8.3 TYPES OF INFLATION

The persistent rise in prices may be of various magnitudes. Accordingly, inflation can be of different types, depending upon the rate of increase in prices. *On the basis of rate of inflation, inflation can be following types:*

1. **Creeping or Mild Inflation:** It occurs when the price level rises at a very slow rate (less than 3% per annum).
2. **Walking or Trotting Inflation:** It occurs when the price level rises at an intermediate range of 3% to 6 per cent per annum.
   - The annual inflation rate is of a single digit.
   - It is a warning signal for the government to control it before it turns into running inflation.
3. **Running Inflation:** It occurs when the sustained rise in prices is over 8% and is generally around 10% per annum.
   - It normally shows two-digit inflation.
   - It affects the poor and middle classes adversely.
   - Its control requires strong monetary and fiscal measures, otherwise it leads to galloping inflation.
4. **Galloping Inflation:** It occurs when the price rises by double or triple digit inflation rates. It means, if prices rise by more than 10% but less than 1000% per annum, then galloping inflation occurs.
   - It is also referred as Jumping inflation.

- India has been witnessing galloping inflation since the second five year plan period.

5. **Hyperinflation Inflation:** It refers to a situation when the prices rise at an alarming high rate. The prices rise so fast that it becomes very difficult to measure its magnitude.
   - In quantitative terms, when prices rise above 1000% per annum, it is termed as Hyperinflation.
   - Hyperinflation is an indication of the highest degree of abnormality in the monetary system of a country.

8.4 DEMAND-PULL INFLATION AND COST-PUSH INFLATION

Demand-Pull Inflation

Demand-pull inflation occurs when the aggregate demand of goods and services exceeds the aggregate supply of goods and services at the existing prices, i.e., when there is excess demand for goods and services. Demand-Pull inflation is a phenomenon of *'Too much money chasing too few goods'*.

- It is also known as *"Excess Demand Inflation"*.
- Excess demand pulls up the price level and leads to emergence of inflation.
- *Causes of demand-pull inflation:* This excess demand for goods and services occurs due to:

  (i) Exploding Population
  (ii) Rising Money Incomes
  (iii) Expansion in Money Supply
  (iv) Rising Volume of Black Money
  (v) Increase in Public Expenditure
  (vi) Increase in Investment

Cost-Push Inflation

Cost-Push Inflation occurs due to increase in cost of production without the corresponding increase in the productivity.

- This type of inflation occurs due to forces operating from the supply side or the cost side. So, it is also known as supply or cost theory of inflation.
- *Causes of cost-push inflation:* It is caused due to:

  (i) Increase in the wages
  (ii) Increase in profit margin
  (iii) Higher taxes
  (iv) Fall in the availability of basic inputs
  (v) Administered higher prices of inputs

8.5 CAUSES OF INFLATION

There are many factors or reasons which lead to inflation. Some of the main causes are:

1. **High Growth rate of Population:** In India, population is increasing at a very high rate and it is putting heavy pressure on the aggregate demand and on the price level of the country.
2. **Increase in Public Expenditure:** Government expenditure has been steadily and continuously increasing over the years. Continuous increase in the Government expenditure puts large money incomes in the hands of general public as expenditure of the Government becomes income for the people. It leads to growing public demand for goods and services and consequent rise in prices.
3. **Increase in Money Supply:** There has been persistent increase in the supply of money since the second five year plan, without any equivalent increase in the Gross Domestic Product (GDP). It has increased the purchasing power of public, which in turn, raises the demand for goods.
4. **Deficit Financing:** Deficit financing refers to printing of currency by Reserve Bank of India to meet deficit (shortage) of money in the Government budget. The rising expenditure of the government is responsible for adopting deficit financing as a method of financing economic development. Printing of new currency increases the money supply, which raises the aggregate demand for goods and services.
5. **Growth of Black Money:** Black money refers to that money which is acquired after evading taxes. Black money is generally used for financing non-productive activities like investment in real estate, purchase of gold, hoarding and black marketing of essential goods, etc. All these give rise to inflation.
6. **Increased Taxation:** With every budget, the government increases the amount of Indirect taxes (taxes on goods and services). It gives an opportunity to the trading classes to raise the prices (often more than the rate of taxes). Such taxes are responsible for pushing up the price level in the country.
7. **Hoarding of Essential Commodities:** At the time of shortage of goods, there is a tendency on the part of traders and merchants to hoard essential commodities for making huge profits. Such a hoarding creates scarcity in the market and leads to still greater rise in prices.
8. **Wage and Cost spiral:** In modern times, strong trade unions are generally successful in increasing the wages of their workers without an equal increase in productivity. Such a rise in wages pushes up the production costs, which in turn push up the prices.

