Subject: Macroeconomics

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Name of the Topic: Inflation (Meaning, Demand & Supply side factors) — Unit 3

Meaning of Inflation

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Inflation is generally defined as a period of sustained rise in prices. First inflation means rising prices and not merely high prices. If prices are very high, but remain constant at that level, it will not be called inflation. Secondly, the rise in prices must be sustained, i.e., prices must be continuously rising. Prices may rise because of a sudden increase in demand or due to a sudden shortfall in supply. But this will not be called inflationary because this type of price rise will not be sustained. It will stop when the demand or supply adjusts to the new level.

Work to do

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Let us now consider a few other definitions of inflation and their drawbacks. Inflation has been defined as "an increase in the supply of money relative to the supply of goods and services". Or "an excess of

anticipated expenditure over available output at full employment" or "a rise in prices due to budget deficit", etc. These definitions are causal definitions in the sense that they specify a cause of inflation to be an inflationary situation. The main difficulty of the causal definition lies in the fact that there may be cases where inflation may not happen even if any cause remains present. For example, it may happen that a budget deficit occurs but the price level does not ~~change~~. rise. Therefore, in that case ~~of~~ budget deficit should not be termed as inflationary. Further the adoption of causal definition may create obstacles for taking appropriate policy measures. For example, it was believed in the USA that budget deficit was inflationary and that's why it was not adopted even during the great depression of the 1930s.

There are three approaches to the theory of inflation: (i) theory of demand inflation, (ii) theory of cost inflation, and (iii) the quantity theory of approach to inflation.

The earliest ~~approach~~ attempt to explain the consequences of rising prices was made by classical economists with the help of the quantity theory of money. In the crude version of the quantity theory the price level depends directly and proportionately on the quantity of money. Inflation occurs when the quantity of money increases and when the quantity of money stabilises inflation comes to a halt. The rate of inflation depends on the rate of new money creation. If $\Delta M/M$ is five percent $\Delta P/P$ will also be five percent. In a situation of demand inflation, prices rise due to excess demand in the market for commodities in a situation of full employment. The excess demand in the product

market pulls prices upwards. The increased profitability of production in turn creates an excess demand in the labour market which pulls wages upward. Thus in a situation of demand inflation prices first rise leading to rise in wages.

Cost inflation arises as a result of an increase in the wage rates. Wage rates may increase because of two factors: (1) an increased demand for labour and (2) due to collective bargaining or trade union pressures even if there is no excess demand for labour. If the wage rate increases as a result of excess demand for labour it should not be termed as true cost inflation, because this is a case of demand inflation where inflationary forces operate not on the product market but on the factor market. For true cost inflation, it is therefore argued that the wage rate increase not due to excess demand for labour but due to trade union pressures.

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The classical economists believed that inflation is caused by the increase in supply of money. The speed of inflation was determined by the rate of increase of the supply of money. This approach of linking quantity theory with the price level is known as the quantity theory approach to inflation. The quantity theory approach as formulated by classical economists assumed that there was always full employment in the economy.

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Demand and Supply side factors of inflation

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Demand side factors of inflation

Both Keynesians and monetarists believe that inflation is caused by increase in aggregate demand. They point toward the following factors which raise it:

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(i) Increase in money supply
(ii) Increase in disposable income
(iii) Increase in public expenditure
(iv) Increase in consumer spending
(v) Cheap monetary policy
(vi) Deficit financing

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(vii) Expansion of the private sector
(viii) Black money
(ix) Repayment of public debt
(x) Increase in exports

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Supply side factors of inflation

There are also certain factors which operate on the opposite side and tend to reduce the aggregate supply.. Some of the factors are as follows:

(i) Shortage of factors of production
(ii) Industrial dispute
(iii) Natural Calamities
(iv) Artificial scarcities
(v) Increase in exports
(vi) Lop-sided production
(vii) Law of diminishing returns
(viii) International factors (often the rise in the prices of a basic raw material like petrol in the international market leads to rise in the prices of all related commodities in a country.)