1.What Is Inflation?

**Inflation is a quantitative measure of the rate at which the average price level of a basket of selected goods and services in an economy increases over some period of time. It is the rise in the general level of prices where a unit of currency effectively buys less than it did in prior periods.**

Inflation is the rate at which the general level of prices for goods and services is rising and, consequently, the purchasing power of currency is falling. Inflation is classified into three types: Demand-Pull inflation, Cost-Push inflation, and Built-In inflation. Most commonly used inflation indexes are the Consumer Price Index (CPI) and the Wholesale Price Index (WPI).Inflation can be viewed positively or negatively depending on the individual viewpoint and rate of change. Those with tangible assets, like property or stocked commodities, may like to see some inflation as that raises the value of their assets. People holding cash may not like inflation, as it erodes the value of their cash holdings. Ideally, an optimum level of inflation is required to promote spending to a certain extent instead of saving , thereby nurturing economic growth.

2. What are the causes of inflation on demand side?

Both Keynesians and monetarists believe that inflation is caused by increase in aggregate demand. The main causes from the demand side are:

**1. Increase in Money Supply:** Inflation is caused by an increase in the supply of money which leads to increase in aggregate demand. The higher the growth rate of the nominal money supply, the higher is the rate of inflation.

**2. Increase in Disposable Income:** When the disposable income of the people increases, it raises their demand for goods and services. Disposable income may increase with the rise in national income or reduction in taxes or reduction in the saving of the people.

**3. Increase in Public Expenditure:** Government activities have been expanding much with the result that government expenditure has also been increasing at a phenomenal rate, thereby raising aggregate demand for goods and services. Governments of both developed and developing countries are providing more facilities under public utilities and social services, and also nationalising industries and starting public enterprises with the result that they help in increasing aggregate demand.

**4. Increase in Consumer Spending:** The demand for goods and services increases when consumer expenditure increases. Consumers may spend more due to conspicuous consumption or demonstration effect. They may also spend more when they are given credit facilities to buy goods on hire-purchase and installment basis.

**5. Cheap Monetary Policy:** Cheap monetary policy or the policy of credit expansion also leads to increase in the money supply which raises the demand for goods and services in the economy. When credit expands, it raises the money income of the borrowers which, in turn, raises aggregate demand relative to supply, thereby leading to inflation. This is also known as credit-induced inflation.

**6. Deficit Financing:** In order to meet its mounting expenses, the government resorts to deficit financing by borrowing from the public and even by printing more notes. This raises aggregate demand in relation to aggregate supply, thereby leading to inflationary rise in prices. This is also known as deficit-induced inflation.

**7. Expansion of the Private Sector:** The expansion of the private sector also tends to raise the aggregate demand. For huge investments increase employment and income, thereby creating more demand for goods and services. But it takes time for the output to enter the market. This leads to rise in prices.
**8. Black Money:** The existence of black money in all countries due to corruption, tax evasion etc. increases the aggregate demand. People spend such unearned money extravagantly, thereby creating unnecessary demand for commodities. This tends to raise the price level further.
**9. Repayment of Public Debt:** Whenever the government repays its past internal debt to the public, it leads to increase in the money supply with the public. This tends to raise the aggregate demand for goods and services and to rise in prices.
**10. Increase in Exports:** When the demand for domestically produced goods increases in foreign countries, this raises the earnings of industries producing export commodities. These, in turn, create more demand for goods and services within the economy, thereby leading to rise in the price level.

These are the responsible causes of inflation from the demand side.

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3. What are the causes of inflation on supply side?

There are certain factors which operate on the opposite side and tend to reduce the aggregate supply. The responsible factors are:
**1. Shortage of Factors of Production:** One of the important causes affecting the supplies of goods is the shortage of such factors as labour, raw materials, power supply, capital, etc. They lead to excess capacity and reduction in industrial production, thereby raising prices.
**2. Industrial Disputes:** In countries where trade unions are powerful, they also help in curtailing production. Trade unions resort to strikes and if they happen to be unreasonable from the employers' viewpoint and are prolonged, they force the employers to declare lock-outs.

In both cases, industrial production falls, thereby reducing supplies of goods. If the unions succeed in rising money wages of their members to a very high level than the productivity of labour, this also tends to reduce production and supplies of goods. Thus they tend to raise prices.
**3. Natural Calamities:** Drought or floods is a factor which adversely affects the supplies of agricultural products. The latter, in turn, create shortages of food products and raw materials, thereby helping inflationary pressures.
**4. Artificial Scarcities:** Artificial scarcities are created by hoarders and speculators who indulge in black marketing. Thus they are instrumental in reducing supplies of goods and raising their prices.
**5. Increase in Exports:** When the country produces more goods for export than for domestic consumption, this creates shortages of goods in the domestic market. This leads to inflation in the economy.
**6. Lop-sided Production:** If the stress is on the production of comfort, luxury, or basic products to the neglect of essential consumer goods in the country, this creates shortages or consumer goods. This again causes inflation.

