Inflation and Deflation

Definition and meaning :

Everyone is familiar with the term ' Inflation ' as rising prices. This means the same thing as fall in the value of money. Inflation is a monetary ailment in an economy and it is defined by economists in so many ways. When there is a persistent and appreciable rise in the general level or average of prices, we have inflation. Crowther defines inflation as " a state in which the value of money is falling, i.e., prices are rising." Piogu defines inflation as a condition " when money income is expanding relatively to the output of work done by the productive agents for which it is the payment". Coulbourn defines it as "too much money chasing too few goods." T.E. Gregory calls inflation a state of abnormal increase in the quantity of purchasing power.

All these definitions indicate one basic phenomenon in the economy. Too much of money in circulation compared with too little goods produced, leading to extraordinary increase in prices

This is what is called the quantity approach to the rise in price level. It should be noted here that *high* prices should not be construed as inflation. It is only a *persistent increase in prices to abnormal extent* which should be termed inflation.

Keynes' Definition :

While increase in volume of money is responsible for rise in the price level, Keynes relates inflation and rise in prices as follows: (a) It comes into existence after the stage of full employment; (b) Rise in prices may be accompanied by an increase in production; and (c) Rise in prices *not* accompanied by increase in production.

If an economy is working at a low level with a number of unemployed people and resources, an expansion of money or other factors will not only increase the prices due to increase in demand, but also increase the volume of goods and services produced in the system. This is the case of rise in prices accompanied by increased production and employment. This condition will continue till all the factors and unemployed are fully utilised, i.e., a stage of full-employment is reached. Beyond this stage, however, any expansion in the volume of money will only lead to rise in prices and not rise in production or employment.

Keynes opines that the stage of increasing prices with increasing output and employment is desirable. Such type of increasing prices is called '*Reflation*' or partial inflation which helps the economy to move towards full employment condition. But increasing prices after full-employment is bad, as there will not be any increase in the production of goods or increase in employment. Hence, *in the Keynesian sense, inflation refers to a rise in the price level after full employment is reached.*

But, in an underdeveloped country, the term 'inflation' cannot be used in the Keynesian sense. A country advancing towards full employment condition, may show signs of inflation. This does not mean that countries having inflationary conditions signify that they are moving towards full employment. In a country like India, we can witness 'inflation' and 'unemployment' existing side by side. Abnormal rise in prices and persistent rise in prices are in no way an indication of prosperity and that the country is moving towards full employment. On the other hand, the backlog of unemployment is mounting up year after year.

① On the Basis of Speed

On the basis of speed or the rapidity with ~~with~~ which prices increase, inflation is divided into four:

a) Creeping Inflation - slow moving and very mild, favourable for economic development.

b) Walking Inflation - rise in prices becomes more marked and it is a danger signal

c) Running Inflation - under this rise in prices will be very sharp and vigorous.

d) Galloping Inflation - the Galloping or hyper - Inflation, there will be no limit to the height of price it will reach, it is dangerous and disastrous to the economy, it cannot be controlled easily. It is also called 'Run Away' Inflation.

② On the Basis of Inducement

Under this it divided into three categories.

a) **Deficit - Induced Inflation** - caused by the adoption of deficit finance.

b) **Wage - Induced Inflation** - a rise in prices due to an increase in money wages.

c) **Profit - Induced Inflation** - this occurs on account of increase in the profits of manufacturers.

③ On the Basis of Time

Emergencies like war or preparation for war, post - war period caused Inflation.

(B) On the Basis of Extent of coverage

On the basis of coverage, Inflation may be classified as

(1) **Economy wide** - covering the entire economy.

(2) **Sporadic** - partial in character, temporary shortage of some specific goods, the shortage of supply may be due to restricted physical condition.

Open Inflation - due to uninterrupted price (non-intervention of govt.)

Suppressed Inflation - administrative machinery will go beyond control like corruption, black-marketing etc.

Unit - (3)

Inflation

5. Effects of Inflation

Inflation has good as well as bad effects on the economy.

Mild inflation may create an all-round expansion of business activity and this proves beneficial to the economy.

"Inflation is welcome up to the stage of full employment"

We shall study the effects of inflation on different sections of the economy

(i) on Producers
(ii) on working class
(iii) on fixed income group
(iv) on Distribution.
(v) on Debtors and creditors
(vi) on government
(vii) social consequence

(i) <u>On Producers</u>

All businessmen, traders, speculators gain during Inflation, there is a time-lag between a rise in the prices of commodities and rise in the cost of production.

(ii) <u>On Working class</u>

Labour classes suffer during Inflation, price rise as their wages do not rise so easily and proportionately, during this their cost of living Increased.

It is said that, "Prices go up by lift, while wages go up by steps".

