IMPACT: International Journal of Research in Humanities, Arts and Literature (IMPACT: IJRHAL)
ISSN (P): 2347-4564; ISSN (E): 2321-8878
Vol. 7, Issue 1, Jan 2019, 343-350

INFLATION :- TYPES, CAUSES AND EFFECTS

Arya Salim

Former Guest Lecturer, Sree Narayana College, Kollam, Kerala, India

Received: 14 Jan 2019 **Accepted:** 21 Jan 2019 **Published:** 29 Jan 2019

ABSTRACT

Inflation is the continuous and persistent increase in the general price level of goods and services in an economy over a period of time. When the general price level rises, each unit of currency will buy fewer goods and services. Therefore, during inflation, there is a loss of value of money. During inflation, the purchasing power of money is falling. Inflation means 'too much money chasing too few goods'. If inflation happens in the economy it means that there is more money chasing less of goods and services. There is more supply of money in the economy and there are less goods and services to buy with that increased money. Therefore goods and services command a higher price than actual as more people are willing to pay a higher value to buy the same goods. In this circumstance, there is no real growth in the output of the economy. The opposite of inflation is deflation, where there is a decrease in the average level of prices. The boundary between inflation and deflation is price stability.

KEYWORDS: *Inflation, Disequilibrium, Demand- Pull Inflation, Cost-push Inflation, Consumer Price Index*

INTRODUCTION

According to Crowther "Inflation is a state in which the value of money is falling i.e., the prices are rising". Inflation is a highly controversial term which has undergone modification since it was first defined by the neo-classical economists. They meant by it a galloping rise in prices as a result of the excessive increase in the quantity of money.

According to them "inflation is a destroying disease born out of lack of monetary control whose results undermined the rules of business, creating havoc in markets and financial ruin of even the prudent". Keynes had a different view from the neo-classicists. He did not believe that there was full employment in the economy which resulted in hyper-inflation with increases in the quantity of money. To Keynes, an increase in the money supply leads to an increase in aggregate demand, output, and employment if underemployment prevails in the economy. Keynes's analysis has two main demerits. First, it gives importance to demand as the cause of inflation but neglects the cost side of inflation. Second, it neglects the possibility that a price rise can lead to further increase in total demand which may again lead to a further rise in prices.

These days all the economies of the world, underdeveloped as well as developed suffer from inflation. Inflation or persistently rising prices is a major problem in the world today. A rate of inflation during the seventies and eighties was very high as compared to the rates of inflation experienced earlier during peace periods. Since in the late nineties, the rate of inflation in several countries has declined. However, in some countries, it still remains very high. To the neo-classical and their followers at the University of Chicago, inflation is mainly a monetary phenomenon. In the words of Friedman, "Inflation is always and everywhere a monetary phenomenon.....and can be produced only by a more rapid increase in the quantity of money than output”. According to Hicks, “Our present troubles are not of a monetary character. According to Johnson “inflation as a sustained rise in prices”. Brooman defines it as “a continuing increase in the general price level”. Shapiro also defines inflation “as a persistent and appreciable rise in the general level of prices”. According to Dernberg and McDougall, “the term usually refers to a continuing rise in prices as measured by an index such as the consumer price index or by the implicit price deflator for gross national product”.

OBJECTIVES OF THE STUDY

To understand the effects of inflation on the economy. To study the causes of inflation. To analyze the different kinds of inflation.

RESEARCH METHODOLOGY

The study is based on secondary data collected from various books of national and international authors. The study is designed as a descriptive one because it describes in detail the state of affairs related to inflation.

TYPES OF INFLATION

Inflation can be divided on the following basis depending upon the rate of inflation. They are,

Moderate Inflation

Moderate inflation is caused by the slow rise in prices. This inflation is not a severe one. Here, the rate of inflation is less than 10% annually. Moderate inflation does not interrupt the economic balance. It can be again divided into two.

- Creeping Inflation - This type of inflation shows that the prices rise very slowly. The movement of the prices is like that of a snail or maybe a creeper. While analyzing the speed, the annual rise in prices will be only less than 3 percent per annum. This increase in price is seen as important for economic growth and development and is totally safe.

- Walking Inflation – It is also called trotting inflation. The annual inflation rate will only be a one-digit number and it will be moderate. The rate of rising in prices will be in the range of 3 to 7 percentage or less than 10. This helps the government by giving a warning signal to control it before reaching running inflation which is dangerous.

Running Inflation

Here, the increase in the price is very fast which is similar to that of the running of a horse. The rate of speed will be 10 to 20 percent per year. This can cause difficulties to the so-called poor and also the middle classes. If the government and the monetary authorities do not take apt measures for its control, it can lead to hyperinflation.

Hyperinflation

This is also called runaway or galloping inflation. Some economists also call it as hyperinflation. Here prices rise very rapidly say, in double or triple digit terms. It can be from more than 20 to 100 rates per year. Here, the price rise will be uncontrollable and very hectic to measure. This type of inflation can bring about a total collapse of the economy and monetary system, as the purchasing power of money continuously falls.

