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Inflation

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The term inflation refers to a general rise in prices. To be more precise it refers to a persistent rise in the general price level. Inflation is defined by economists in various ways. According to Prof. Crowther "inflation is a state in which the value of money is falling i.e. prices are rising". According to Prof. Hawtrey "inflation refers to the issue of too much currency". Inflation is defined by Edward Shapiro as "a persistent and appreciable rise in the general level of prices". Some economists consider inflation as a purely monetary phenomenon while others consider it as a post full employment phenomenon. Generally, it is regarded as situation where too much of money chases too few goods.

TYPES OF INFLATION:

Inflation has been classified into various types on the following grounds:

(1) On the basis of rate of inflation:

(a) **Creeping inflation:** When the rate of inflation is 3 percent per annum, it is termed as creeping inflation. This is considered as mild inflation and it is said to be a tolerable one. A mild inflation is said to be good for the economy as the rise in price will lead to more profits leading to more investments.

(b) **Walking inflation:** When the inflation rate is between 3-6% it is termed as walking inflation.

Prof. Samuelson clubbed creeping and walking inflation together and termed it as moderate inflation. According to him moderate inflation should not be allowed to become galloping inflation. Otherwise moderate inflation will not have beneficial effects on the economy.

(c) **Running inflation:** When the rate of inflation is between 10-20% it is called running inflation.

(d) **Galloping inflation:** Here the price rise would be more than 20%. It is a serious problem as it will erode the purchasing power of the people and affect all the sectors of the economy.

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(e) **Hyper inflation:** In this case price level will rise every moment. The change in price would be difficult to measure as the rise in price would be very severe. In terms of percentage it would be more than 1000% per year. Austria, Hungary, the former U.S.S.R., Poland and Germany experienced hyper inflation during the First World War period. Germany experienced severe hyper inflation in 1924. The nature of this type of inflation was indicated by Prof. Samuelson's statement that "we used to go to the store with money in our pockets and come back with food in our baskets. Now we go with money in baskets and return with food in our pockets. Everything is scarce except money." Hyper inflation is a very serious problem as it always creates severe distortions in the economy.

The above types of inflation can be depicted diagrammatically below:

