Inflation

Meaning

- Inflation may be defined as 'a sustained upward trend in the general level of prices' and not the price of only one or two goods. G. Ackley defined inflation as 'a persistent and appreciable rise in the general level or average of prices'. In other words, inflation is a state of rising prices, but not high prices.

Types

- On the Basis of Speed or Intensity:

1. Creeping or Mild Inflation:

If the speed of upward thrust in prices is slow but small then we have creeping inflation. What speed of annual price rise is a creeping one has not been stated by the economists. To some, a creeping or mild inflation is one when annual price rise varies between 2 p.c. and 3 p.c.

Types

2. Walking Inflation:

If the rate of annual price increase lies between 3 p.c. and 4 p.c., then we have a situation of walking inflation. When mild inflation is allowed to fan out, walking inflation appears. These two types of inflation may be described as ‘moderate inflation’.

Types

3. Galloping and Hyperinflation:

Walking inflation may be converted into running inflation. Running inflation is danger-ous. If it is not controlled, it may ulti-mately be converted to galloping or hyperinflation. It is an extreme form of inflation when an economy gets shatter-ed."Inflation in the double or triple digit range of 20, 100 or 200 p.c. a year is labelled "galloping inflation".

Causes of Inflation

- Inflation is mainly caused by excess demand/ or decline in aggregate supply or output. Former leads to a rightward shift of the aggregate demand curve while the latter causes aggregate supply curve to shift left-ward. Former is called demand-pull inflation (DPI), and the latter is called cost-push infla-tion (CPI). Before describing the factors, that lead to a rise in aggregate demand and a de-cline in aggregate supply, we like to explain “demand-pull” and “cost-push” theories of inflation.

Demand-Pull Inflation

- According to Keynesians, aggregate demand may rise due to a rise in consumer demand or investment demand or govern-ment expenditure or net exports or the com-bination of these four components of aggreate demand. Given full employment, such in-crease in aggregate demand leads to an up-ward pressure in prices. Such a situation is called DPI.

Inflation

- Monetarist: An increase in nominal money supply shifts aggregate demand curve rightward. This enables people to hold excess cash balances. Spending of excess cash balances by them causes price level to rise. Price level will continue to rise until aggregate demand equals aggregate supply.

- Keynesians argue that inflation originates in the non-monetary sector or the real sector. Aggregate demand may rise if there is an increase in consumption expenditure following a tax cut. There may be an autonomous increase in business investment or government expendi-ture. Government expenditure is inflationary if the needed money is procured by the gov-ernment by printing additional money.

- There are other reasons that may push aggregate demand and, hence, price level up-wards. For instance, growth of population stimulates aggregate demand. Higher export earnings increase the purchasing power of the exporting countries. Additional purchasing power means additional aggregate demand. Purchasing power and, hence, aggregate demand may also go up if government repays public debt.

Cost-Push Inflation

- In addition to aggregate demand, aggregate supply also generates inflationary process. As inflation is caused by a leftward shift of the aggregate supply, we call it CPI.
- CPI arises due to the increase in cost of produc-tion. Cost of production may rise due to a rise in cost of raw materials or increase in wages.
- However, wage increase may lead to an increase in productivity of workers. If increase in wage does not increase the productivity .Such increases in costs are passed on to consumers by firms by raising the prices of the products.
- Rising wages lead to rising costs. Rising costs lead to rising prices. And, rising prices again prompt employee to demand higher wages. Thus, an inflationary wage-price spiral starts. This causes aggregate supply curve to shift leftward.

Causes for Cost-Push Inflation

- It is the cost factors that pull the prices up-ward. One of the important causes of price rise is the rise in price of raw materials. For in-stance, by an administrative order the government may hike the price of petrol or diesel or freight rate. Firms buy these inputs now at a higher price. This leads to an upward pres-sure on cost of production.

- Increase in the price of petrol by OPEC compels the government to increase the price of petrol and diesel. These two important raw materials are needed by every sector, especially the transport sector. As a result, transport costs go up resulting in higher general price level.

- Again, CPI may be induced by wage-push inflation or profit-push inflation. Trade unions demand higher money wages as a compensation against inflationary price rise. If increase in money wages exceed labour productivity, aggregate supply will shift upward and leftward. Firms often exercise power by pushing prices up independently of consumer demand to expand their profit margins.

Causes for Cost-Push Inflation

- Fiscal policy changes, such as increase in tax rates also leads to an upward pressure in cost of production. For instance, an overall increase in excise tax of mass consumption goods is definitely inflationary. That is why government is then accused of causing inflation.

