What is Inflation?

- Inflation is the **sustained increase in the general price level of goods and services in an economy over time.**
- When inflation occurs, **each unit of currency buys fewer goods and services, effectively reducing purchasing power.**
- It is typically **measured as an annual percentage increase in the Consumer Price Index (CPI).**
- **Moderate inflation is normal** in growing economies, but **high inflation can erode savings and destabilize markets.**
- **High inflation** means that **prices are rising rapidly**, whereas **low inflation** means that **prices are rising more slowly**.

TYPES OF INFLATION BASED ON CAUSES.

DEMAND-PULL

Occurs when **aggregate demand exceeds aggregate supply**. Too much money chasing too few goods drives prices upward across the economy.

COST-PUSH

Happens when production costs or prices for inputs increase, forcing businesses to raise prices. Rising wages, raw materials, or energy costs are common triggers.

BUILT-IN

Results from adaptive expectations where workers demand higher wages anticipating future inflation, creating a wage-price spiral cycle.

STRUCTURAL INFLATION

Occurs due to economic issues such as rigid supply chains or monopolistic market structures, leading to periodic price hikes in specific sectors.

PROTEIN INFLATION

Rrefers to price increases in protein-rich food products like pulses, eggs, and meat, often due to demand shifts or supply constraints.

Types of Inflation Based On Rate.

CREEPING INFLATION (MILD OR LOW INFLATION).

A gradual increase in prices, usually less than 3% annually, which is considered manageable and may positively stimulate demand and investment.

WALKING INFLATION (TROTTING INFLATION).

Prices increase at a moderate pace, generally around 3% to 10% per year. If unchecked, it can lead to economic overheating.

GALLOPING INFLATION (HOPPING OR RUNNING INFLATION).

Occurs when prices increase rapidly at double—or triple-digit annual rates, between 10% and 50%. It disrupts economic stability and can severely affect consumer purchasing power.

HYPERINFLATION.

An extreme form of inflation where prices rise over 50% monthly. Hyperinflation can decimate a currency’s value, as seen historically in Zimbabwe and Germany’s Weimar Republic.

Demand-Pull Inflation (DPI).

- An **increase in aggregate demand over the available output leads to a rise in the price level**. Such inflation is called demand-pull inflation (henceforth DPI).
- But **why does aggregate demand rise**? **Classical economists** attribute this rise in aggregate demand to **money supply**. If the supply of money in an economy exceeds the available goods and services, DPI appears. It has been described by Coulborn as a situation of "too much money chasing too few goods."
- **Keynesians** hold a different argument. They argue that there can be an autonomous increase in aggregate demand or spending, such as a rise in consumption demand or investment or government spending or a tax cut or a net increase in exports (i.e., C + I + G + X – M) with no increase in money supply. This would prompt upward adjustment in price.
- Thus, DPI is caused by **monetary factors (classical adjustment) and non-monetary factors (Keynesian argument).**
- DPI can be explained in terms of figure 4.2, where we measure output on the horizontal axis and price level on the vertical axis. In Range 1, total spending is too short of full employment output, YF. There is little or no rise in the price level. As demand now rises, output will rise. The economy enters Range 2, where output approaches towards full employment situation. Note that in this region price level begins to rise. Ultimately, the economy reaches full employment situation, i.e., Range 3, where output does not rise but price level is pulled upward. This is demand-pull inflation. The essence of this type of inflation is that "too much spending chasing too few goods."