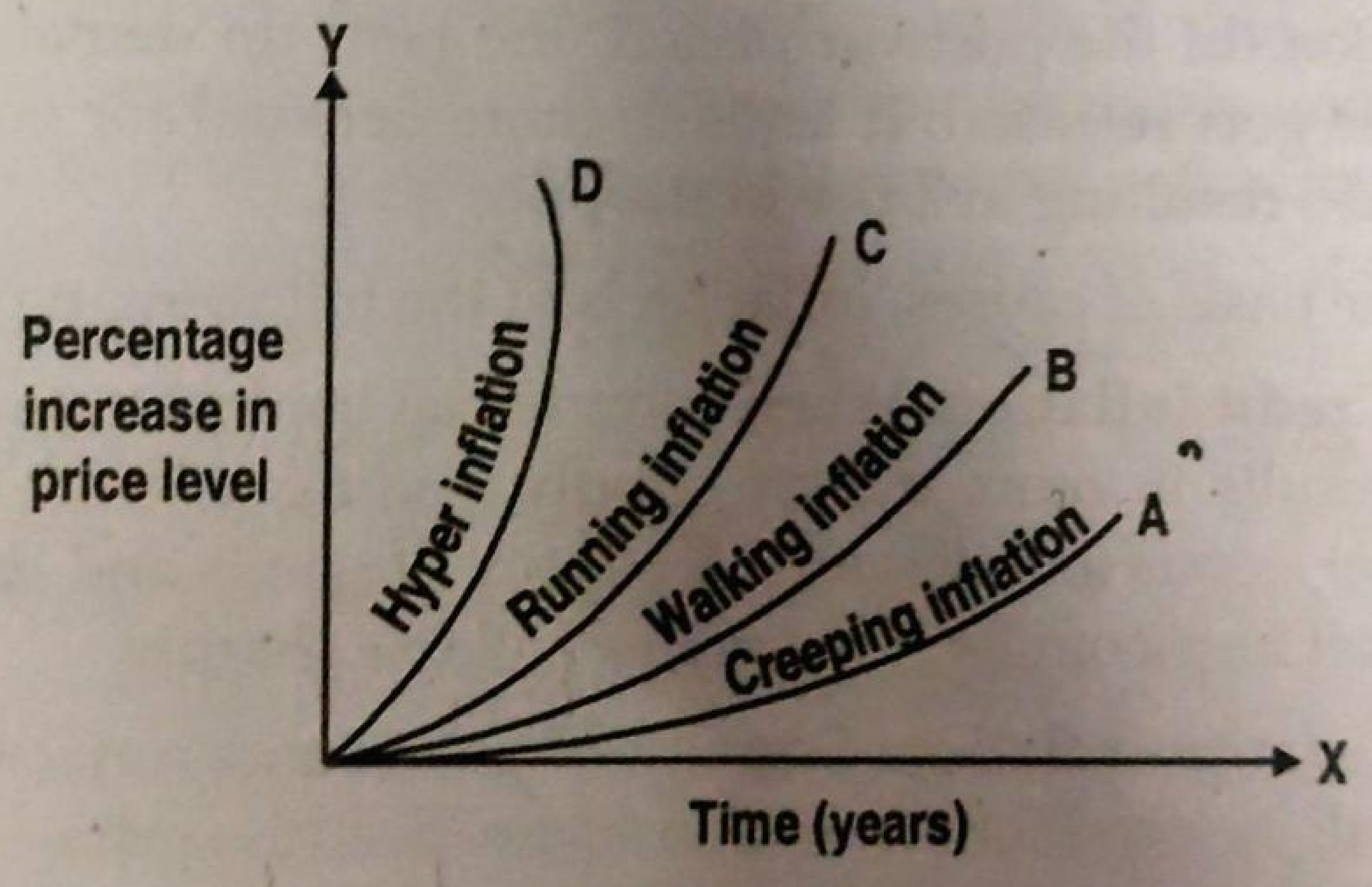

Fig. 11.1

2) **On the basis of government's intervention:** Inflation is classified into open inflation and repressed inflation based on government's response. Repressed inflation is one in which the government takes measures to control inflation. Open inflation refers to a situation where the government does not

interfere in controlling inflation. It is left to market forces to regulate the rise in prices.

(3) **On the basis of coverage, inflation is divided into sporadic inflation and comprehensive inflation:** When inflation occurs in a particular sector of the economy, it is said to be sporadic in nature. If it covers the entire economy, it is termed as comprehensive inflation.

(4) Time period is also used to classify inflation as peacetime inflation, war time inflation and post war inflation. Peacetime inflation occurs due to excessive expenditure of the government. When government invests on a number of projects, money supply increases and the demand for goods and services also start increasing. If supply is not forthcoming, then prices tend to rise. This is termed as peacetime inflation. War time inflation refers to the rise in prices during war time. During the period of war resources of the country would be diverted towards defence purposes. Hence the supply of civilian goods will be affected leading to inflation. In the postwar period, the pent up demand of the people gets released. It leads to more demand for goods and services resulting in a rise in the price level.

(5) On the basis of causes, inflation is of the following types:

(a) **Credit inflation:** When commercial banks create credit, it results in more money supply leading to more demand for goods and services. If supply of goods and services is not forthcoming, then prices will rise sharply.

(b) **Scarcity inflation:** Scarcity of goods and services due to fall in production or due to artificial hoarding leads to scarcity induced inflation.

(c) **Deficit inflation:** When government's expenditure exceeds its revenue, it has a deficit budget. To meet the excess expenditure, it resorts to deficit financing. Deficit financing refers to creation of new money by the central bank. Under economic planning many projects and schemes are launched by the government to accelerate the growth rate. This leads to more money supply, mor...

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demand for goods and rise in the price level. This inflation due to deficit financing is called deficit inflation.

(d) **Currency inflation:** When the supply of money is more than the supply of goods and services, then prices tend to rise which is known as currency inflation.

(e) **Profit inflation:** Profit inflation is induced by the excess profits earned by the entrepreneurs. Generally during inflation, the entrepreneurial class earns more profit due to rise in prices. This increase in the profits encourage them to invest more. Alongwith an increase in investment, real goods and services should increase. Otherwise the economy will be affected by profit inflation.

(f) **Tax inflation:** Due to increase in the rates of commodity taxes like excise duty, sales tax etc. prices of goods tend to rise. This is known as tax inflation.