**7. Law of Diminishing Returns:** If industries in the country are using old machines and outmoded methods of production, the law of diminishing returns operates. This raises cost per unit of production, thereby raising the prices of products.

**8. International Factors:** In modern times, inflation is a worldwide phenomenon. When prices rise in major industrial countries, their effects spread to almost all countries with which they have trade relations. Often the rise in the price of a basic raw material like petrol in the international market leads to rise in the prices of all related commodities in a country.

These are the responsible causes of inflation from the supply side.

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4**. Explain clearly the demand pull inflation.**

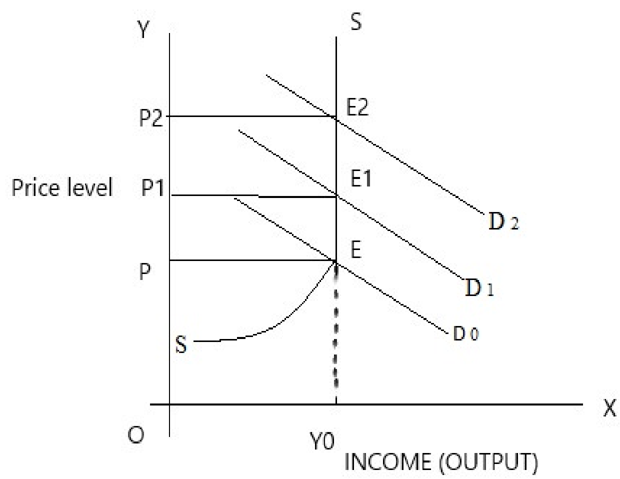
Keynes and his followers emphasise the increase in aggregate demand as the source of demand-pull inflation.

Demand-pull inflation occurs when the overall demand for goods and services in an economy increases more rapidly than the economy's production capacity. It creates a demand-supply gap with higher demand and lower supply, which results in higher prices. For instance, when the oil producing nations decide to cut down on oil production, the supply diminishes. It leads to higher demand, which results in price rises and contributes to inflation.

There may be more than one source of demand. Consumers want more goods and services for consumption purposes. Businessmen want more inputs for investment. Government demands more goods and services to meet civil and military requirements of the country. Thus the aggregate demand comprises consumption, investment and government expenditures. When the value of aggregate demand exceeds the value of aggregate supply at the full employment level, the inflationary gap arises.

The larger the gap between aggregate demand and aggregate supply, the more rapid the inflation. Given a constant average propensity to save, rising money incomes at the full employment level would lead to an excess of aggregate demand over aggregate supply and to a consequent inflationary gap. Thus Keynes used the notion of the inflationary gap to show an inflationary rise in prices.

In the Keynesian view so long as there in unemployment, all the change in income is in output, and once there is full employment, all is in prices.




SS- Aggregate Supply Function which is more elastic till $Y_o$

$Y_o$- Full Employment Level of Income or Output from which SS becomes perfectly inelastic.

$D_0$- Original Aggregate Demand Function.

$P_0$– Price Level.

$Y_0$– Equilibrium Income.

If there is an increase in money stock and credit,increase in consumption, investment or government expenditure, $D_0$– shifts to $D_1$.

$E_1$- New Equilibrium with Increased demand and Fixed supply.

$P_1$- Increased Price level.

Consumer will purchase more in anticipation that the price will rise more. It will raise the aggregate expenditure so that $D_1$ shifts to $D_2$ at new equilibrium $E_2$.

Thus in the demand pull inflation the process of raising price is not only initiated by the pull of demand but is also perpetuated by the pull of Demand.

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5. **Explain clearly the Cost Push inflation**.

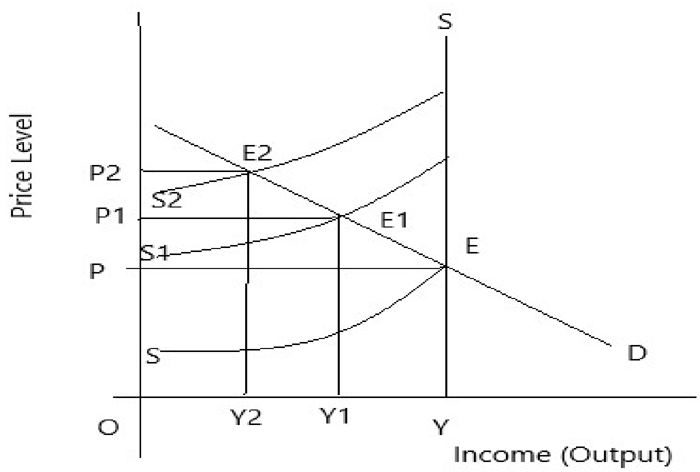
Cost-push inflation occurs when overall prices increase (inflation) due to increases in the cost of wages and raw materials. Higher costs of production can decrease the aggregate supply (the amount of total production) in the economy. Since the demand for goods hasn't changed, the price increases from production are passed onto consumers creating cost-push inflation.