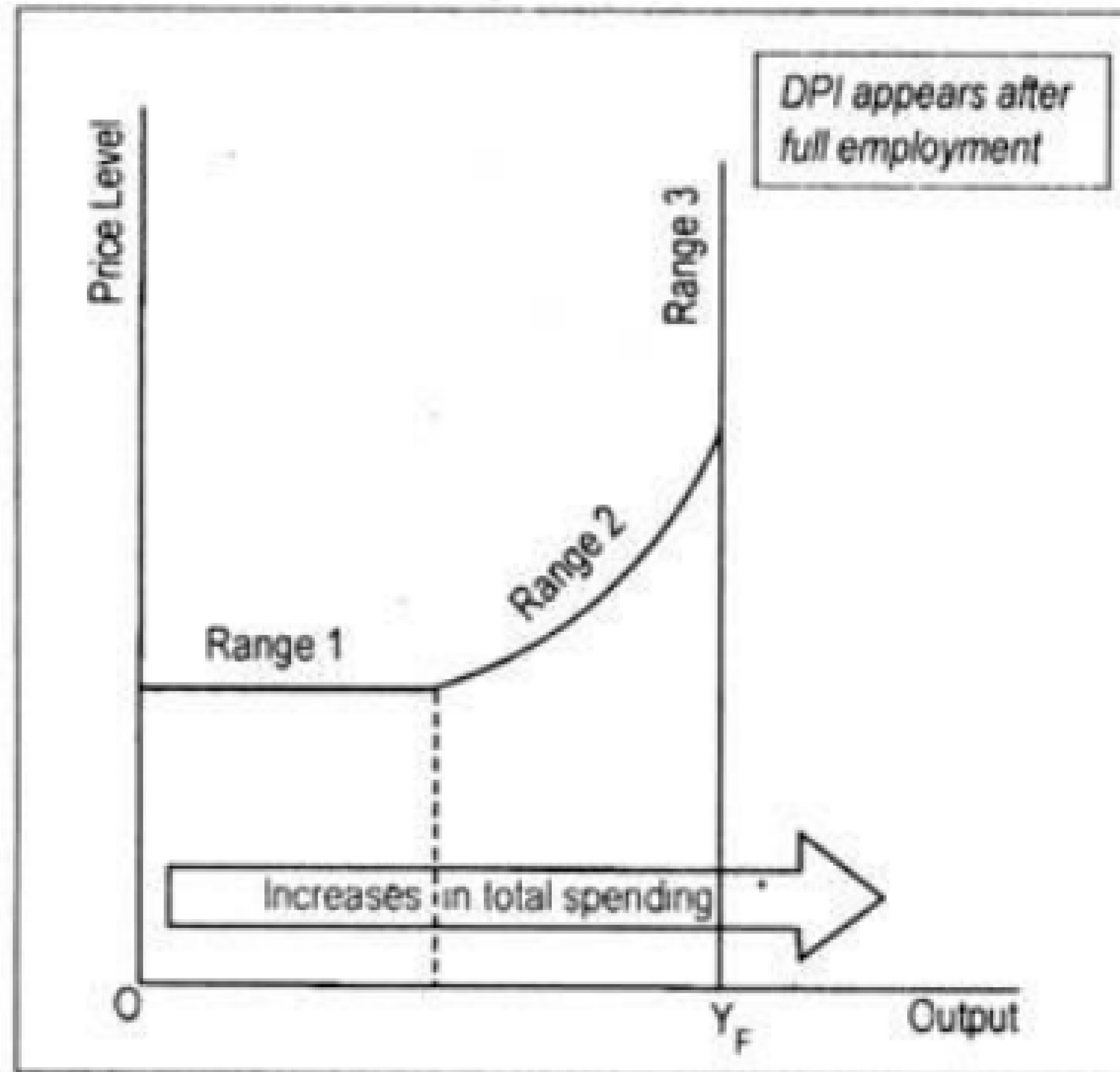

Fig. 4.2: Demand-pull Inflation

CAUSES OF DEMAND-PULL INFLATION.

1. EXCESSIVE MONEY SUPPLY (THE MONETARIST VIEW).

Printing Money: When the government or central bank increases the supply of money too rapidly, people find themselves with excess cash.
Increased Spending: As people spend this extra cash, they bid up the prices of limited goods. This continues until the price level rises enough to match the new money supply.

2. CHANGES IN THE REAL SECTOR (THE KEYNESIAN VIEW).

Inflation can also start from non-monetary shifts in the components of Aggregate Demand (C + I + G + Net Exports):
Consumption (C): A cut in personal income taxes gives households more disposable income, leading to higher spending.
Investment (I): If businesses become optimistic and increase their spending on new projects or equipment, demand spikes.
Government Spending (G): An increase in government expenditure—especially if funded by printing money rather than taxes—is a major driver of inflation.

3. POPULATION GROWTH.

A growing population naturally increases the demand for basic necessities and services. If the supply of these goods doesn't grow at the same pace, prices rise.