(g) **Wage inflation or cost inflation:** When prices rise due to a rise in the cost of production it is said to be cost inflation. Cost of production consists of various components like wages, rent, interest and normal profit. Of this wages are an important component. Cost inflation often occurs due to a rise in the wage rate of the workers.

(h) **Foreign trade induced inflation:** When a country experiences export boom, if supply does not keep pace with the demand for exports, then prices will start shooting up. Moreover increased exports will lead to more export earnings. This in turn will result in rise in prices which is termed as export induced inflation. This is one of the types of foreign trade inflation. Another type of inflation is the import price like inflation wherein the rise in the price of imported components will lead to a rise in the price of the final product. This is known as import induced inflation.

Apart from the above types of inflation, economists give lot of importance to two types of inflation namely demand

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pull inflation and cost push inflation. They can be elabor
as follows:

(i) **Demand-pull Inflation:** The concept of demand
inflation was developed by J. M. Keynes. It refers to
type of inflation which arises due to aggregate dem
for goods and services being more than the supply
goods and services. The demand for goods and serv
may be more due to increase in money supply. Dem
pull inflation is generally associated with the level of
employment. Full employment refers to a situation wh
the resources of the economy are fully employed. In s
a situation, if money supply increases, demand for go
and services will increase. However, supply canno
increased as resources are fully utilised. Other factors
increase in public expenditure, increase in investme
increase in export earnings etc. can lead to an increase
demand and this in turn lead to demand pull inflati
Demand-pull inflation can be explained with the help
the following diagram:

