B.Com (HONS), Sem-II

Introductory Macroeconomics

UNIT-3, INFLATION

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WHAT IS INFLATION?

Inflation is a persistent increase in the general price level of goods and services in an economy over a period of time. It is the rise in the general level of prices where a unit of currency effectively buys less than it did earlier (or a reduction in the purchasing power per unit of money). G. Ackley defined inflation as 'a persistent and appreciable rise in the general level or average of prices'.

A small rise in prices or a sudden rise in prices is not inflation since they may reflect the short term workings of the market.

Inflation can be contrasted with deflation, which occurs when prices instead decline.

TYPES OF INFLATION

A. On the basis of degree:-
   1. creeping: mild inflation
   2. galloping: high inflation
   3. hyper-inflation: uncontrolled inflation

B. On the basis of causes:-

   1. Demand –pull (those leading to increase in dd)
      a. growth of population
      b. rising levels of income
      c. rise in public expenditure
      d. rise in expectations

    e. rapid pace of urbanization

2. Cost –push (those leading to decrease in ss)
    a. Erratic agricultural supply
    b. Hoarding of essential goods
    c. Slow pace of industrial production
    d. High price of imports
    e. Rise in input prices

(NOTE- Detailed explanation of above points taken in online lectures)

IMPACT OF INFLATION

The effects of unanticipated inflation can be categorized under two broad headings:

(a) Effect on distribution of income and wealth

(b) Effect on economic growth

(a) Effects of Inflation on Distribution of Income and Wealth:

During inflation, usually people experience rise in incomes. But some people gain during inflation at the expense of others. Some individuals gain because their money incomes rise more rapidly than the prices and some lose because prices rise more rapidly than their incomes during inflation. Thus, it redistributes income and wealth.

(i) Creditors and debtors:

Borrowers gain and lenders lose during inflation because debts are fixed in rupee terms. When debts are repaid their real value declines by the price level increase and, hence, creditors lose. An individual may be interested in buying a house by taking loan of Rs.10 lakhs from an institution for 5 years.

The borrower now welcomes inflation since he will have to pay less in real terms than when it was borrowed. Lender, in the process, loses since the rate of interest payable remains unaltered as per agreement. Because of inflation, the borrower is given ‘dear’ rupees, but pays back ‘cheap’ rupees.

(Note: In reality, the loan-giving institution makes adequate safeguard against the erosion of real value.)

(ii) Bond and debenture-holders:

Bondholders earn fixed interest income. These people suffer a reduction in real income when inflation occurs. In other words, the value of one’s savings decline if the interest rate they receive is less than the inflation rate. Similarly, beneficiaries from life insurance programs are also hit badly by inflation since real value of savings deteriorate.

(iii) Investors:

People who invest their money in shares during inflation are expected to gain since the possibility of earning of business profit brightens. Higher profit induces owners of firm to distribute profit among investors or shareholders.

(iv) Salaried people and wage-earners:

Anyone earning a fixed income is worse-off by inflation. Sometimes, unionized worker succeeds in raising wage rates of white-collar workers as a compensation against price rise. But wage-rate changes with a long time lag. Usually, wage rate increases always lag behind price increases. Hence, inflation results in a reduction in real purchasing power of fixed income-earners.

Result:

Thus, there occurs a redistribution of income and wealth. It is said that rich becomes richer and poor becomes poorer during inflation.

These effects of inflation may persist if inflation is unanticipated. However, the redistributive burdens of inflation on income and wealth are most likely to be minimal if inflation is anticipated by the people. With anticipated inflation, people can build up their strategies to cope with inflation.

If the annual rate of inflation in an economy is anticipated correctly people will try to protect them against losses resulting from inflation.

However, it is difficult to anticipate inflation accurately. Further, even if it is anticipated, it cannot be perfect. In addition, adjustment with the new expected inflationary conditions may not be possible for all categories of people. Thus, adverse redistributive effects are likely to occur.

Finally, anticipated inflation may also be costly to the society. If people's expectation regarding future price rise become stronger they will hold less liquid money. Mere holding of cash balances during inflation is unwise since its real value declines. That is why people use their money balances in buying real estate, gold, jewelry, etc. Such investment is referred to as unproductive investment. Thus, during inflation of anticipated variety, there occurs a diversion of resources from priority to non-priority or unproductive sectors.

(b) Effect on Production and Economic Growth:

Inflation may or may not result in higher output. Below the full employment stage, inflation has a favorable effect on production. In general, profit is a rising function of the price level. An inflationary situation gives an incentive to businessmen to raise prices of their products so as to earn higher volume of profit. Rising price and rising profit encourage firms to make larger investments.

TYPES OF INFLATION INDICES (INDEXES)

Depending upon the selected set of goods and services, multiple types of inflation values are calculated as inflation indexes. They are:-

1. The Consumer Price Index

The CPI is a measure that examines the weighted average of prices of a basket of goods and services which are of primary consumer needs. They include transportation, food, and medical care. CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them based on their relative weight in the whole basket. The prices in consideration are the retail prices of each item, as available for purchase by the individual citizens. Changes in the CPI are used to assess price changes associated with the cost of living, making it one of the most frequently used statistics for identifying periods of inflation or deflation.

2. The Wholesale Price Index

The WPI is another popular measure of inflation, which measures and tracks the changes in the price of goods in the stages before the retail level. While WPI items vary from one country to other, they mostly include items at the producer or wholesale level.

3. The Producer Price Index

The producer price index is a family of indexes that measures the average change in selling prices received by domestic producers of goods and services over time. The PPI measures price changes from the perspective of the seller and differs from the CPI which measures price changes from the perspective of the buyer.

Conclusion: In all such variants, it is possible that the rise in the price of one component (say oil) cancels out the price decline in another (say wheat) to a certain extent. Overall, each index represents the average weighted cost of inflation for the given constituents which may apply at the overall economy, sector or commodity level.