

Inflation

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.

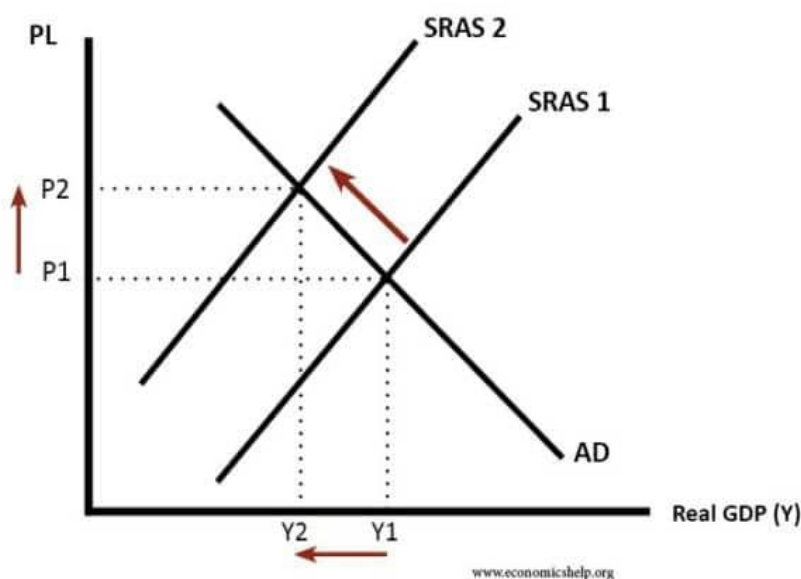
As inflation is a state of rising prices, deflation may be defined as a state of falling prices but not fall in prices. Deflation is, thus, the opposite of inflation, i.e., a rise in the value of money or purchasing power of money. Disinflation is a slowing down of the rate of inflation.

Types of Inflation:

1. Cost-Push Inflation:

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. Cost-push inflation is different to demand-pull inflation which occurs when aggregate demand grows faster than aggregate supply. Cost-push inflation can lead to lower economic growth and often causes a fall in living standards, though it often proves to be temporary.

Diagram Showing Cost-Push Inflation

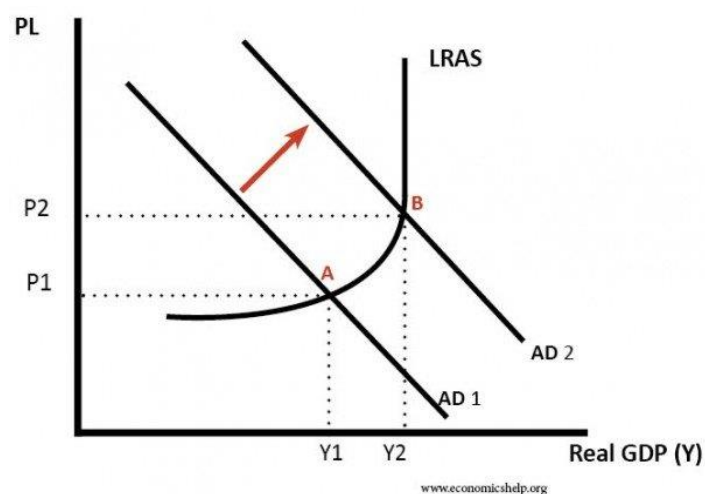


Short-run aggregate supply curve shifts to the left, causing a higher price level and lower real GDP.

Causes of Cost-Push Inflation:

- **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 (e.g. 1970s, 2008, 2010-11)
- **Imported Inflation.** Devaluation will increase the domestic price of imports. Therefore, after devaluation, we often get an increase in inflation due to rising cost of imports.
- **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)
- **Higher Taxes.** Higher VAT and Excise duties will increase the prices of goods. This price increase will be a temporary increase.
- **Profit-push inflation.** If firms gain increased monopoly power, they are in a position to push up prices to make more profit.
- **Higher Food Prices.** In western economies, food is a smaller percentage of overall spending, but in developing countries, it plays a bigger role. (food inflation)

2. **Demand-pull Inflation:** Demand-pull inflation is a period of inflation which arises from rapid growth in aggregate demand. It occurs when economic growth is too fast.



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

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.