4. FOREIGN TRADE & EXPORT EARNINGS.

When a country earns more from exports, it brings additional purchasing power into the domestic economy. This extra income increases the local demand for goods and services.

5. REPAYMENT OF PUBLIC DEBT.

When the government pays back loans to the public, it puts more money into the hands of citizens. This increase in liquid cash boosts private spending and aggregate demand.

6. BLACK MONEY AND CONSPICUOUS CONSUMPTION.

People holding "black money" (unaccounted wealth) often spend it lavishly on luxury items or "conspicuous consumption." This sudden, high-volume spending adds fuel to the inflationary fire.

COST-PUSH INFLATION (CPI).

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 is usually associated with non-monetary factors.** CPI **arises due to the increase in cost of production.** 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 this happens, then the AS curve will shift to the right- ward** not leftward—direction. We assume here that productivity does not change in spite of an increase in wages. 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 trade unions to demand higher wages. Thus, an inflationary wage-price spiral starts. This causes aggregate supply curve to shift leftward.** This can be demonstrated graphically where AS1 is the initial aggregate supply curve. Below the full employment stage this AS curve is positive sloping and at full employment stage it becomes perfectly inelastic. Intersection point (E1) of AD1 and AS1 curves determine the price level (OP1). Now there is a leftward shift of aggregate supply curve to AS2. With no change in aggregate demand, this causes price level to rise to OP2 and output to fall to OY2. With the reduction in output, employment in the economy declines or unemployment rises. Further shift in AS curve to AS3 results in a higher price level (OP3) and a lower volume of aggregate output (OY3). Thus, CPI may arise even below the full employment (YF) stage.

