

Pinky Rani

Guest Faculty

Department of Economics

Maharaja College

Veer Kunwar Singh University, Ara

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Topic: Inflation

Inflation is a gradual loss of purchasing power that is reflected in a broad rise in prices for goods and services over time. The inflation rate is calculated as the average price increase of a basket of selected goods and services over one year. High inflation means that prices are increasing quickly, while low inflation means that prices are growing more slowly. Inflation can be contrasted with deflation, which occurs when prices decline and purchasing power increases.

- Inflation measures how quickly the prices of goods and services are rising.
- Inflation is classified into three types: demand-pull inflation, cost-push inflation, and built-in inflation.
- The most commonly used inflation indexes are the Consumer Price Index and the Wholesale Price Index.
- Inflation can be viewed positively or negatively depending on the individual viewpoint and rate of change.
- Those with tangible assets may like to see some inflation as it raises the value of their assets.

An increase in the money supply is the root of inflation, though this can play out through different mechanisms in the economy. A country's money supply can be increased by the monetary authorities by:

- Printing and giving away more money to citizens

- Legally devaluing (reducing the value of) the legal tender currency
- Loaning new money into existence as reserve account credits through the banking system by purchasing government bonds from banks on the secondary market

Other causes of inflation include supply bottlenecks and shortages of key goods, which can push prices to rise.

When inflation occurs, money loses its purchasing power. This can occur across any sector or throughout an entire economy. The expectation of inflation itself can further sustain the devaluation of money. Workers may demand higher wages and businesses may charge higher prices, in anticipation of sustained inflation. This, in turn, reinforces the factors that push prices up.

Types of Inflation

Inflation can be classified into three types: demand-pull inflation, cost-push inflation, and built-in inflation.

Demand-Pull Effect

Demand-pull inflation occurs when an increase in the supply of money and credit stimulates the overall demand for goods and services to increase more rapidly than the economy's production capacity. This increases demand and leads to price rises.

When people have more money, it leads to positive consumer sentiment. This, in turn, leads to higher spending, which pulls prices higher. It creates a demand-supply gap with higher demand and less flexible supply, which results in higher prices.

Cost-Push Effect

Cost-push inflation is a result of the increase in prices working through the production process inputs. When additions to the supply of money and credit are channeled into a commodity or other asset markets, costs for all kinds of intermediate goods rise. This is especially evident when there's a negative economic shock to the supply of key commodities.

These developments lead to higher costs for the finished product or service and work their way into rising consumer prices. For instance, when the money supply is expanded, it creates a speculative boom in oil prices. This means that the cost of energy can rise and contribute to rising consumer prices, which is reflected in various measures of inflation.

Built-In Inflation

Built-in inflation is related to adaptive expectations or the idea that people expect current inflation rates to continue in the future. As the price of goods and services rises, people may expect a continuous rise in the future at a similar rate.

As such, workers may demand more costs or wages to maintain their standard of living. Their increased wages result in a higher cost of goods and services, and this wage-price spiral continues as one factor induces the other and vice versa.