment rate.

How demand-pull inflation occurs

If aggregate demand is rising at 4%, but productive capacity is only rising at 2.5%; firms will see demand outstripping supply. Therefore, they respond by increasing prices.

Also, as firms produce more, they employ more workers, creating a rise in employment and fall in unemployment. This increased demand for workers puts upward pressure on wages, leading to wage-push inflation. Higher wages increase the disposable income of workers leading to a rise in consumer spending.



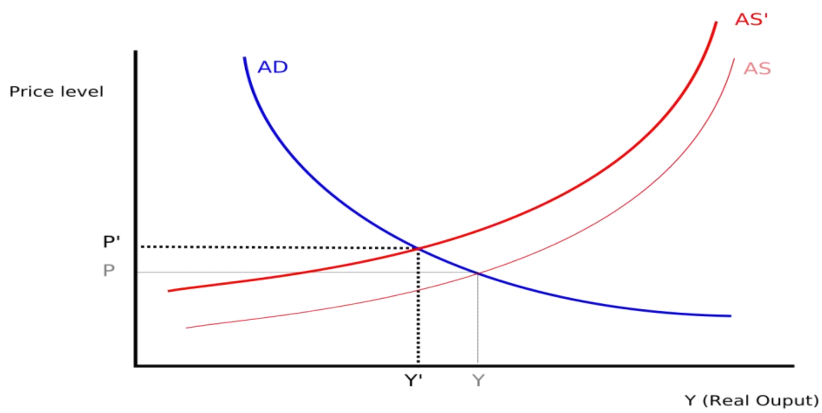
Causes of Demand pull Inflation:

1. A quick **increase in consumption and investment** along with extremely confident firms.
2. There is a sudden **increase in exports** due to huge under-valuation of the currency.
3. There is a lot of **government spending.**
4. The expectation that **inflation** will rise often leads to a rise in inflation. Workers and firms will increase their prices to 'catch up' to inflation.
5. There is **excessive monetary growth**, when there is too much money in the system chasing too few goods. The 'price' of a good will thus increase.
6. There is a rise in **population.**

Cost push Inflation:

Cost-push inflation is a type of inflation caused by substantial increases in the cost of important goods or services where no suitable alternative is available. Higher prices are then the result, as costs of production increases due to a decreased aggregate supply. Shortages or cost increases in labor, raw materials, and capital goods create cost-push inflation. These components of supply are also part of the four factors of production.

Cost-push inflation occurs when we experience rising prices due to higher costs of production and higher costs of raw materials. Cost-push inflation is determined by supply-side factors, such as higher wages and higher oil prices.



Causes of Cost push Inflation

1. **Higher Price of Commodities**. A rise in the price of oil would lead to higher petrol prices and higher transport costs. All firms would see some rise in costs. As the most important commodity, higher oil prices often lead to cost-push inflation

2. **Imported Inflation**. A devaluation will increase the domestic price of imports. Therefore, after a devaluation, we often get an increase in inflation due to rising cost of imports.
3. **Higher Wages**. Wages are one of the main costs facing firms. Rising wages will push up prices as firms have to pay higher costs (higher wages may also cause rising demand)
4. **Higher Taxes**. Higher VAT and Excise duties will increase the prices of goods. This price increase will be a temporary increase.
5. **Profit-push inflation**. If firms gain increased monopoly power, they are in a position to push up prices to make more profit
6. **Higher Food Prices**. In western economies, food is a smaller % of overall spending, but in developing countries, it plays a bigger role. (food inflation)

Measures/Methods to control Inflation

There are broadly two ways of controlling inflation in an economy:

1) Monetary measures and
2) Fiscal measures
3) Other measures

1) Monetary Measures

The most important and commonly used method to control inflation is monetary policy of the Central Bank. Most central banks use high interest rates as the traditional way to fight or prevent inflation.

Monetary measures used to control inflation include:
(i) bank rate policy
(ii) cash reserve ratio and
(iii) open market operations.

i) **Bank rate policy** is used as the main instrument of monetary control during the period of inflation. When the central bank raises the bank rate, it is said to have adopted a dear money policy. The increase in bank rate increases the cost of borrowing which reduces commercial banks borrowing from the central bank. Consequently, the flow of money from the commercial banks to the public gets reduced. Therefore, inflation is controlled to the extent it is caused by the bank credit.

ii) Cash Reserve Ratio (CRR) : To control inflation, the central bank raises the CRR which reduces the lending capacity of the commercial banks. Consequently, flow of money from commercial banks to public decreases. In the process, it halts the rise in prices to the extent it is caused by banks credits to the public.

iii) Open Market Operations: Open market operations refer to sale and purchase of government securities and bonds by the central bank. To control inflation, central bank sells the government securities to the public through the banks. This results in transfer of a part of bank deposits to central bank account and reduces credit creation capacity of the commercial banks.

2) Fiscal Measures

Fiscal measures to control inflation include taxation, government expenditure and public borrowings. The government can also take some protectionist measures (such as banning the export of essential items such as pulses, cereals and oils to support the domestic consumption, encourage imports by lowering duties on import items etc.).

(a) Reduction in Unnecessary Expenditure:

The government should reduce unnecessary expenditure on non-development activities in order to curb inflation. This will also put a check on private expenditure which is dependent upon government demand for goods and services. But it is not easy to cut government expenditure. Though this measure is always welcome but it becomes difficult to distinguish between essential and non-essential expenditure. Therefore, this measure should be supplemented by taxation.

(b) Increase in Taxes:

To cut personal consumption expenditure, the rates of personal, corporate and commodity taxes should be raised and even new taxes should be levied, but the rates of taxes should not be so high as to discourage saving, investment and production. Rather, the tax system should provide larger incentives to those who save, invest and produce more.

(c) Increase in Savings:

Another measure is to increase savings on the part of the people. This will tend to reduce disposable income with the people, and hence personal consumption expenditure. But due to the rising cost of living, people are not in a position to save much voluntarily.

(d) Surplus Budgets:

An important measure is to adopt anti-inflationary budgetary policy. For this purpose, the government should give up deficit financing and instead have surplus budgets. It means collecting more in revenues and spending less.

(e) Public Debt:

At the same time, it should stop repayment of public debt and postpone it to some future date till inflationary pressures are controlled within the economy. Instead, the government should borrow more to reduce money supply with the public.

3. Other Measures:

The other types of measures are those which aim at increasing aggregate supply and reducing aggregate demand directly.

(a) To Increase Production:

One of the foremost measures to control inflation is to increase the production of essential consumer goods like food, clothing, kerosene oil, sugar, vegetable oils, etc. All possible help in the form of latest technology, raw materials, financial help, subsidies, etc. should be provided to different consumer goods sectors to increase production.

(b) Rational Wage Policy:

Another important measure is to adopt a rational wage and income policy. To control this, the government should freeze wages, incomes, profits, dividends, bonus, etc.

(c) Price Control:

Price control and rationing is another measure of direct control to check inflation. Price control means fixing an upper limit for the prices of essential consumer goods. They are the maximum prices fixed by law and anybody charging more than these prices is punished by law. But it is difficult to administer price control.

(d) Rationing:

Rationing aims at distributing consumption of scarce goods so as to make them available to a large number of consumers. It is applied to essential consumer goods such as wheat, rice, sugar, kerosene oil, etc. It is meant to stabilise the prices of necessaries and assure distributive justice.

Conclusion

From the various monetary, fiscal and other measures discussed above, it becomes clear that to control inflation, the government should adopt all measures simultaneously.