~~(iii) On working class~~

(iii) <u>On Fixed Income Group</u>

People living on past savings, fixed interest on investment, Pensioners, salaried class like teachers and government servants become the worst sufferers.

(iv) <u>On Distribution</u>

Inflation has bad effects on distribution, example - the price of industrial goods go up rapidly during inflation and price of agricultural produce are not so flexible, this creates imbalance in the income of the different sectors.

(v) <u>On Debtors and creditors</u>

during the inflationary period the debtors (borrowers) gain much while creditors (lenders) lose heavily.

(vi) <u>On Government</u>

the government is both beneficier and looser of inflation

beneficier → paid old debt.
looser - its expenditure increase.

(vii) <u>Social consequence</u>

It makes the rich will become richer and poor will become poorer.

Unit - (2)

Inflation

A. Causes of Inflation

(i) Demand - Pull Inflation
(ii) Cost - Push Inflation
(iii) Demand - Shift Inflation

(i) Demand - Pull Inflation

This type of Inflation occurs when there is an excess demand force acting in the economy leading to rise in prices.

It emerges when the aggregate demand exceeds the level of full-employment output.

It is a situation where "too much money will be chasing too few goods".

Keynes calls this "bottle-neck Inflation".

Demand - Pull Inflation may be caused by an increase in the quantity of Money.

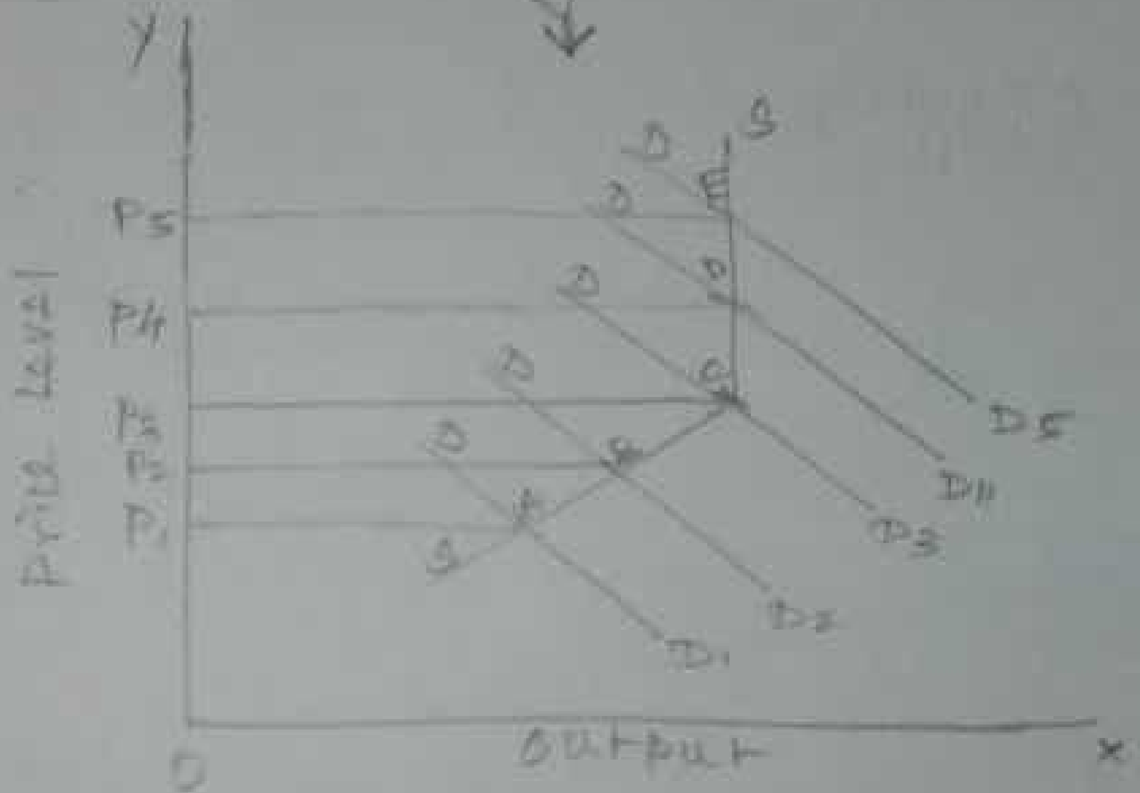

Figure - ① Demand - Pull Inflation

SS - Supply Function

DD (D1 D2 D3 D4 D5) } — Aggregate Demand curve

P (P1 P2 P3 P4 P5) } — Price Line

A, B, C — Full employment not reached

C, D, E — Full employment reached, so at 'C' economy faces inflation

(ii) Cost - Push Inflation

According to this, Inflation starts not by an excess of general demand, but by increase in costs.

Rise in cost of raw materials and wages prices being raised.

'Cost - Push' Inflation can also be called 'Wage - Push' Inflation.