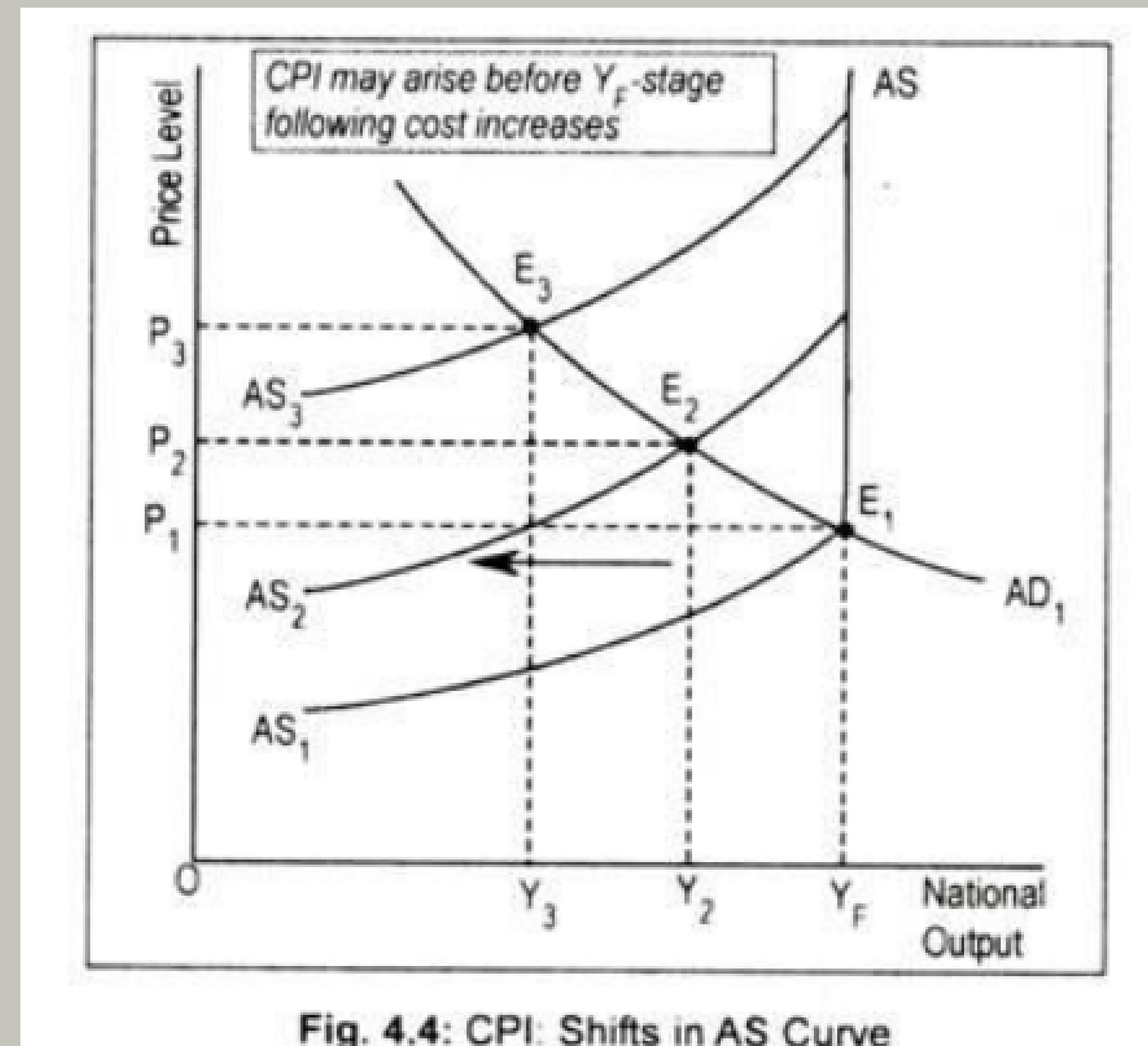

Fig. 4.4: CPI: Shifts in AS Curve

CAUSES OF COST-PUSH INFLATION.

Cost-push inflation is rarely the result of a single event. It is usually a "domino effect" where rising costs in one area (like fuel or wages) tumble through the rest of the economy.

1. RISING COSTS OF RAW MATERIALS.

- **Government Action:** Decisions to hike the price of essential inputs like petrol, diesel, or electricity (often through administrative orders) immediately increase production costs for firms.
- **Imported Inflation:** If global prices for essential commodities rise (e.g., OPEC raising oil prices), domestic prices must follow, affecting almost every sector—especially transport.

2. WAGE-PUSH INFLATION.

- **Labour Demands:** Trade unions often negotiate for higher wages to keep up with the cost of living.
- **Productivity Gap:** If wages increase faster than the actual output (productivity) of the workers, firms pass these extra labor costs on to consumers through higher prices.

3. PROFIT-PUSH INFLATION.

- **Market Power:** Large firms with little competition may intentionally raise prices to expand their profit margins, regardless of whether consumer demand has actually increased.

4. FISCAL POLICY & TAXES.

- **Indirect Taxes:** When the government increases excise duties or sales taxes on mass-consumption goods, the cost of these goods rises immediately. This is why governments are often blamed for "inducing" inflation.

5. SUPPLY CHAIN SETBACKS.

- **Natural Factors:** Disasters, power cuts, or the exhaustion of natural resources can cause a sudden drop in total output.
- **Artificial Scarcity:** Traders and hoarders may hide stocks to create a "fake" shortage, driving prices up even further during a crisis.

6. STRUCTURAL INEFFICIENCIES.

- **Poor Management:** Corruption, economic mismanagement, and industrial strikes lead to wasted resources and lower efficiency, which ultimately makes production more expensive.

Controlling Inflation

Governments and central banks employ two main policy approaches to combat inflation. Fiscal policy involves government spending and taxation decisions, while monetary policy focuses on controlling money supply through the central bank. Both aim to reduce excess demand and stabilize prices, often working together for maximum effectiveness.

MONETARY POLICY.

Central banks control money supply and interest rates. Key tools include raising interest rates to discourage borrowing, increasing reserve requirements for banks, and selling government securities. These measures reduce money circulation and credit availability, cooling inflationary pressures. The monetary measures to control inflation generally aims at reducing money incomes.
These are:

(a) Credit Control: The central bank adopts 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 Policy

Government uses taxation and spending to control inflation. Key measures include increasing taxes to reduce disposable income, cutting government spending to lower demand, and reducing budget deficits. These actions decrease overall demand in the economy, helping to stabilize prices. 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 Budget: 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.

IMPACT OF INFLATION.

Inflation impacts various aspects of the economy, from reducing purchasing power and increasing interest rates to widening income inequality and affecting investment returns. It also hampers export competitiveness and raises business costs, complicating economic planning.