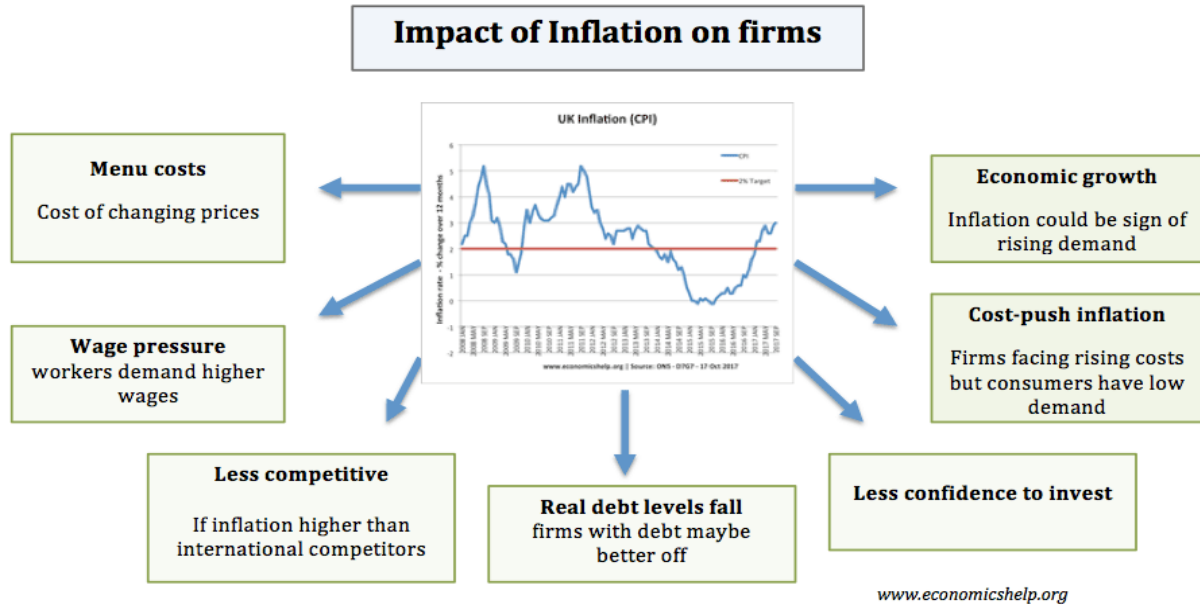
Also, as firms produce more, they employ more workers, creating a rise in employment and fall in unemployment. This increased demand for workers puts upward pressure on wages, leading to wage-push inflation. Higher wages increase the disposable income of workers leading to a rise in consumer spending.

Causes of demand-pull inflation

- **Lower interest rates.** A cut in interest rates causes a rise in consumer spending and higher investment. This boost to demand causes a rise in AD and inflationary pressures.
- **The rise in house prices.** Rising house prices create a positive wealth effect and boost consumer spending. This leads to economic growth.
- **Rising real wages.** For example, unions bargaining for higher wage rates.
- **Devaluation.** A depreciation of the exchange rate which makes exports more competitive in overseas markets leading to an injection of fresh demand into the circular flow and a rise in national income and demand for factor resources – there may also be a positive multiplier effect on the level of demand and output arising from the initial boost to export sales.
- **Higher demand from a government (fiscal) stimulus** e.g. via a reduction in direct or indirect taxation or higher government spending and borrowing. If direct taxes are reduced, consumers will have more disposable income causing demand to rise. Higher government spending and increased borrowing feeds through directly into extra demand in the circular flow.
- **Monetary stimulus to the economy:** A fall in interest rates may stimulate too much demand – for example in raising demand for loans or in causing rise in house price inflation.
- **Faster economic growth in other countries** – providing a boost to exports overseas.

Effects of Inflation

Effects on business



A rise in inflation is likely to mean a rise in the cost of raw materials. Also, workers are likely to demand higher wages to cope with the higher cost of living. This rise in prices can also cause greater volatility and uncertainty. With firms uncertain about future costs, they may hold back from making investment decisions. Firms generally prefer a low and stable inflation rate.

Also, with an inflation rate, firms may expect rising interest rates, which will increase cost of borrowing – another reason to hold back on investment.

With higher inflation, firms may face menu costs (the cost of changing and updating prices). However, with modern technology this cost has diminished in importance – as it is easier for firms to update prices automatically.