Labour Unions demand higher wages, Labour Union Push the Producers to paid more wages.

See Page A

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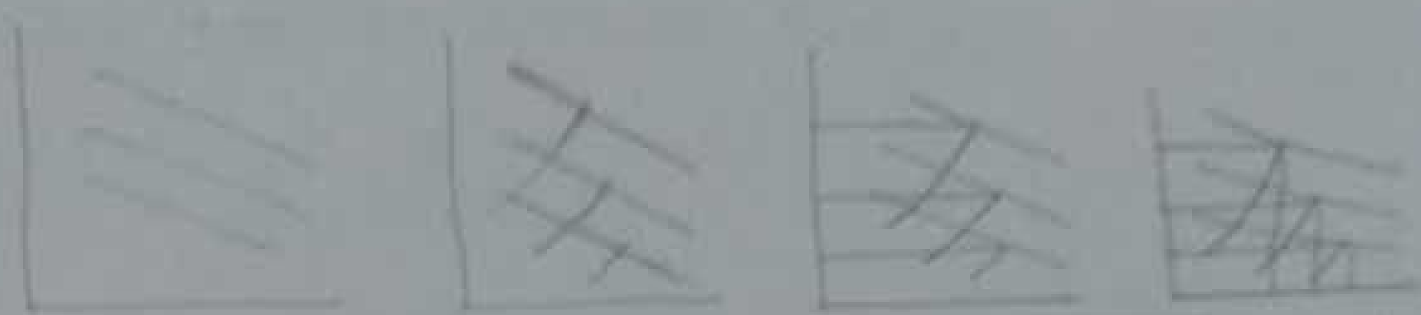

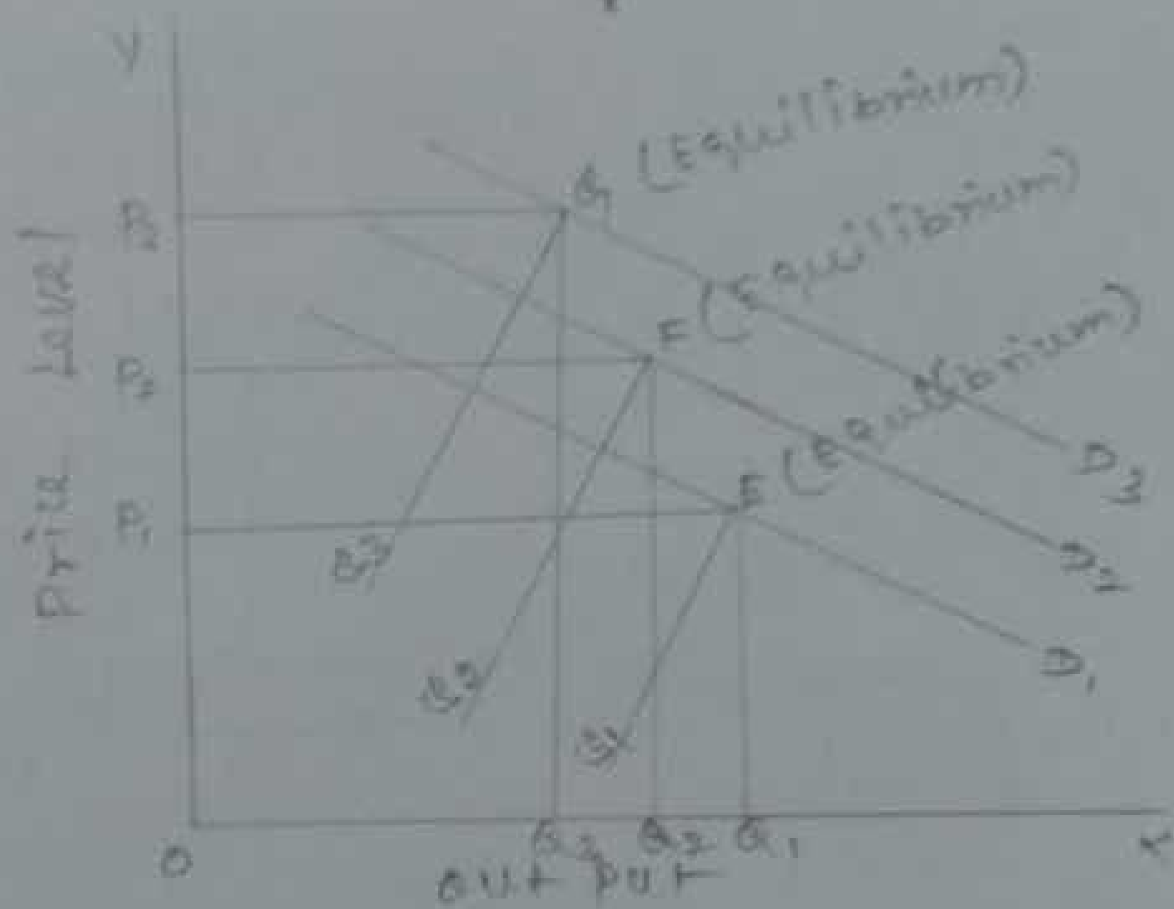

<u>Figure - ③ Cost-Push Inflation</u>

P (P_1 P_2 P_3) — Prices
D (D_1 D_2 D_3) — Demand curves
S (S_1 S_2 S_3) — Supply
Q (Q_1 Q_2 Q_3) — Output