9. **Easy Finance Facilities:** Easy availability of credit for the purchase of consumer goods has significantly raised the level of aggregate demand in India, which in turn, pushes up the price level in the country.

10. **Rise in Administered prices:** Price level in the country is also increasing due to continuous upward revision of several administered prices such as those of petrol, diesel, coal, etc.

8.6 ADVERSE EFFECTS OF INFLATION (PROBLEMS DUE TO INFLATION)

Inflation has caused certain serious imbalances in the Indian economy. The main harmful effects of inflation are as follows:

1. **Creates Business Uncertainty:** Unless price rises are predictable, they introduce an element of uncertainty into the economy. Production is adversely affected on account of business uncertainty. Persistent rise in price level discourages the entrepreneurs from taking risks involved in production.

2. **Adverse effect on Balance of Payment:** Inflation often leads to increased import and/or reduced export. This results in deficit in the balance of payments, which in turn causes a drain on the foreign exchange reserves.

3. **Rise in Inequalities in Income:** During inflation, speculators and profiteers gain without any effort on their part. Thus, inflation gives rise in disparities in the distribution of income and wealth.

4. **Leads to hoarding and Black marketing:** During inflation, the traders hoard essential goods with the aim of getting higher profits. The buyers also hoard essential goods for the fear of paying higher prices in future. Thus, inflation leads to growth of black marketing.

5. **Adverse effects on savings and investment:** Persistent rise in price level reduces the value of money, which reduces the purchasing power. It leads to fall in savings and investment.

6. **Adverse effect on weaker sections:** The continuous rise in prices adversely affects the consumption of the weaker sections of the population as they are not compensated for the rise in prices.

8.7 POLICIES TO CONTROL INFLATION

In view of the serious adverse effects of inflation, it is very important that inflation must be effectively controlled before it starts threatening the very existence of economic and political system of the country. The measures, which can be used to control inflation are broadly categorised as:

- Monetary Policy
- Fiscal Policy
- Other Measures

Monetary Policy

Monetary Policy is the policy of Central Bank to control money supply and credit creation in the economy. India's Central Bank is the Reserve Bank of India (RBI). Following two instruments of monetary policy are used by RBI to control inflation:

Quantitative Instruments

These instruments aim to influence the total volume of credit in circulation. Major instruments or measures are:

1. **Increase in Bank Rate:** The term 'Bank Rate' refers to the rate at which central bank lends money to commercial banks as the lender of last resort. *During inflation, central bank increases the bank rate, which raises the cost of borrowings from the central bank.* It forces the commercial banks to increase their lending rates, which discourages borrowers from taking loans. It reduces the availability of credit in the economy and helps to correct inflation.
2. **Open Market Operations (Sale of securities):** Open market operations refer to sale and purchase of securities in the open market by the central bank. It directly influences the level of money supply in the economy. *During inflation, central bank offers securities for sale.* Sale of securities reduces the reserves of commercial banks. It adversely affects the bank's ability to create credit and helps to control inflation.
3. **Increase in Legal Reserve Requirements (LRR):** Commercial banks are obliged to maintain legal reserves. There are two components of legal reserves:
   (i) *Cash Reserve Ratio (CRR)*: It is the minimum percentage of net demand and time liabilities, to be kept by commercial banks with the central bank.
   (ii) *Statutory Liquidity Ratio (SLR):* It refers to minimum percentage of net demand and time liabilities, which commercial banks are required to maintain with themselves.

