Inflation

Inflation is an important and widely talked about concept in modern economics. In simple words, inflation means a situation in which there is a continuous rise in general price level. But according to economics, rise in prices is only an indicator of inflation. For example, in the words of Silverman,

“Inflation is the term given to the expansion of money supply, in excess of the amount justified by the state of the trade, resulting in a general rise in prices.**”**

Coulborn has beautifully defined the term as: **“**Too much money chasing too few goods.**”**

And a well known expert in monetary economics, Crowther says, **“**Inflation is a state of economy in which the value of money is falling i.e. price are rising.**”**

There are many other definitions of inflation given by various writers. Going through which we come to the conclusion that a conclusion that a situation of inflation has three main features:

- **a)** It is a process of continuously rising prices.
- **b)** It starts when some changes in the economy take place and it becomes impossible to satisfy the whole of demand for goods at existing prices. So prices start rising.
- **c)** Due to initial rise in prices, the buyers start anticipating further rise in prices. So they buy more quantity of goods in hurry. This induces further rise in prices. Thus inflation is propagated.

Kinds of Inflation:

There are generally two most important kinds of inflation:

1) Demand-Pull Inflation:

In this kind inflation arises when a country’s total demand for goods (aggregate demand) exceeds supply at current prices. This demand may rise due to many causes including increased money supply, deficit financing, population explosion, etc. but whatever may be the cause if aggregate demand exceeds supply inflation will result. Moreover, in an economy there are three main types of buyers i.e. consumers, the investors (firms) and the government. If any of these groups increases its demand, while the demand of others remains the same, aggregate demand will rise and, hence, inflation will take place. Greater part of inflation in Pakistan is demand-pull type.

2) Cost-Push Inflation:

In cost-push inflation, inflation originates from rise in production costs. Because when the firms have to bear increased production costs, they pass on these increased costs to consumers in the form of higher prices of products, inflation takes place. Here the important sources of rise in cost include workers' demand for higher wages, increase in taxes and high prices of imports.

Causes of Inflation:

<u>A. Demand Pull Factors:</u>

1) Deficit Financing & Excessive Increase in Money Supply:

This is the major cause of rising prices. Because a large part of development expenditure is done out of deficit financing while the production does not rise at the same rate, so the level of prices rises.

2) Population Explosion:

If the population grows rapidly than the rate of growth of GNP, the increase in output will be insufficient to solve the problem of scarcity of goods. Thus inflation will arise.

3) Profiteering, Hoardings and Artificial Scarcity of Goods:

All these are commonly practiced evils which are adopted in order to earn huge profits. But these lead to create scarcity of goods which in turn results in inflation.

4) Black Money, Concentration of Wealth and Unproductive Expenditures:

Black money is not spent on productive activities. Either it goes to real estate, jewellery, speculation, expensive marriages or it is carelessly spent on consumer goods. All such additional expenditures put pressure on prices.

<u>B. Cost –Push Factors:</u>

1) Devaluation and Depreciation in Exchange Value:

Devaluation and depreciation in exchange value act as fuel for inflation.

2) Development Expenditures:

Huge expenditure on mega development projects also creates inflation. Because although spending of money raises incomes and demand for goods but production from such projects takes a long time to be available.

3) Political Instability:

Political instability discourages investment and encourages speculation and hoarding. Because frequent rumors about political instability change create fear among investors. So, under such circumstances, the industrialists and businessmen feel insecure and cannot make good plans.

4) Imported Inflation & High Oil Prices:

Higher prices of imported goods and oil also tend to bring about inflation in the country.

5) Wage Increases:

The increase in wages of workers also contributes to inflation. Because increase in wages results in higher cost of production. So their prices rise.

6) Indirect Taxes:

Taxes on commodities like sales tax and excise duty push up prices of goods.

7) Climatic Factors:

The countries like Pakistan which heavily depend upon agriculture, due to unfavourable weather conditions many crops fall short of target, thus pushing up pieces.

Effects of Inflation:

Inflation has both positive and negative effects for the economy. But mostly harmful effects are greater than good effects. These effects are as follows:

A. Good Effects:

Healthy effects of inflation on the economy are felt only when the inflation is of mild nature (say, 2% per year). These effects are:

1) Increase in Production:

When prices are rising slowly, the profits of the industrialists and businessmen rise. So they try to produce more goods.