- **Reduced Purchasing Power:** Inflation erodes the purchasing power of money, meaning consumers can buy fewer goods and services with the same income, ultimately affecting their quality of life and standard of living.
- **Increased Interest Rates:** To control inflation, central banks often raise interest rates, making borrowing more expensive for individuals and businesses, which can slow down economic growth and investment activities.
- **Income Inequality:** Inflation impacts income groups unevenly. Lower-income households feel the pinch more as a larger portion of their income goes toward essentials, widening the gap between socioeconomic classes.
- **Investment Returns:** Inflation diminishes real returns on investments, especially fixed-income assets, as the actual purchasing power of returns is reduced, potentially discouraging savings and long-term investment.
- **Export Competitiveness:** Rising domestic prices make exports less competitive internationally, as foreign buyers may seek cheaper alternatives elsewhere, potentially harming industries that rely on exports for revenue.
- **Business Costs and Planning:** Inflation raises operational costs for businesses, especially in materials and labour, leading to challenges in pricing and long-term planning as businesses struggle to maintain profit margins.

EFFECTS OF INFLATION.

Effects of Inflation on various sectors of the economy can be seen as follows.

1. **Redistribution of Income and Wealth:** It leads to the redistribution of income and wealth from one hand to another. It **results into loss to some group of people and gains to another group of people.**

- **Borrower (Debtor) Vs Lender (Creditor):** The **borrower (debtor)** is the **gainer**, **lender (creditor)** is the **loser**.

For example, suppose the debtor borrows 100/- at the interest rate of 5% per annum. So, he has to pay 105/- to the creditor next year. But, suppose inflation increases by more than 5% in a year, then what 100/- could buy this year cannot be bought by 105/- in the next year. So, the effective value of money for the creditor decreases.

- **Producer Vs Consumer:** The purchasing power of money held by consumers falls. So, they have to pay more money to producers for the same amount of goods and services. Thus, the **producer** is the **gainer**, and the **consumer** is the **loser.**

- **Flexible Income Group Vs Fixed Income Group: Flexible income groups** like sellers, self-employed etc., whose salary is adjusted according to inflation **don't get affected**. On the other hand, **fixed-income groups** like daily-wage earners **lose** as the purchasing power of their fixed income falls.

- **Debentures or Bond Holders Vs Issuers: Bond Issuers gain**, and the **bond-holders lose**. This is because the fixed rate paid for the bonds is not enough to compensate for inflation.

- **Equity Holders:** The income of equity holders depends on the profit of the company. In an inflationary situation, companies earn more profit. So, **equity holders also earn more income.**

EFFECTS OF INFLATION.

2. **EFFECTS ON PRODUCTION AND CONSUMPTION.**

A **rise in prices leads to a fall in demand for goods and services**. As a result, it may force a cut down in the production.
It may also lead to a shift in investment from other sectors to those in which price rise has taken place. (as investors intend to make a higher profit)

3. **OTHER EFFECTS OF INFLATION**

- **Savings: As inflation reduces the value of money**, holding money is not a prudent economic decision. So, **people would like to deposit money in the banks to negate the effect of inflation.**

- **Growth and Employment:** In the **short run, an increase in inflation is usually accompanied by an increase in economic growth and hence employment. But, in the long term, it does not necessarily hold true.**

- **Balance of Payment (BoP): High price reduces exports and increase imports from other countries** where goods are available at a cheaper rate. It results in an **unfavorable Balance of Payment (BoP).**

- **Exchange Rate:** A **high import and low export mean high demand for foreign currencies vis-a-vis domestic currency. This depreciates domestic currency.**

- **Social and Political Impacts: High level of prices leads to social and political tensions like strikes, dharnas, etc.**

CONCLUSION.

Ultimately, inflation is a multifaceted economic phenomenon characterized by a sustained increase in the general price level, which effectively erodes the purchasing power of money over time. Whether it is triggered by an excess of demand (Demand-Pull), rising production costs (Cost-Push), or embedded expectations (Built-In), its impact reverberates through every level of the economy. While moderate inflation is often viewed as a sign of a growing economy, excessive or volatile price hikes can lead to diminished consumer savings, distorted international trade, and significant uncertainty for investors. By understanding the intricate balance between these causes and their downstream effects, policymakers can better implement fiscal and monetary strategies to maintain price stability and ensure long-term economic health.

Thank You