- Finally, production setbacks may result in decreases in output. Natural disaster, gradual exhaustion of natural resources, work stop-pages, electric power cuts, etc., may cause ag-gregate output to decline. In the midst of this output reduction, artificial scarcity of any goods created by traders and hoarders just simply ignite the situation.

- Inefficiency, corruption, mismanagement of the economy may also be the other reasons. Thus, inflation is caused by the interplay of various factors. A particular factor cannot be held responsible for any inflationary price rise.

Effect of Inflation

- **Effects of Inflation on Distribution of Income and Wealth:**

During inflation, usually people experience rise in incomes. But some people gain during inflation at the expense of others. Some individuals gain because their money incomes rise more rapidly than the prices and some lose because prices rise more rapidly than their incomes during inflation. Thus, it redistributes income and wealth.

Effect of Inflation

Effect of Inflation on Creditors and debtors:

- Borrowers gain and lenders lose during inflation because debts are fixed in rupee terms. When debts are repaid their real value declines by the price level increase and, hence, creditors lose. An individual may be interested in buying a house by taking loan of Rs. 7 lakh from an in-stitution for 7 years.

- The borrower now welcomes inflation since he will have to pay less in real terms than when it was borrowed. Lender, in the process, loses since the rate of interest payable remains unaltered as per agree-ment. Because of inflation, the borrower is given 'dear' rupees, but pays back 'cheap' ru-pees. However, if in an inflation-ridden economy creditors chronically loose, it is wise not to advance loans or to shut down business.

Effect of Inflation

- **Effect on Bond and debenture-holders:**

In an economy, there are some people who live on interest income—they suffer most. Bondhold-ers earn fixed interest income: These people suffer a reduction in real income when prices rise. In other words, the value of one's sav-ings decline if the interest rate falls short of inflation rate. Similarly, beneficiaries from life insurance programmes are also hit badly by inflation since real value of savings deterio-rate.

- **Effect on Investors:**

People who put their money in shares during inflation are expected to gain since the possibility of earning of business profit brightens. Higher profit induces own-ers of firm to distribute profit among inves-tors or shareholders.

Effect Inflation

- **Effect on Salaried people and wage-earners:**

Any-one earning a fixed income is damaged by inflation. Sometimes, unionised worker succeeds in raising wage rates of white-collar workers as a compensation against price rise. But wage rate changes with a long time lag. In other words, wage rate increases always lag behind price increases. Naturally, inflation results in a reduction in real purchasing power of fixed income-earners.

On the other hand, people earning flexible incomes may gain during inflation. The nominal incomes of such people outstrip the general price rise. As a result, real incomes of this income group increase.

Effect Inflation

- **Effect on Profit-earners, speculators and black marketeers:**

It is argued that profit-earners gain from inflation. Profit tends to rise during inflation. Seeing inflation, businessmen raise the prices of their products. This results in a bigger profit. Profit margin, however, may not be high when the rate of inflation climbs to a high level.

However, speculators dealing in business in essential commodities usually stand to gain by inflation. Black marketers are also benefited by inflation.

Thus, there occurs a redistribution of in-come and wealth. It is said that rich becomes richer and poor becomes poorer during infla-tion. However, no such hard and fast gener-alisation can be made. It is clear that someone wins and someone loses during inflation.

Effect of Inflation

- **Effect on Production and Economic Growth:**

Inflation may or may not result in higher output. Below the full employment stage, inflation has a favourable effect on production. In general, profit is a rising function of the price level. An inflationary situation gives an incentive to businessmen to raise prices of their products so as to earn higher volume of profit. Rising price and rising profit encourage firms to make larger investments.

As a result, the multiplier effect of investment will come into operation resulting in a higher national output. However, such a favourable effect of inflation will be temporary if wages and production costs rise very rapidly.

Effect of Inflation

Further, inflationary situation may be associated with the fall in output, particularly if inflation is of the cost-push variety. Thus, there is no strict relationship between prices and output. An increase in aggregate demand will increase both prices and output, but a supply shock will raise prices and lower output.

One may also argue that inflation creates an air of uncertainty in the minds of business community, particularly when the rate of in-flation fluctuates. In the midst of rising infla-tionary trend, firms cannot accurately estimate their costs and revenues. That is, in a situa-tion of unanticipated inflation, a great deal of risk element exists.

It is because of uncertainty of expected inflation, investors become reluc-tant to invest in their business and to make long-term commitments. Under the circum-stance, business firms may be deterred in in-vesting. This will adversely affect the growth performance of the economy.

How to Control Inflation?