CAUSES OF INFLATION

- **Increase in Money Supply -** When there is more circulation of money in the economy; people have more money in their hands to purchase goods and services resulting in increased demand. But the supply of products cannot be increased in accordance with the increased demand. So there arises a shortage in supply. In this circumstance, sellers try to sell their products at a high price by raising the price of the commodities. The increase in money supply has been seen most when governments have financed spending in a crisis by printing money excessively. This often leads to hyperinflation where prices rise at extremely high rates. Inflation is mainly caused by an increase in the money supply that outpaces economic growth.

- **Demand-Pull Effect –** There can be a situation where there is an increase in the wages of people living in an economic system. When wages increase, then it increases the purchasing power of each individual. They demand more goods and services than before. Such an increase in liquidity leads to an increase in the demand for consumer goods and services. Thus sellers or the companies raise the prices to the level the consumer will bear to keep incorrect balance of supply and demand.

- **Cost-Push Effect –** At times, the cost of production of companies will increase. Cost of production includes increased input costs like raw goods and materials or wages. The businessmen will try to preserve their profitability by passing this increased cost of production onto the consumer in the form of higher prices.

- **Increase in Public Expenditure –** Not only the democratic but all forms of government demand increase in public expenditure especially for welfare programs and infrastructure developmental activities. This leads to an increase in demand for goods and services. So the sellers try to sell their goods at an increased price. Here, there is a transfer of purchasing power to the household through public works programs.

- **Increase in Consumer Spending –** The consumer spending increases when there is an increasing demand for goods and services. This happens because of a rise in the money income of the factors of production.
- **Reduction in Taxation –** When the government reduces the direct taxes, people will have to pay less proportion of their income as tax. So, more disposable income is left in the hands of the public. This will increase their purchasing power and therefore results in higher demand in the economy, which can lead to demand-pull inflation.
- **Increase in Population** – More population means more demand. A fast-growing population puts a lot of pressure on demands for goods and services in the economy. This increases the price level.
- **Increase in Exports -** With the increase in exports, more goods and services will flow to other countries, thus leading to a shortage of stock of goods available for domestic consumption. This gives rise to inflationary pressure in the economy.

EFFECTS OF INFLATION

- Inflation is a situation where the balance between supply and demand goes out of control. In this situation, buyers will change their spending habits as they meet their purchasing thresholds and producers will suffer and be forced to cut output. This leads to higher unemployment rates. In this situation, imbalances are created.
- Inflation redistributes income from those on fixed incomes such as pensioners and shifts it to those who draw variable income, such as wages and profits which may keep pace with inflation.
- Inflation leads to a decrease in the real value of debt. So this may benefit the debtors.
- Inflation redistributes wealth from those who lend a fixed amount of money to those who borrow. For instance, where the government is a net debtor, it will reduce this debt redistributing money towards the government. Thus inflation is similar to a hidden tax.
- In a fixed exchange rate system, inflation makes exports more expensive and tend towards a weakening balance of trade.
- Rising inflation can prompt trade unions to demand higher wages to keep up with the increasing consumer prices. Rising wages means increased cost of production which will fuel inflation.
- Inflation distorts the keystone of our economy. Since prices do not change uniformly and at the same speed, it becomes very difficult for businessmen to make calculations about consumers' demand and the cost of their operations.
- Inflation lowers the general standard of living of people.
- When inflation is high, people may lose confidence in money, as the real value of savings is severely decreased.
- When prices increase, workers agitate for more wages through trade unions. So their wages are increased which leads to increase in the cost of production. Again price increases. This is known as wage-price spiral.
- Inflation negatively affects business planning. Since inflation creates uncertainty in case of both prices and costs, budgeting becomes difficult and this may decrease planned investment spending.

- Inflation leads to a loss of international competitiveness and a subsequent worsening of the trade performance of a country which also leads to higher unemployment.
- Inflation increases uncertainty about future real incomes and hence induces people to accumulate more financial assets in order to protect future consumption levels.
- Inflation reduces the real value of liquid assets. Households save more in order to rebuild their real liquid asset stocks.
- Inflation causes people to misperceive relative prices. Most of them only observe relatively few prices in, say, a week and is unaware of what the current rate of inflation is, particularly when inflation is accelerating.

BENEFITS OF INFLATION

- **Higher Revenues and Profits –** In case of moderate inflation, it allows business firms to raise their prices, revenues and profits. Workers can also expect to see an increase in their pay. This can give psychological boosts and might lead to rising investment.
- **Tax Revenues -** The government gains from inflation through 'fiscal drag effects'. As prices rise, so does the amount of tax revenue flowing into the treasury.
- **Cutting the Real value of Debt –** Low and stable inflation like the moderate inflation helps to reduce the real value of outstanding debts.
- **Avoiding Deflation –** One of the benefits of positive inflation is that an economy can manage to avoid some of the bad effects of a deflationary recession.

