Class XI Economics

Ch: Inflation: Problems & Policies

Inflation: It is a situation of persistent & considerable rise in prices, leading to a fall in purchasing power of money.

Deflation: It occurs when prices are declining over time. It is a situation when the supply of goods rises faster than the supply of money.

Stagflation: It is a condition of slow economic growth & relatively high unemployment, accompanied by a rise in prices.

Types of Inflation:

- **Demand Pull Inflation:** It arises when there is an excess of demand for goods over their supply. When there is a persistent increase in demand & supply does not increase proportionately, then price tends to rise.

  Causes for Demand Pull Inflation:

  - **Increase in Public Expenditure:** When people have confidence in the economy, they start spending more & save less. Also they resort for lending to fulfill various demands like home loans etc. This leads to an increase in the overall demand in the economy.
  - **Increase in Govt. Spending:** As the government spends more in any particular segment of the economy, it drives up demand. For example, military spending raises prices for military equipment.
  - **Increase in Money Supply:** 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.
  - **Improved business confidence**: It prompts firms to raise prices and achieve better profit margins
  - **Increase in Population**: With increasing population, the demand for basic goods & services increase at a much faster pace than the increase in the supply. This leads to demand pull inflation.

- **Cost Push Inflation:** It occurs when rise in price is due to rise in the cost of production. In this type of inflation, supply factors play an important role. Once, this type of inflation sets in one industry, it spreads to all other industries of an economy.

  Causes for Cost Push Inflation:

  - **Rising Labor Cost:** Increase in the wage rate, especially in the labor intensive industry, leads to an increase in the cost of production.

- **Higher indirect taxes imposed by the government**: for example a rise in the specific duty on alcohol and cigarettes, an increase in fuel duties. These taxes are levied on producers who pass this on to the consumers by raising the prices of the products.
- **Creating Monopolies**: cost-push inflation can be created by companies that achieve a monopoly over an industry. This has the same effect as reducing the supply, because the company controls the supply of that good or service.
- **Depletion of Inputs:** A fall in the availability of inputs due to their over usage also leads to an increase in their pieces resulting in an increase in cost of production.

Measures of Inflation/ Indicators of Inflation

- **Consumer Price Index (CPI):** Consumer Price Index measures the increase in the price of a given "basket" of goods and services purchased by the average consumer. The percentage increase in the price for these goods in one year is the inflation rate. If the percentage increase is negative, then it's called deflation rate.
- **Wholesale Price Index:** An index that measures and tracks the changes in price of goods in the stage at wholesale level. It refers to a mix of agricultural and industrial goods at various stages of production and distribution, including import duties.
- **Gross Domestic Product Deflator:** It accounts for inflation by converting output measured at current prices into constant prices. The GDP deflator shows how much a change in the base year's GDP relies upon changes in the price level.

Whole Sale Price Index

For measuring inflation level of any country, wholesale price index is mostly taken into consideration. All commodities to which the index relates are classified into three groups:

- Primary articles consisting of food, non food & minerals
- Fuel consisting of power, light & lubricants
- Manufactured products

It has been noticed from the past trends that growth rate of inflation in food items & fuel is higher than in case of manufacturing products.

Effects/ Problems of Inflation:

- **Micro Level- On Individual**
  - **Fall in Purchasing Power:** Purchasing power means the quality of goods & services one can buy from his fixed income. Inflation leads to reduction in the purchasing power, particularly of the fixed income groups.

- **Increase in Input Prices:** Inflation also leads to rise in prices of the goods & services used by the producers, e.g. raw materials, machines etc. This raises cost of production & forces the producers to raise the prices of products they produce. This results in further inflation.
- **Creates Social Problems:** Inflation changes the allocation of resources & income. Only rich people are able to purchase the basic necessities of life & this leads to the social tensions in the economy.

- **Macro Level- On Economy**
  - **Increase in Speculation:** Inflation leads to a handful of the consumers in making extensive speculation, to derive advantage of the high price levels. Since some of the purchases are high-risk investments, they result in diversion of the expenditures from regular channels.
  - **Increase in Poverty Level:** Price increase can worsen the poverty affecting low income household.
  - **Creates Uncertainty:** Rising prices creates uncertainty**.** In a climate of uncertainty both domestic and foreign entrepreneurs will be reluctant to invest. This will slow down the potential for economic growth.
  - **Increase in Nominal Rates:** Inflation will lead to increases in nominal interest rates. The real value of interest payments will be eroded with inflation and thus banks and financial institutions will have to raise their nominal interest rates in order to try to persuade people to keep their money deposited with banks. Increases in interest rates will make the cost of acquiring credit higher. This will cause firms to cut back on investment.

Policy Measures to Control Inflation

- **Monetary Measures:**
  - **Check on Money Supply:** Reduction in money supply will result in the fall in purchasing power & hence reduction in demand for goods & services bringing down the prices.
  - **Increasing Interest Rates:** Increase in interest rates would reduce the borrowing capacity of households & investors thus leading to the fall in the money circulation in economy.
  - **Measures by RBI:** By raising cash reserve ratio, statutory liquidity ratio & selling the securities in open market, RBI could attempt to reduce inflation.
- **Fiscal Measures:**
  - **Check on Public Expenditure:** By reducing the expenditure done by govt., there could be a reduction in the circulation of money in the economy. Thus reducing the inflation.
  - **Increase in Taxes:** Increase in tax rates would reduce the purchasing power of individuals & hence controlling inflation.
  - **Public Borrowing:** If govt. resorts to the borrowing from public, then it would reduce the money with the public & hence combating inflation.