1. Monetary measures
2. Fiscal measures
3. Wage and price controls
4. Other Measures
5. Two Group of Thoughts

Monetary Measures

- Most central banks use high interest rates and slow growth of the money supply as the traditional way to fight or prevent inflation.
- Monetary measures used to control inflation include: Bank Rate Policy of Credit Control, Cash Reserve Ratio, Open Market Operations, Maintaining Gold Standard, Fixed Exchange Rates

Bank Rate Policy

- Bank rate is the rate charged by the central bank for lending funds to commercial banks.

- Bank rate policy is used as the main common tool against 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.

Cash Reserve Ratio (CRR)

- Cash Reserve Ratio (CRR) is a certain minimum amount of deposit that the commercial banks have to hold as reserves with the central bank.

- To control inflation, the central bank should raise the CRR which reduces the lending capacity of the commercial banks. Consequently, flow of money from commercial banks to public decreases.

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 should sell 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.

Maintaining Gold Standard

- The gold standard is a monetary system in which a regions common media of exchange are freely convertible into pre-set, fixed quantities of gold. The standard specifies how the gold backing would be implemented, including the amount of gold per currency unit. Economies based on the gold standard rarely experience inflation above 2percent annually. Thus inflation here is determined by the growth rate of the supply of gold relative to total output.

Fixed exchange rates

- Under a fixed exchange rate currency regime, a country's currency is tied in value to another single currency or to a basket of other currencies (or sometimes to another measure of value, such as gold). A fixed exchange rate is usually used to stabilize the value of a currency, vis-a-vis the currency it is pegged to. It can also be used as a means to control inflation. However, as the value of the reference currency rises and falls, so does the currency pegged to it.

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.).
- Reduction in Unnecessary Expenditure
- Increase in Taxes
- Increase in Savings
- Surplus Budgets

Wage and Price Control

- Adjust wages as prices fluctuate. Wage and price controls have been successful in war time environments in combination with rationing.

Other Measures

- To Increase Production: This quenches the excess demand of a commodity and lowers its price.
- Cost-of-living allowance: In many countries, employment contracts, pension benefits, and government entitlements are tied to a cost-of-living index, typically to the CPI. A cost-of-living allowance (COLA) adjusts salaries based on changes in a cost-of-living index

Two Groups of Thoughts

- ***Monetarists*** emphasize keeping the growth rate of money steady, and using monetary policy to control inflation (increasing interest rates, slowing the rise in the money supply).

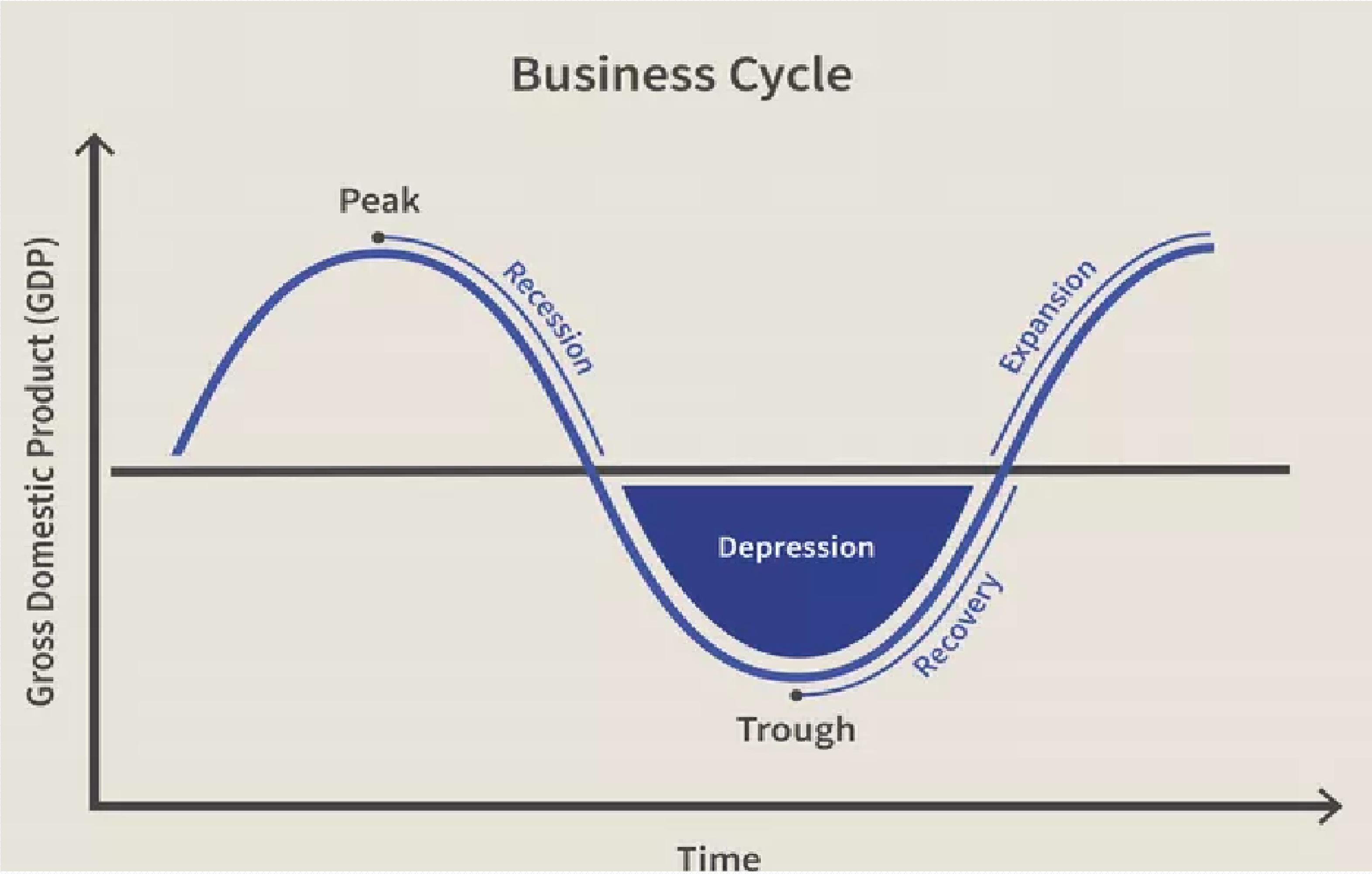
- ***Keynesians*** emphasize reducing aggregate demand during economic expansions and increasing demand during recessions to keep inflation stable. Control of aggregate demand can be achieved using both monetary policy and fiscal policy.

