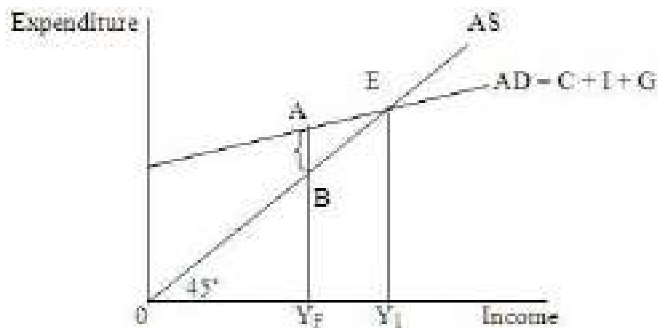
Inflation

Inflation may be defined as a persistent and appreciable rise in the general price level. Inflation is statistically measured in terms of percentage increase in the price index over a period of time usually a year or a month.

Inflationary gap: The inflationary gap is the amount by which aggregate demand exceeds aggregate supply at the full employment level of income. The inflationary gap is explained diagrammatically in the following figure.



In the figure YF is the full employment level of income, the 45° line represents aggregate supply (AS), and the C + I + G line represent the aggregate demand (AD). The economy's aggregate demand curve (AD) intersects the aggregate supply curve (AS) at point E at the income level OY1 which is greater than the full employment income level OYF. The amount by which aggregate demand YFA exceeds the aggregate supply YFB at the full employment income level is the inflationary gap. This is AB in the figure. Thus, the inflationary gap leads to inflationary pressures in the economy which are the result of excess aggregate demand.

Types of Inflation

There are several types of inflation in the economy which are classified on different basis. Some of the important types of inflation are discussed below.

Creeping, Walking, Running and Galloping Inflation:

(a) Creeping Inflation: When the rise in prices is very slow (less than 3% per annum) like that of a snail or creeper, it is called creeping inflation. Such an increase in prices is regarded safe and essential for economic growth.

(b) Walking or Trotting Inflation: When prices rise moderately and the annual inflation rate is a single digit (3% - 10%), it is called walking or trotting inflation. Inflation at this rate is a warning signal for the government to control it before it turns into running inflation.

(c) Running Inflation: When prices rise rapidly like the running of a horse at a rate of speed of 10% - 20% per annum, it is called running inflation. Its control requires strong monetary and fiscal measures, otherwise it leads to hyperinflation.

(d) Galloping or Hyperinflation: When prices rises between 20% to 100% per annum or even more, it is called galloping or hyperinflation. Such a situation brings a total collapse of the monetary system because of the continuous fall in the purchasing power of money.

Demand-Pull and Cost-Push Inflation:. Demand-pull inflation takes place when aggregate demand is rising while the available supply of goods is less. The monetarists emphasize the role of money as the principal cause of demand-pull inflation while the Keynesians emphasize the increase in aggregate demand as the causes of inflation. On the other hand, Cost-push inflation is caused by wage increases enforced by trade unions and profit increases by employers.

Comprehensive and Sporadic Inflation: When the prices of all commodities in the economy rise it is called comprehensive inflation. On the other hand, sporadic inflation is a sectoral inflation in which the prices of a few commodities rise because of certain physical bottlenecks which may impede any attempt to increase their production.

Open and Suppressed Inflation: Inflation is said to be open when the government takes no steps to control the rise in the price level. Thus open inflation is the result of the uninterrupted operation of the market mechanism. On the other hand, inflation is said to be suppressed when the government actively intervenes to check the rise in the price level.

Mark-up Inflation: This type of inflation resulted from the peculiar method of pricing adopted by the big business organizations. According to this method, the big business organizations calculate their production costs first and then add to these costs a certain mark-up to yield the targeted rate of profit.

Besides the above types of inflation, there are several other types of inflation which are classified on the basis of time or the causes of inflation. On the basis of time there are peacetime, wartime and postwar inflation. On the basis of factors causing inflation there are credit inflation, deficit-induced inflation, scarcity-induced inflation etc.

Causes of Inflation

Broadly speaking inflation arises when the aggregate demand exceeds the aggregate supply of goods and services. We analyse the factors which lead to increase in demand and the shortage of supply.

Factors Causing Increase in Demand: Both Keynesians and monetarists believe that inflation is caused by increase in the aggregate demand. Following are the factors which cause an increase in the size of demand:

Increase in Money Supply: Inflation is caused by an increase in the supply of money which leads to increase in aggregate demand. The higher the growth rate of nominal money supply, the higher is the rate of inflation.

Increase in Disposable Income: When the disposable income of the people increases, it raises their demand for goods and services. Disposable income may increase with the rise in national income or reduction in taxes or reduction in the saving of the people.

Increase in Public Expenditure: In modern world government activities have been expanding which resulted in increase government expenditure. This raised the aggregate demand for goods and services, thereby causing inflation.

Increase in Consumer Spending: The demand for goods and services also increases when consumer spending increases due to conspicuous consumption or demonstration effect.

Cheap Monetary Policy: Cheap monetary policy or the policy of credit expansion also leads to increase in the money supply which raises the demand for goods and services in the economy thereby leading to inflation. This is also known as credit-induced inflation.