   To correct inflation, *the central bank increases CRR or/and SLR.* It reduces the amount of effective cash resources of commercial banks and limits their credit creating power. It ultimately helps in controlling inflation in the economy.

Qualitative Instruments

These instruments aim to regulate the direction of credit. Major qualitative instruments or measures are:

1. ***Increase in Margin Requirements:*** Margin requirement refers to difference between the market value of security offered and the value of amount lent. When the economy is suffering from inflation, *central bank increases the margin, which restricts the credit creating power of banks.* Borrowers find it less attractive to borrow money and it helps to control inflation.
2. ***Moral Suasion (Advise to Discourage Lending):*** This is a combination of persuasion and pressure that Central Bank applies on other banks in order to get them act, in a manner, in line with its policy. Moral suasion is exercised through discussions,

letters, speeches and hints to banks. During inflation, *the central bank advises, requests or persuades the commercial banks not to advance credit* for speculative or non-essential activities. It helps to control inflation.

3. ***Selective Credit Controls (Introduce Credit Rationing):*** It refers to a method in which the central bank gives directions to other banks to give or not to give credit for certain purposes to particular sectors. During inflation, *the central bank introduces rationing of credit in order to prevent excessive flow of credit,* particularly for speculative activities. It helps to wipe off the excess demand and helps in controlling inflation in the economy.

Fiscal Policy

Fiscal policy refers to the policy of central government to control the situation of money supply in the economy. It is also known as 'Revenue and Expenditure Policy'. Government can control inflation through its fiscal policy. The main constituents or tools or instruments of Fiscal Policy are:

1. **Expenditure Policy** *(Decrease in Government Spending)*: Government spends huge amount on infrastructural and administrative activities. To control the situation of inflation, Government should reduce its expenditure to the maximum possible extent. More emphasis should be placed to reduce expenditure on defense and unproductive works as they rarely help in growth of a country. *Decrease in Government spending will reduce the level of aggregate demand in the economy and helps to correct inflationary pressures in the economy.*
2. **Revenue Policy** *(Increase in taxes)*: *Revenue policy of the government is expressed in terms of taxes.* Government imposes different kinds of direct and indirect taxes on the public. During inflation, government increases the rates of taxes and even imposes some new taxes. It leads to decrease in the level of aggregate expenditure in the economy and helps to control inflation.
3. **Public Borrowings** *(Increase in borrowings)*: Government borrows money from public in the form of public deposits. During inflation, government borrows money from the public to withdraw excess money held by them. It helps to reduce the money supply in the economy and helps in controlling inflation.
4. **Deficit Financing** *(Decrease)*: Deficit financing, i.e. printing of currency increases the supply of money in the economy. During inflation, government avoids deficit financing to prevent increase of money supply.

Other Measures

There are certain other measures also, which can be undertaken to control inflation. These measures are discussed below:

1. **Income Policy:** The primary objective of income policy is to ensure that wages, salaries and other incomes should increase in tune with increase in productivity. The rise in income of any factor should be consistent with the rise in productivity,

in order to control inflation. However, it is difficult to implement such a policy, especially in case of wage incomes due to pressure of trade unions.

2. **Price Control of Essential Items:** Under price control policy, the government fixes the maximum price at which certain commodities could be sold. Prices of essential goods need to be controlled in order to ensure their availability to all sections of the society.
3. **Improvement in Public Distribution System:** Price control policy needs to be accompanied by rationing. Under rationing, specified quantity of goods is given to consumers at the controlled price through Public Distribution System (PDS). Government should take reasonable steps to improve PDS so that essential commodities can be made available to the weaker sections at the controlled prices.
4. **Increase in availability of goods:** The problem of inflation can be controlled to a great extent by increasing the availability of goods in the economy. It needs two measures:
   (a) *Increase in Domestic Production:* The domestic production should be increased by allocating more resources, providing subsidies and removing bottlenecks which obstruct the production of these goods.
   (b) *Import Goods:* If domestic production falls short of demand, then government should go for import of essential items, so as to minimise inflationary pressures.
5. **Population Control Measures:** Effective population control measures will help a lot in reducing excess demand and controlling inflation.