Inflation

Inflation is a phase of rapid rise in prices arising under conditions of full employment. It can lead to no further rise in incomes and employment in the economy. In other words, inflation is generally associated with rapidly rising prices which causes a decline in the purchasing power of money.

A state in which value of money is falling and prices are rising is termed as inflation. If all prices change in the same direction at the same time and in the same degree, the problems presented by fluctuation in their value of money would be minor. Even then, certain maladjustments would arise, for the burden of outstanding indebtedness would grow lighter with a rise in the general price level and heavier with a fall.

Types of Inflation

1. Creeping Inflation: when prices rise by about 1-3 percent per annum, it is called Creeping Inflation. Economists do not consider it harmful as it has very little adverse effect on economic activities. So, it is not considered so harmful.

2. Walking Inflation: When the price rise is about 3-5 percent per annum, it is called Walking Inflation. Even this is not considered so dangerous as it also has a little adverse effect on economic activities.

3. Running Inflation: When prices rise by about 10 percent per annum, it is called Running Inflation. This type of inflation is not considered favourable for the economy as it brings fall in the living standard in the real terms.

Sources of Inflation

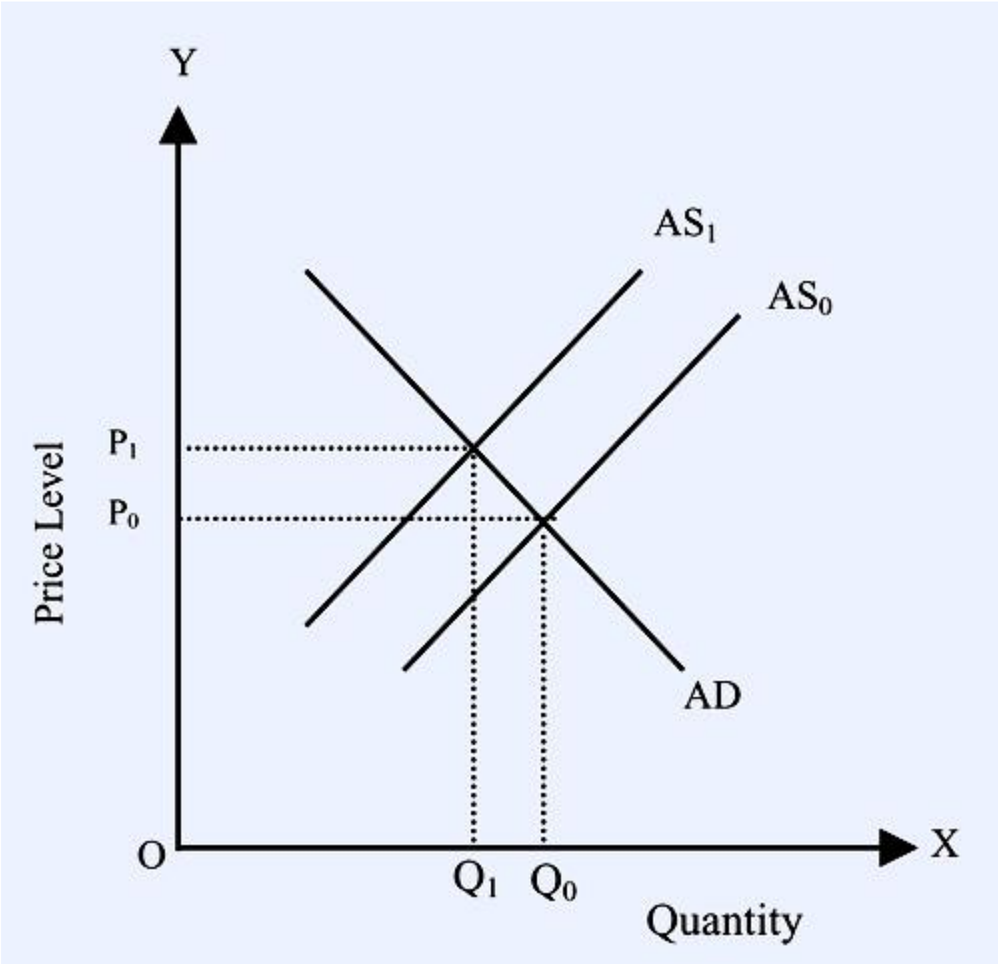
1. Cost-Push Inflation

Cost-push inflation occurs when prices increase due to increases in production costs, such as raw materials and wages. The demand for goods is unchanged while the supply of goods declines due to the higher costs of production. As a result, the added costs of production are passed onto consumers in the form of higher prices for the finished goods.