Effects on consumers

With rising prices, consumers may be more inclined to try and purchase more quickly before prices rise further. With rising prices, it can create more confusion over which prices are good value. It could lead to costs of consumers looking around different shops comparing prices (this is known as shoe leather costs). However, for moderate rises in inflation, this is unlikely to be too

serious. Also, the internet and price comparison sites can make it easier to compare prices.

Effect on Central Bank and interest rates

Most Central Banks have an inflation target of around 2%. Therefore, if inflation rises above the target, they may feel the need to increase interest rates. Higher interest rates will increase borrowing costs and slow down the rate of investment and economic growth. Lower economic growth will lead to lower demand-pull inflation (though there can be time-lags).

However, it is possible, that Central Banks respond to higher inflation by keeping interest rates the same. If inflation was due to cost-push factors and economic growth was low – the Bank may feel it would be inappropriate to raise interest rates.

Effect on savers

For savers with cash under the bed or receiving fixed interest payments, a higher inflation rate could reduce the real value of their savings. For example, if bond holders buy government bonds with interest rate of 3% and anticipated inflation of 2% – then they expect a real interest rate of 1%. However, if inflation rises to 7% and their interest rate stays at 3%, their effective real interest rate is 4% – in this case, their savings reduce in value.

Effect on workers

Higher inflation will raise the cost of living. The impact on workers depends on what happens to nominal wages. For example, if inflation is caused by rising demand and falling unemployment, firms are likely to raise wages to keep attracting workers. In this case, workers' real wages will continue to rise.

Effect on the exchange rate

If inflation in India rises faster than her international competitors, the Indian goods will become relatively uncompetitive leading to lower demand for Indian goods and for Rupee. This will cause depreciation in the exchange rate.

Effect on economic growth

The effect on economic growth is uncertain. Sometimes inflation is caused by a rapid rate of economic growth. However, if growth is above the long-run trend rate – this may not be sustainable – especially if interest rates rise. Therefore, higher inflation may be a sign the economic cycle is getting close to the end of the boom period and may be followed by a recession.

NATURE OF INFLATION IN A DEVELOPING ECONOMY

Developing countries in their bid to raise the standards of living of their people through development plans have often found themselves in the grip of inflation. But the nature of inflation in under-developed and developing economies is quite different from that found in advanced or developed countries.

In advanced countries true inflation starts after the level of full-employment is attained. But in developing countries like India huge unemployment and inflation exist side by side. In other words, in developing countries, serious inflation is in evidence long before the level of full-employment is reached.

This is so because the nature of unemployment in developing countries differs from that which prevails in developed countries during times of depression. In order to get the economy out of depression, governments in advanced countries take various steps to increase the level of investment. The additional investment expenditure leads to an increase in effective demand depending upon the magnitude of the multiplier. But this increase in investment and effective demand does not generate serious inflationary pressures because of the elastic nature of the supply curve of output. Instead, increase in investment and effective demand helps a great deal in removing depression and unemployment which are caused by the lack of effective demand. This is the case of developed economies. In advanced countries, during depression, there is a lot of excess capacity in the system so that an increase in output presents no difficult problems. Thus, the supply of output can be increased easily so as to match increase in effective demand; there need be no inflationary pressures.

The situation in developing countries is, however different. Here an increase in investment does create additional demand but a corresponding increase in the supply of output cannot be taken for granted. Unemployment in developing economics is not due to the lack of effective demand but due to the dearth of

real capital. In these countries, level of national income can be increased and the unemployment can be removed by accumulating more real capital. But increase in the rate of capital formation requires stepping up the level of investment.

Now, developing countries, under their development plans, are making huge investment expenditure to increase the rate of capital formation and thus to obtain rapid economic growth. This huge investment expenditure leads to a sharp increase in prices.

Another approach to inflation in emerging countries and why it tends to be higher is that many of these countries are experiencing rapid economic growth contrasted with slower growth in advanced economies.

Fast growth can lead to excess demand and a positive output gap thereby causing demand-pull inflation. It also brings about cost-push inflation for example because of rising global demand for raw materials.

A second reason why inflation in developing countries is higher is because many of these countries have volatile exchange rates and do not necessarily have a well-established central bank to operate monetary policy.

Therefore, if a fast-growing country has a large current account deficit, this can lead to a large depreciation in their exchange rate. One effect of this is a big jump in the prices of essential imports such as foodstuffs and energy.