Business cycle

The term **business cycle** (or **economic cycle**) refers to economy-wide fluctuations in production or economic activity over several months or years. These fluctuations occur around a long-term growth trend, and typically involve shifts over time between periods of relatively rapid economic growth (expansion or boom), and periods of relative stagnation or decline (contraction or recession).

- Peak or prosperity
- Recession
- Depression
- Trough
- Recovery
- Expansion of economic activity

The Phases of the Business Cycle



Explanation

Expansion: **The first stage in the business cycle is expansion. In this stage, there is an increase in positive economic indicators such as employment, income, output, wages, profits, demand, and supply of goods and services. Debtors are generally paying their debts on time, the velocity of the money supply is high, and investment is high. This process continues as long as economic conditions are favorable for expansion..**

Peak: **The economy then reaches a saturation point, or peak, which is the second stage of the business cycle. The maximum limit of growth is attained. The economic indicators do not grow further and are at their highest. Prices are at their peak. This stage marks the reversal point in the trend of economic growth.**

Recession : **The recession is the stage that follows the peak phase. The demand for goods and services starts declining rapidly and steadily in this phase. Producers do not notice the decrease in demand instantly and go on producing, which creates a situation of excess supply in the market. Prices tend to fall. All positive economic indicators such as income, output, wages, etc., consequently start to fall.**

Depression : There is a commensurate rise in unemployment. The growth in the economy continues to decline, and as this falls below the steady growth line, the stage is called a depression.

Trough: In the depression stage, the economy's growth rate becomes negative. There is further decline until the prices of factors, as well as the demand and supply of goods and services, contract to reach their lowest point. The economy eventually reaches the trough. It is the negative saturation point for an economy.

Recovery: After the trough, the economy moves to the stage of recovery. In this phase, there is a turnaround in the economy, and it begins to recover from the negative growth rate. Demand starts to pick up due to low prices and, consequently, supply begins to increase. The population develops a positive attitude towards investment and employment and production starts increasing.

Possible Questions

1. As an adviser to the Ministry of Finance suggest and explain important fiscal measures to control the price rising situation in the economy.

2. Explain the monetary policy of controlling inflation.

3. What is inflation? Explain causes of inflation.

4. Explain the following fiscal measures to control inflation in an economy

(i) Increase in Taxation

(ii) Reduction in Public Expenditure

5. Explain the following measures to check inflation.

(i) Open Market Operation (OMO)

(ii) Statutory Liquidity Ratio (SLR)

6. With the help of right figures clearly demonstrate the Demand-Pull and Cost-Push inflation. Between Demand-Pull and Cost-Push which one do you consider to be more responsible for inflationary situation in your economy?

7. Monetary measures are always instrumental in controlling the inflationary situation of an economy. In light of this explain the following monetary measures taken by the apex bank for curbing inflationary pressure

(i)Statutory Liquidity Ratio

(ii)Cash Reserve Ratio

Thank You