One of the signs of possible cost-push inflation can be seen in rising commodity prices such as oil and metals since they're major production inputs. For example, if the price of copper rises, companies that use copper to make their products might increase the prices of their goods. If the demand for the product is independent of the demand for copper, the business will pass on the higher costs of raw materials to consumers. The result is higher prices for consumers without any change in demand for the products consumed.

Wages also affect the cost of production and are typically the single biggest expense for businesses. When the economy is performing well, and the unemployment rate is low, shortages in labour or workers can occur. Companies, in turn, increase wages to attract qualified candidates, causing production costs to rise for the company. If the company raises prices due to the rise in employee wages, cost-plus inflation occurs.

Natural disasters can also drive prices higher. For example, if a hurricane destroys a crop such as corn, prices can rise across the economy since corn is used in many products.



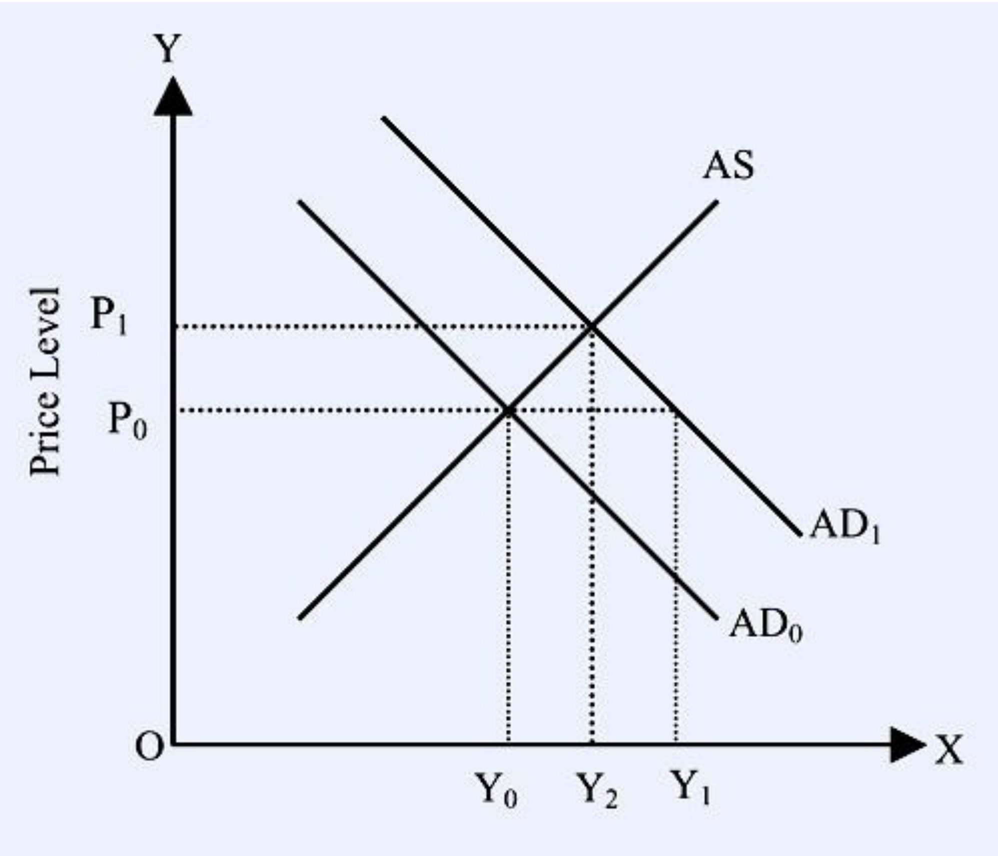
2.Demand-Pull Inflation

Demand-pull inflation can be caused by strong consumer demand for a product or service. When there's a surge in demand for a wide breadth of goods across an economy, their prices tend to increase. While this is not often a concern for short-term imbalances of supply and demand, sustained demand can reverberate in the economy and raise costs for other goods; the result is demand-pull inflation.