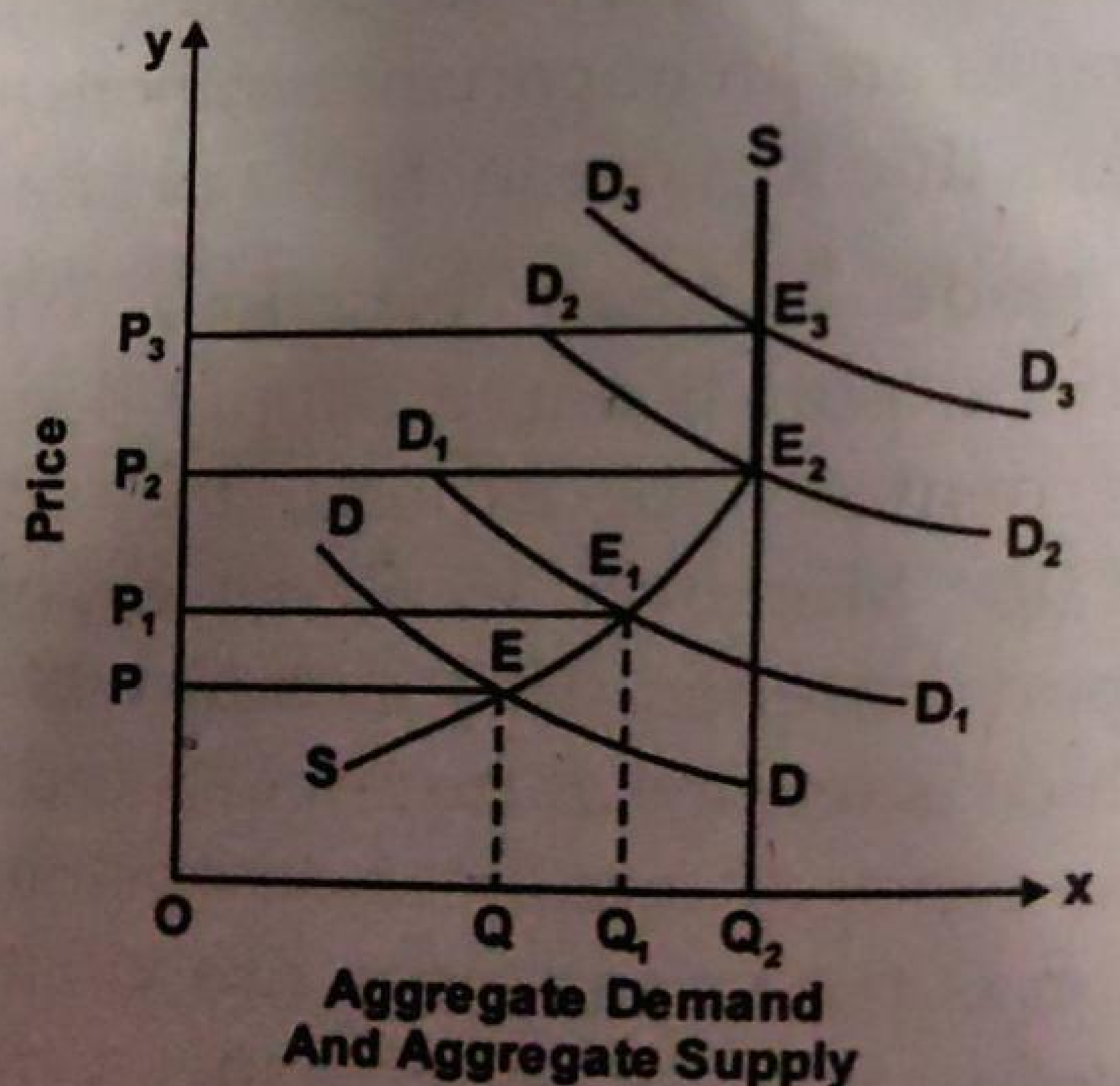

Fig. 11.2

Equilibrium price is determined at the point wh
demand for goods is equal to its supply. In the abo
diagram initially the demand curve intersects the sup

curve at point E. The equilibrium price is OP. When demand increases from DD to D_1D_1, supply increases from OQ to OQ_1. Still price rises from OP to OP_1. The supply curve slopes upwards upto point E_2 and afterwards it becomes a vertical straight line. It implies that the economy has attained full employment situation. If demand increases further, price level will continue to rise further. At the full employment level, the equilibrium price is OP_2 and the quantity demanded and supplied is equal to OQ_2. If demand increases further, supply cannot be increased. As a result, price level will continue to rise further. This rise in price level is known as demand pull inflation. Initially, when demand rises, supply increases. But at the same time price level also increases. This is termed as bottleneck inflation. In the diagram this is indicated upto point E_2. After that full employment is attained and when demand rises, supply does not increase leading to demand pull inflation. According to Keynes, inflation which occurs after full employment is attained is known as true inflation. Increase in public expenditure, increase in marginal propensity to consume of the people, higher investment, increased earnings through exports and diversification of resources from the civilian sector to the defence sector or from consumer goods to capital goods industries are considered as the factors responsible for demand pull inflation.

(ii) **Cost-push Inflation:** Cost-push inflation refers to the rise in the price level due to a rise in cost of production. Contrary to demand pull inflation, some economists are of the opinion that a rise in cost of production is the root cause for inflation and this inflation is also termed as 'cost inflation'. Cost-push inflation may occur due to a rise in the wage rate or due to a rise in the rate of profit. Of the various components of cost of production, wages are a major component. When the demand for labour is more, wage rates tend to rise. It adds to the cost of production and the employers try to pass on this burden

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... of inflation. ... declining which led been initiated to boost the growth rate and employment. Further reforms have also

CAUSES OF INFLATION:

Inflation arises due to a variety of factors. It is a complex phenomenon. It is very difficult to attribute one particular cause for the rise in prices. The most important causes of inflation are:

(1) **Factors influencing the demand side:**

(a) **Expansion of money supply:** Money supply will expand whenever banks create too much credit, government adopts deficit financing and incurs huge defence expenditure. The increased money supply will lead to more demand for goods and services causing inflationary spiral in the economy.

(b) **Increase in disposable income:** Disposable income refers to the income available to the person for spending after meeting the tax commitments. Whenever disposable income increases due to a reduction in tax rate or increase in income, demand for goods and services will increase leading to inflation.

(c) **External demand:** When demand from foreigners rise, availability of goods to the domestic population will be affected leading to rise in prices.

(d) **Rise in expenditure:** Increase in the expenditure of the households and business firms will also lead to inflation. Households tend to spend more when there is an increase in their disposable income, use their past savings for present consumption etc. When demand for goods and services increases, investment of the entrepreneurs will increase leading to more employment, more income

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and more demand for goods and services. This increased demand will result in a rise in the price level.

(e) **Future expectations:** If people expect the prices to rise in future, more will be demanded at present causing an increase in the price level.