SOCIAL COSTS OF INFLATION

- Inflation stimulates conflicts between buyers and sellers. Conflicts among consumers, producers, and regulatory agencies are created during the inflationary period.
- Some people lose because their incomes do not keep pace with the average prices of the goods they buy. Income redistribution from inflation is a major source of social cost.
- A basic problem is that inflation is often blamed for unfavorable events that would have arisen because of shifts in demands and supplies which are not inflated. Most people feel that increases in our paychecks are much-deserved rewards for hard works.
- Even if the nominal income keeps pace with inflation, it erodes the value of money we have saved.
- The prices of physical assets such as land and housing often rise even more rapidly than the rate of inflation. Home-owners gain during inflation and prospective home buyers lose.

- A government, business firms, farmers and young families tend to be net debtors and often gain from unexpected inflation. Established households and mature people anticipating retirement are usually savers and lose from inflation.
- Inflation harms many senior citizens to the extent that portions of their incomes are fixed.
- Redistributions caused by inflation are commonly seen as arbitrary but many social ills blamed on it actually result from other forces.
- The income redistribution aspects of inflation generally do not affect the real level of national production. Rather, the redistributive properties of inflation are part of the larger problem of achieving and maintaining an equitable distribution of our real national income.
- During inflation, the cost of holding currency in hand increases. This is because, when there is an increase in the inflation rate, more interest is paid on bank deposits and also for buying bonds. If the currency is kept in hand, people will not get a chance to earn interest. In order to reduce the cost of holding currency, people will tend to reduce their holdings of currency for transaction purposes. Accordingly, people will hold less currency with them and keep as long as possible, a greater amount of money in bank deposits and bonds that yield interest. Therefore, instead of withdrawing a large amount of money from banks, they will withdraw less money which is sufficient for meeting daily expenses. For doing so, the people will make more trips to withdraw cash. This involves a greater cost to the people in the form of petrol expense, wear, and tear of car and the time spend on making a trip. All these costs of making more trips to the bank are called shoe-leather costs, because walking to the bank often includes wear and tear of shoes. People have to spend money on buying new shoes.
- Another cost of inflation is the menu cost. Menu cost arises because high inflation requires them to change their listed prices more often. During inflation, the prices of food items keep on changing. So, to inform customers about the changed price, the firms have to print new catalogues listing new prices and distribute them to their customers. They even have to spend money on advertisements to inform the public about their new prices.

MEASURES TO CONTROL INFLATION

Monetary Measures

- The volume of legal tender money may be reduced either by withdrawing a part of the notes already issued or by avoiding large scale issue of notes.
- Restrictions on bank credits
- Freezing and blocking a specific type of assets.
- Increasing bank rate and other interest rates.
- Sale of government securities in the open market by the central bank.

- Prescribing a higher margin that bank and other lenders must maintain for the loans granted by them against stocks and shares.
- Regulation of consumer's credit.
- Rationing of credit.

Fiscal Measures

- Reduction in the volume of public expenditure.
- Rise in the levels of taxes, the introduction of new taxes and bringing more people under the coverage of taxes.
- More internal borrowing by public authorities.
- Postponing the repayment of debts to people.
- Control on the volume of deficit financing.
- Preparation of a surplus budget.
- Incentive to savings.
- Tariffs should be reduced to increase imports and thus allow a part of the increased domestic money income to leak out.
- Inducing wage earners to by voluntarily government bonds, securities etc.

Direct or Administrative Measures

- Expansion in the volume of domestic output so as to meet the increasing demand.
- Introduction of rationing and direct control of prices.
- Control of gambling and speculative activities.
- Adopting appropriate wage-profit policy to freeze wage-profit.
- An appropriate income policy should be adopted.
- Over-valuation of currency.

Indexing and control of the population

CONCLUSIONS

Inflation is the persistent and continuous rise in price level. The main cause of inflation is the increased circulation of money in the economic system. When there is an increased supply of money in the economy, people have more cash in their hands and due to this increased liquidity, they demand more goods and services. But the output cannot be increased in accordance with the increased demand. Therefore the sellers try to sell their goods at a higher price. According to the rates, different types of inflation are creeping inflation, walking inflation, running inflation and hyperinflation. Inflation has both bad and good effects on the economy. Mild inflation is good for economic growth but high inflation adversely affects the economy. The government and the monetary authorities should try to control inflation with apt monetary and fiscal measures.

REFERENCES

1. *M.L.Jhingan, 2010, Macro Economic Theory, Vrinda Publications pvt ltd.*
2. *Dr.H.L.Ahuja, 2012, Macroeconomics theory And Policy, S Chand and company pvt ltd*
3. *Rosalind Levacic and Alexander Rebmann, 1982, Macroeconomics An Introduction To Keynesian-Neoclassical Controversies, Macmillan Press ltd.*
4. *Dr.H.L.Ahuja, 1970,Advanced Economic Theory, S.Chand and Company pvt.ltd.*
5. *R.K.Lekhi, Joginder Singh, 2015, Public Finance, Kalyani Publishers pvt ltd.*
6. *Does Consumer Price Index Represent the Actual Rate of Inflation? – A Study on General Measurement of Inflation in the Current Era, International Journal of Economics, Commerce and Research (IJECR), Volume 3, Issue 1, February-March 2013, pp. 129-142*
7. *L.M.Bhole, Jitendra Mahakud, 2014, Financial Institutions And Markets, Mc Graw Hill Education pvt. ltd.*