The most common cause of cost-push inflation starts with an increase in the cost of production, which may be expected or unexpected. For example, the cost of raw materials or inventory used in production might increase, leading to higher costs.

For cost-push inflation to take place, demand for the affected product must remain constant during the time the production cost changes are occurring. To compensate for the increased cost of production, producers raise the price to the consumer to maintain profit levels while keeping pace with expected demand.

Main Points of Cost Push Inflation are:

a) Cost-push inflation occurs when overall prices increase (inflation) due to increases in the cost of wages and raw materials.
b) Cost-push inflation can occur when higher costs of production decrease the aggregate supply (the amount of total production) in the economy.
c) Since the demand for goods hasn't changed, the price increases from
d) Production is passed onto consumers creating cost-push inflation.




In the diagram:
D- Aggregate Demand Function which is negatively sloped.
SS- Original Supply Function. It is more elastic till Full employment level exists.
E- Equilibrium.
Y- Full Employment Income.
P- Price Level.

If there is increase in money wages and costs, the aggregate supply function shifts to $S_1S$ . Here,
$E_1$- Newe Equlibrium.
$P_1$- Increased Price.
$Y_1$- Decreased Income bellow full employment.
Y- $Y_1$ – The Unemployment Gap.
The increase in price level makes the trade unions to put pressure further so that the living standard of the workers is kept intact. Hence the employers has to raise the wages of the workers which will increase the cost of production. As a result average supply function shifts to $S_2S$. $E_2$ will be the new equilibrium and Price level raises to $P_2$.
$Y_1$ –$Y_2$ – The raised Unemployment Gap.

This process of rising prices and increasing unemployment goes on so long as the cost push is present.

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6. Q: What are the impacts of inflation on economic activities?

The following points highlight the six major effects of inflation. The effects are: 1. Effects on Distribution of Income and Wealth 2. Effects on Production 3. Effects on Income and Employment 4. Effects on Business and Trade 5. Effects on the Government Finance 6. Effects on Growth.

1. Effects on Distribution of Income and Wealth:The impact of inflation is felt unevenly by the different groups of individuals within the national economy—some groups of people gain by making big fortune and some others lose.We may now explain in detail this effect of inflation on different groups of people:

(a) Creditors and debtors: During inflation creditors lose because they receive in effect less in goods and services than if they had received the repayments during a period of low prices. Debtors, on other hand, as a group gain during inflation, since they repay their debts in currency that has lost its value (i.e., the same currency unit will now buy less goods and services).

(b) Producers and workers:Producers gain because they get higher prices and thus more profits from the sale of their products. As the rise in prices is usually higher than the increase in costs, producers can earn more during inflation. But, workers lose as they find a fall in their real wages as their money wages do not usually rise proportionately with the increase in prices. They, as a class, however, gain because they get more employment during inflation.

(c) Fixed income-earners: Fixed income-earners like the salaried people, rent-earners, landlords, pensioners, etc., suffer greatly because inflation reduces the value of their earnings.

(d) Investors: The investors in equity shares gain as they get dividends at higher rates because of larger corporate profits and as they find the value of their shareholdings appreciated. But the bondholders lose as they get a fixed interest the real value of which has already fallen.

(e) Traders, speculators, businesspeople and black-marketers: They gain because they make more profits from the persistent rise in prices.

(f) Farmers: Farmers also gain because the rise in the prices of agricultural products is usually higher than the increase in the prices of other goods.

Thus, inflation brings a shift in the pattern of distribution of income and wealth in the country, usually making the rich richer and the poor poorer. Thus during inflation there is more and more inequality in the distribution of income.

2. Effects on Production: The rising prices stimulate the production of all goods—both of consumption and of capital goods. As producers get more and more profit, they try to produce more and more by utilising all the available resources at their disposal.

But, after the stage of full employment the production cannot increase as all the resources are fully employed. Moreover, the producers and the farmers would increase their stock in the expectation of a further rise in prices. As a result hoarding and cornering of commodities will increase.