(2) **Factors influencing the supply side:** Inflation arises when demand for goods and services is more than the supply of goods and services. Supply may not keep pace with demand due to the following factors:

(a) **Inadequate resources:** Lack of resources in terms of labour, raw materials, spare parts etc. will lead to shortage of production of goods and services resulting in inflation.

(b) **Hoarding and black marketing:** Traders resort to hoarding and black marketing when they expect shortage of goods and services. This leads to artificial scarcity and prices tend to rise. Households also would like to store more if they expect scarcity of goods. This will result in more demand leading to further rise in the price level.

(c) **Natural calamities:** Natural calamities like floods, droughts etc. affect the supply of foodgrains and raw materials resulting in a rise in the price level.

(d) **Exports:** If more goods are diverted to the external market, there will be shortage of supply in the domestic market inducing the prices to go up.

(e) **Full employment situation:** If the economy has attained already full employment of resources, supply cannot be increased with an increase in demand. This will lead to an inflationary spiral in the economy.

Thus inflation could emerge due to factors operating on either demand side or supply side or both.

EFFECTS OF INFLATION:

Inflation is one of the serious socio-economic problems. It affects the different sections of the economy differently. Inflation has been rightly remarked as "public enemy number one" by presidents Ford and Carter. The various effects of inflation are as follows:

A mild inflation, according to Keynes is beneficial for the economy. If there is mild inflation, the moderate rise in price will encourage entrepreneurs to increase investments and production. This is because of the increase in profits. Increased production will lead to more employment and more income and more demand for goods and services. The beneficial effects will not last forever. When the rate of inflation becomes higher, serious consequences will emerge. The following are the effects of inflation on productive activities.

EFFECTS OF INFLATION ON PRODUCTION:

(1) **Adverse effects on capital formation:** Inflation reduces the savings of the public as the cost of living rises. Less savings leads to less investment and poor capital formation. This will result in less production, employment and income.

(2) **Production distortions:** Inflation distorts the pattern of production by diverting resources to the production of non-essential goods from essential goods. The goods demanded by the rich gets priority while the mass consumption goods get neglected.

(3) **Hoarding and black marketing:** The supply of goods and services gets affected due to widespread hoarding and black marketing. Traders, businessmen and even households try to hoard goods. This leads to scarcity and pushes up the price level further. Traders and businessmen indulge in widespread black marketing to make quick profits.

(4) **Speculation:** Inflation leads to speculative activities and disrupts productive activities. Businessmen focus on speculation rather than on production as they aim at making quick profits.

(5) **Profit orientation and quality deterioration:** Inflation results in a seller's market whose main objective is profit maximisation. In the process quality of goods and services is ignored.

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(6) **Erosion in the value of money:** Inflation reduces the purchasing power of money. The confidence of the public gets eroded and this leads to flight of capital to other countries. This results in low investment and low production.

EFFECTS OF INFLATION ON DISTRIBUTION OF INCOME AND WEALTH:

Inflation affects different sections of the society differently. It is generally said to be redistributing income in favour of the rich people at the expense of the poor. Cost of production of goods tends to increase during inflation. However, prices would rise more than the rise in cost of production ensuring higher profits for businessmen. During inflation, traders, businessmen and speculators gain the maximum. Windfall gains accrue to the flexible income groups. The worst affected section during inflation is the fixed income group. Wage-earners, pensioners and those live on fixed savings constitute the fixed income group. Their real income will decline due to inflationary spiral in the economy. Through trade unions, labourers try to get higher wages to protect them against inflation. This leads to cost-push inflation, further eroding the purchasing power of the people. Pensioners and unorganised labour suffer severely during inflation.

Inflation affects debtors and creditors differently. Debtors benefit during inflation due to the fall in the value of money when they pay back their loans. During the period of inflation in real terms they will be paying less. The creditors on the other hand lose during inflation as they receive the money when the value of money is less.

Investors are also affected by inflation. Those who invest in shares are bound to reap good returns due to increase in the profits of the companies. On the other hand, those who invest in assets yielding fixed returns like debentures, fixed deposits etc. would be adversely affected.

Farmers benefit during inflation. The rise in the price of farm products enable the farmers to get a higher level of income. Though cost of production increases, prices rise at a faster rate ensuring greater profits for the farm community. Generally the benefits go to the rich farmers rath...