(iii) Demand - Shift Inflation

A rise in the price level may occurs even without an increase in aggregate demand.

This may due to structural shift in demand.

The structure of demand will change so rapidly that the resources cannot be shifted equally fast.

Such type of structural shift in demand will take place either after the war or due to any political upheavals.

after war sudden reduction in government expenditure causes these.

Inflationary Gap - Definition

"It is the amount of the government's expenditure against which there is no corresponding ~~real~~ release of real resources of manpower or materials by some other member of the community."

Unit - (3)

Inflation

7. Inflationary Gap

We can illustrate the concept of Inflationary gap by assuming 'War - economy', which will be more or less a full employment economy.

During the war period, the volume of money expenditure increases because of the government's expenditure on the armed forces and armaments.

This increased government expenditure will result in increased income to the people in the different sectors of the economy.

The community will increase the consumption expenditure and also investment due to increase in its income.

∴ Keynes introduced the concept of 'Inflationary Gap' in the context of excess spending over the available goods at full employment level.

Unit - (2)

Deflation

1. Deflation

Deflation is the opposite of Inflation.

According to Paul Einzig, "Deflation is a state of disequilibrium in which a contraction of purchasing power tends to cause or is the effect of, a decline of the price level."

The essential feature of deflation is falling prices, reduced money supply and unemployment.

If the prices fall from the level of full employment, it is called deflation.

2. Effects of Deflation

The effects of deflation will be more or less the opposite of effect of inflation.

1. Effects on Production
2. Effects on Employment
3. Effects on Income Distribution
4. Effects on Debtors and creditors.
5. Political and social consequences.

(i) Effects on Production

bring negative effects to producers caused by deficiency in aggregate demand and fall in price level.

(ii) Effects on Employment

Millions of people will remain unemployed.

(iii) Effects on Income Distribution

due to fall in price fixed income groups like pensioners, government servant, etc. are benefited. consumers, creditors, investors, rent-earners, small savers are benefited.

(iv) Effects on Debtors and creditors

the creditors gain much, while debtors lose heavily, the government will be a loser, if it redeems the public debt during deflation.

(v) Political and social consequences

Moral degradation, theft and pilfering etc. this may also create problems of law and order.

the social, political and moral life may be threatened seriously.

6. **Anti-Inflationary Measures**

(i) Monetary Measures
(ii) Fiscal Methods
(iii) Physical and Direct Measures.

(i) **Monetary Measures**

a) Changing the Bank-Rate
b) open Market operations
c) Increasing the reserve ratio of commercial banks and
d) placing effective curbs on advances made by commercial banks.

(ii) **Fiscal Methods**

a) taxation (introduce new taxes)
b) public expenditure
c) public borrowing
d) surplus Budgeting

(iii) **Physical and Direct Measures**

wage-freeze, income-freeze, imposed, wages, salaries, profit margins are controlled. price-control, rationing resorted, control black marketing and hoarding ensure equitable distribution.

during the period ... did not have enough ...
corn for fuel purposes, as they did not have enough

CONTROL OF DEFLATION

Since deflation is caused by the deficiency of aggregate demand due to poor purchasing power of the people, the anti-deflationary policies should aim at increasing the level of employment. As we had studied already, *autonomous investments* by the government is the first essential requirement to combat the severity of deflation and reduction of unemployment.

Secondly, to stimulate private investment along with government investments, several monetary measures should be undertaken by the government. These measures are liberal extension of credit and low rates of interest. In addition, the fiscal measures like rationalised business tax policies, provision of tax relief and payment of subsidies to raise investment production and exports may be undertaken by the government. The most significant of all fiscal measures is the increased government expenditure, financed by *deficit budgeting*, for the provision of relief, social insurance payment, expenditure on the promotion of scientific and industrial research, direct public participation in industrial investment and undertaking of the public works programme. The public works programme can absorb unemployed workers and raise their purchasing power in addition to raising the level of output. While undertaking the public works, precaution must be taken that they do not offset private investment. For this purpose, the government should make investment in such projects or areas where the private investment and enterprises are not forthcoming. The public works financed through public borrowing or through deficit financing are more effective in counteracting the deflationary situation than those financed through taxation.