But such favourable effects of inflation upon production are not always found. Sometimes, production may come to a standstill position despite rising prices, as was found in recent years in developing countries like India, Thailand and Bangladesh. This situation is described as stagflation.

3. Effects on Income and Employment:Inflation tends to increase the aggregate money income (i.e., national income) of the community as a whole on account of larger spending and greater production. Similarly, the volume of employment increases under the impact of

increased production. But the real income of the people fails to increase proportionately due to a fall in the purchasing power of money.

4. Effects on Business and Trade:The aggregate volume of internal trade tends to increase during inflation due to higher incomes, greater production and larger spending. But the export trade is likely to suffer on account of a rise in the prices of domestic goods. However, the business firms expand their businesses to make larger profits.

During most inflation since costs do not rise as fast as prices profits soar. But wages do not increase proportionate with prices, causing hardships to workers and making more and more inequality. As the old saying goes, during inflation prices move in escalator and wages in stairs.

5. Effects on the Government Finance:During inflation, the government revenue increases as it gets more revenue from income tax, sales tax, excise duties, etc. Similarly, public expenditure increases as the government is required to spend more and more for administrative and other purposes. But the rising prices reduce the real burden of public debt because a fix sum has to be paid in instalment per period.

6. Effects on Growth:A mild inflation promotes economic growth, but a runaway inflation obstructs economic growth as it raises cost of development projects. Although a mild dose of inflation is inevitable and desirable in a developing economy, a high rate of inflation tends to lower the growth rate by slowing down the rate of capital formation and creating uncertainty.

But inflation, especially a runaway inflation, is an unstable situation. It makes the business world uneasy and uncertain. Society gets disturbed as there grows discontentment among the salaried people and they demand an increase in their wages and salaries.

The middle-class people suffer hard as the real value of their income becomes very low. Inflation is also unjust as it makes one class of people richer and the other poorer. But the most serious effect of inflation from the standpoint of the economy is that it makes the economic environment of business unstable.

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7. What is Redistributive Effect of Inflation?

The effect of inflation is to redistribute wealth and income from savers and those on fixed income to debtors and those on variable income. The borrower gains and the lender loses as long as the interest rate is not adjusted for the rate of inflation. The
price effect suggests individuals can gain real income by selecting and purchasing goods and services that are increasing in price at a lower rate than alternative selections

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**8. What is Hyperinflation? What are its effects?**

**Hyperinflation** is a term to describe rapid, excessive, and out-of-control general price increases in an economy. While **inflation** is a measure of the pace of rising prices for goods and services, **hyperinflation** is rapidly raising **inflation**, typically measuring more than 50% per month.

The main points of understanding of hyperinflation are:

1. When prices soar over 50% in one month, the economy is experiencing hyperinflation.
2. This is often caused by a government that prints more money than its nation's GDP can support.
3. Hyperinflation tends to occur during a period of economic turmoil or depression.
4. Demand-pull inflation can also cause hyperinflation. Soaring prices cause people to hoard, creating a rapid rise in demand chasing too few goods. The hoarding may create shortages, aggravating the rate of inflation.
5. Countries that have suffered horrendous inflation rates are Germany, Venezuela, Zimbabwe, and the United States during the Civil War. Venezuela is still trying to cope with hyperinflation in the present day.

   Zimbabwe had hyperinflation between 2004 and 2009. The government printed money to pay for the war in the Congo. Also, droughts and farm confiscation restricted the supply of food and other locally produced goods. As a result, hyperinflation was worse than in Germany. The inflation rate was 98% a day, and prices doubled every 24 hours. It finally ended when the country changed its currency to the U.S. dollar.

**Effects Of Hyperinflation**:

To keep from paying more tomorrow, people begin hoarding. That stockpiling creates shortages. It starts with durable goods, such as automobiles and washing machines. If hyperinflation continues, people hoard perishable goods, like bread and milk. These daily supplies become scarce, and the economy falls apart.

People lose their life savings as cash becomes worthless. For that reason, the elderly are the most vulnerable to hyperinflation. Soon, banks and lenders go bankrupt since their loans lose value. They run out of cash as people stop making deposits.

Hyperinflation sends the value of the currency plummeting in foreign exchange markets. The nation's importers go out of business as the cost of foreign goods skyrockets. Unemployment rises as companies fold. Then government tax revenues fall and it has trouble providing basic services. The government prints more money to pay its bills, worsening the hyperinflation.

There are two winners in hyperinflation.

1.The first beneficiaries are those who took out loans and find that higher prices make their debt worthless by comparison until it is virtually wiped out

2. Exporters are also winners, because the falling value of the local currency makes exports cheaper compared to foreign competitors. Additionally, exporters receive hard foreign currency, which increases in value as the local currency falls.

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