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Thus inflation redistributes income in favour of businessmen, debtors and farmers at the expense of fixed income groups, creditors and consumers. The poor people are the worst affected during inflation as inflation erodes their purchasing power and lowers their standard of living. The gap between the rich and the poor widens during inflation.

EFFECTS OF INFLATION ON CONSUMPTION AND WELFARE:

Inflation reduces the consumption of goods and services and affects the general welfare of the people. Higher prices reduce consumption of goods and lowers the standard of living of the people.

SOCIAL AND POLITICAL EFFECTS OF INFLATION:

Apart from economic effects, inflation also creates certain social and political effects. Inflation helps the rich to become richer and makes the poor people poorer. Inequality widens leading to social injustice. Inflation provides lot of scope for businessmen and traders to earn quick profits. It gives rise to a seller's market providing ample scope to sell sub-standard products at high prices. Adulteration, black marketing and hoarding of goods prevail on a large scale. People start losing faith in the government due to the hardships imposed by inflation and they start revolting against the government. Thus social harmony and political stability are at stake if inflation is not effectively controlled by the government.

Thus effects of inflation are many and generally inflation has adverse effects unless it is a mild one. If inflation persists for a long time, it disturbs the planning process, reduces the competitiveness of the economy in the international market and lowers the external value of the currency. To avoid the economic, social and political effects of inflation, all efforts should be taken to control it at the earliest.

MEASURES TO CONTROL INFLATION:

Inflation is a complex phenomenon. Variety of measures have to be used to control inflation. Inflation is the result of disequilibrium between demand and supply. Hence the measures

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are directed towards factors influencing demand and supply sides. The following measures are generally adopted to control inflation.

(1) Monetary Measures.

(2) Fiscal Measures and

(3) Other Measures.

These measures can be explained as follows:

(1) **Monetary Measures:** Generally, inflation is considered as a monetary phenomenon. It arises due to excessive money supply in the economy. The central bank controls money supply by controlling the credit created by commercial banks. The central bank uses two methods – quantitative and qualitative methods – to control the credit created by commercial banks. The quantitative method controls the total volume of credit created by the banking system. Bank rate, open market operation, cash reserve ratio are used to control the volume of credit. On the other hand, qualitative method aims at controlling the quality or direction of credit. Consumer credit regulation, varying the margin requirements, rationing of credit etc. are some of the instruments used here. These measures help in allocating the funds to the productive sectors of the economy.

(2) **Fiscal Measures:** The measures related to taxation, public expenditure and public debt are known as fiscal measures. During inflation, the government can use taxation, public expenditure and public debt in the following ways:

(a) To reduce the excess demand, the government can increase the tax rates and can also introduce new taxes. To mop up the excessive purchasing power in the hands of the rich people direct tax rates can be increased.

(b) Reduction in public expenditure will lead to a reduction in demand for goods and services and thereby prices can be stabilised.

(c) Public debt is an effective anti-inflationary measure. The borrowings of the government from the public will absorb the excess money supply leading to less demand for goods and services thereby resulting in decline in prices.

To control inflation effectively, modern governments use a combination of both fiscal and monetary measures.

(3) **Other Measures:**

(a) Incentives are offered by the government to the producers of essential items.

(b) Efforts are undertaken to increase the production of agricultural and industrial goods. By increasing supply, excess demand for goods and services can be easily managed.

(c) Controlling the prices of essential items and rationing of essential goods are also adopted.

(d) Through public distribution system, essential items are supplied at subsidised prices.

(e) Import of essential items may be resorted to face the shortage. It is a short term measure and it also depends on the balance of payments position.

(f) If inflation is due to a rise in wage rates then the government can bring about a wage freeze to avoid further rise in prices.

Thus inflation has to be tackled from various angles. All the above measures in the right combination are required to effectively control inflation. The long term solution to control inflation would be to accelerate economic growth. This requires a high level of savings and investment, suitable technology and optimum utilisation of resources.

DEFLATION:

Deflation refers to a situation where prices keep declining accompanied by a fall in employment, output and income. It occurs when there is a sustained fall in the price level. It is the opposite of inflation. Sometimes prices fall due to the measures taken by the government. However, such decline in prices are not termed as deflationary. Only when the decline in prices is

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