Deficit Financing: In order to meet it’s mounting expenses, the government resorts to deficit financing by borrowing from the public and even by printing more notes. This raises aggregate demand in relation to aggregate supply, thereby leading to inflationary rise in prices.

Increase in Exports: When the demand for domestically produced goods increases in foreign countries, this raises the earnings of industries producing export commodities. These, in turn, create more demand for goods and services within the economy.

Apart from the above factors, expansion of the private sector, existence of black money and the repayment of public debt by the government also increases the aggregate demand for goods and services in the economy.

Factors Causing Shortage of Supply: Following are the factor which result in a reduction in the supply of goods and services:

Shortage of factors of production: When there is shortage of factors of production like labour, capital, raw materials, etc. there is bound to be reduction in the production of goods and services.

Industrial Disputes: In countries where trade unions are powerful, they resort to strikes and lock-outs which resulted in a fall in industrial production thereby reducing the supply of goods.

Natural Calamities: Natural calamities like droughts, floods, etc. adversely affects the supplies of agricultural products. This creates shortage of food products and raw materials, thereby helping inflationary pressures.

Artificial Scarcities: Artificial scarcities are created by hoarders and speculators who indulge in black marketing. Thus, they are instrumental in reducing supplies of goods and raising their prices.

Increase in Exports: When the country produces more goods for exports than for domestic consumption, this creates shortages of goods in the domestic market. This leads to inflation in the economy.

Lop-sided production: If the stress is on the production of comforts, luxuries, or basic products to the neglect of essential consumer goods in the country this creates shortages of consumer goods. This again causes inflation.

Law of Diminishing Returns: If industries in the country are using old machine and outmoded methods of production, the law of diminishing returns operates. This raises cost per unit of production, thereby raising the prices of products.

International Factors: In modern times, inflation is a worldwide phenomenon. When prices rise in major industrial countries, their effects spread to almost all countries with which they have trade relations.

Often the rise in price of a basic raw material like petrol in the international market leads to rise in the price of all related commodities in a country.

Measures To Control Inflation

Inflation is caused by the failure of aggregate supply to equal the increase in aggregate demand. Therefore, inflation can be controlled by increasing the supplies of goods and reducing money income. The various measures to control inflation are discussed below.

Monetary Measures

The monetary measures to control inflation generally aims at reducing money incomes. These are:

(a) Credit Control: The central bank could adopt a number of methods to control the quantity and quality of credit to reduce the supply of money. For this purpose, it raises the bank rates, sells securities in the open market, raises reserve ratio, and adopts a number of selective credit control measures, such as raising margin requirements and regulating consumer credit.

(b) Demonetisation of Currency: Another monetary measure is to demonetise currency of higher denominations. Such a measure is usually adopted when there is abundance of black money in the country.

(c) Issue of New Currency: The most extreme monetary measure is the issue of new currency in place of the old currency. Under this system, one new note is exchanged for a number of the old currency. Such a measure is adopted when there is an excessive issue of notes and there is hyperinflation in the economy.

Fiscal Measures

Monetary policy alone cannot control inflation. Therefore, it should be supplemented by fiscal measures. The principal fiscal measures are discussed below.

(a) Reduction in Unnecessary Expenditure: The government should reduce unnecessary expenditure on non-development activities in order to curb inflation.

(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 too high as to discourage saving, investment and production.

(c) Increase in Savings: Another measure is to increase savings on the part of the people so that their disposable income and purchasing power would be reduced. For this the government should encourage savings by giving various incentives.

(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: In addition, the government should stop repayment of public debt and postpone it to some future date till inflationary pressures are controlled. Instead, the government should borrow more to reduce money supply with the public.

Other (Direct) Measures

Other measures to control inflation generally aims at increasing aggregate supply and reducing aggregate demand directly. These are :-

(a) To Increase Production. The following measures should be adopted to increase production:

(i) The government should encourage the production of essential consumer goods like food, clothing, kerosene oil, sugar, vegetable oils, etc.

(ii) 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 policy. The best course for this is to link increase in wages to increase in productivity. This will have a dual effect. It will control wage and at the same time increase production of goods in the economy.

(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.

(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 stabilize 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.

Effects of Inflation

Inflation affects different people differently. When price rises or the value of money falls, some groups of the society gain, some lose and some stand in between. Let us discuss the effects of inflation on distribution of income and wealth, production, and on the society as a whole.

Effects of Inflation on Business Community: Inflation is welcomed by entrepreneurs and businessmen because they stand to profit by rising prices. They find that the value of their inventories and stock of goods is rising in money terms. They also find that prices are rising faster than the costs of production, so that their profit is greatly enhanced.

Fixed Income Groups: Inflation hits wage-earners and salaried people very hard. Although wage- earners, by the grace of trade unions, can chase galloping prices, they seldom win the race. Since wages do not

rise at the same rate and at the same time as the general price level, the cost of living index rises, and the real income of the wage earner decreases.

Farmers: Farmers usually gain during inflation, because they can get better prices for their harvest during inflation

Investors: Those who invest in debentures and fixed-interest bearing securities, bonds, etc, lose during inflation. However, investors in equities benefit because more dividend is yielded on account of high profit made by joint-stock companies during inflation.

Inflation will lead to deterioration of gross domestic savings and less capital formation in the economy and less long term economic growth rate of the economy.