2) Increase in Employment:

To increase production, the firms employ more workers. If idle resources exist in the economy, then as a result of inflation, they get employment. In some cases, the country may achieve the goal of full employment.

3) Increase in Investment:

With the improvement in the prospects of profits, investment activity is boosted. The capitalists become optimistic and readily put their capital in some productive business.

4) Increase in Economic Development:

Low inflation is helpful for economic development. Because if money supply increases, the government's resources increase, hence, new money can be used on mew development projects.

5) Research and Innovations are encouraged:

When industry is expanding and business activities are going on full pace, the producers devote more attention and funds to research. Thus innovations in the form of new products or new methods of production are introduced.

B. Harmful Effects:

It is very difficult to control inflation at low rate. Inflation feeds on itself and has the following harmful effects on the economies:

1) Increase in Cost of Living:

The working classes are hard hit. Because wages do not rise at the rate prices are rising. So those sections of society who have fixed incomes, like salaried class, find difficulty in buying their daily needs.

2) Inequality in Income Distribution Increases:

When prices are rising and businessmen and big landlords are making huge money, the distribution of income among various classes of society becomes more unequal. The position of wage earners becomes weaker. They get a smaller share of national income and, hence, the gap between rich and the poor increases.

3) Decrease in Saving:

During rising prices the savings of common people are adversely affected. Because the greater part of their incomes is used to buy consumer goods.

4) Less Exports and More Imports:

Local goods become costly for the foreigners. They start buying from other countries. So inflation has an adverse effect on the balance of payments position.

5) Productive Investment Falls:

When prices rise sharply, speculation and hoarding of commodities is encouraged. A person, by not selling goods for few days, can make huge profits. Thus businessmen become profiteers. While due to the fast rising cost of raw materials, investment plans are distributed.

6) Increased Rate of Interest:

Rate of interest tends to rise which has bad effects for investment.

Measures to Control Inflation:

The following three kinds of measures should be taken to control inflation:

A. On Demand Side:

1) Control of Money Supply:

Volume of credit and money supply should be controlled i.e. tight monetary policy be followed. Because decrease in money supply means less purchasing power with the people.

2) No Deficit Financing:

Deficit financing should be discontinued. The development expenditure on budget deficit should be met through taxation or borrowing and not by printing new money.

3) Population Control:

Growth of population must be slowed. For this purpose campaign of population planning should be started through advertisements and various other measures..

4) Simple Living:

Luxurious life style should be discouraged and simple living be promoted. For this purpose the political leaders should set examples to be followed by others. Moreover, heavy taxes should be levied on luxury items.

5) Price Control:

Prices of essential commodities should be controlled. The demand and supply conditions in markets of such commodities should be constantly reviewed and as soon as some trouble appears, appropriate steps should be applied.

B. On Supply Side:

1) Increases of Output:

The most effective method to control inflation is to increases the supply of goods. For this purpose, industrial and agricultural output should be increased.

2) Control of Smuggling, Hoarding and Speculation:

Through publicity as well as punishments smuggling, hoarding and speculation of all essential goods should be strictly checked.

3) Industrial Peace:

Industrial peace should be ensured to maintain the supply of goods and avoid the danger of scarcity. For this purpose, the disturbances in the country like terrorism should be controlled.

4) Cheap Sources of Energy:

To reduce cost of production cheap energy is needed. So efforts should be doubled to increase such sources of energy like dams, nuclear energy, etc.

C. Measures to be taken by the Government:

1) Monetary Policy:

Monetary policy is used to control the supply of money and cost of borrowing. In this regard the central bank proceeds in two directions:

i. It reduces the money supply in circulation.

ii. It raises the interest rate. Because of higher interest rate borrowing from the banks is discouraged and total money supply is reduced.

2) Fiscal Policy:

Fiscal policy refers to the government policy of public expenditure and taxes and can be used as anti-inflationary measure. Because through it the government reduces its expenditure on unproductive activities. It raises direct taxes which decrease disposable income of the consumers and aggregate demand for goods falls.

3) Direct Measures:

Direct measures mean the steps of the government like rationing of goods and freezing of prices and wages. The government can also increase voluntary savings of the people by giving them various incentives and can also increase export duties and reduce import duties on various essential items. However, in a direct economy, direct measures can succeed only for a very short period.