Consumer confidence tends to be high when unemployment is low, and wages are rising—leading to more spending. Economic expansion has a direct impact on the level of consumer spending in an economy, which can lead to a high demand for products and services.

As the demand for a particular good or service increases, the available supply decreases. When fewer items are available, consumers are willing to pay more to obtain the item—as outlined in the economic principle of supply and demand. The result is higher prices due to demand-pull inflation.

Companies also play a role in inflation, especially if they manufacture popular products. A company can raise prices simply because consumers are willing to pay the increased amount. Corporations also raise prices freely when the item for sale is something consumers need for everyday existence, such as oil and gas. However, it's the demand from consumers that provides the corporations with the leverage to raise prices.



Measures to Check Inflation

Various measures can be adopted to control inflation. These measures can be grouped into three categories:

(A) Monetary Measures:

These are adopted by the central bank (RBI) of the country. Following are the monetary measures which help in controlling inflationary situation.

1. Making Note Issue Policy Strict: The central bank should adopt strict note issue policies so that it may not issue additional money. For making note issue more stringent, the gold or foreign exchange reserve should be enhanced. If there is no provision of keeping reserve, it should be started. Adoption of such measures makes note issue system a difficult one. These measures also check inflationary situation.

2. Issue of New Currency: When the inflation reaches to a uncontrollable situation, the government issues new currency and squeeze out old currency out of circulation. These measures are also called demonetization. It is an unusual method of controlling inflation.

3. Control on Credit Money: To control inflation, it is essential to control credit money also. For this purpose, the central bank of the country adopts the following measures:

I. **Increase in Bank Rate**: Bank rate is the rate of which the central bank rediscounts the bills of commercial bank or at which it extends financial accommodation to the commercial banks. If there is much expansion of credit in the banking system, in such cases to control credit central bank increases bank rate. Increase in bank rate will check rising inflationary situation

II. **Open Market Operations:** Another method to check inflation is that the central bank of the country resorts to selling government securities to the public and the banks. When the public and the banks purchase the securities, they have to make payments for these securities to the central bank. The result is that the cash moves from the commercial banks to the central bank. This reduces commercial bank ability to create credit

III. **High Reserve Requirement:** The central bank in order to reduce the money supply in the economy increases the limit of the reserve requirement of commercial banks. This method prevents the commercial bank from forming a basis for further credit expansion.

(B) Fiscal Measures:

The following fiscal measures could be adopted by the government for combating inflation:

(i) **Taxation:** During inflation, efforts should be made to reduce the size of disposable income in the hands of public. This can be done either by imposing new taxes on by increasing the existing rates of taxation. This will leave less money supply with the public.

(ii) **Government Expenditure:** To control inflation, government should reduce its expenditure especially unproductive expenditure. Any drastic cut in the government expenditure to curb inflationary situation may land the economy in the slump.

(iii) **Balanced Budget:** To control inflationary situation, government should adopt the policy of Balanced Budget because deficit budget further increases inflation in the economy. In case of inflationary boon, government should also try to prepare surplus budget

(iv) **Increase in Savings**: To provide a positive incentive to promote saving which will reduce outlays and curb inflation, the government should have in its budgetary policy incentives for savings also.

(v) **Increase in Public Debts**: To check inflation, the government should also issue debentures and bonds and encourage the public for its purchase. By issue of debentures and bonds, the government can take back additional purchasing power. The amount collected by the government through these sources, should be utilized in productive channels.

(C) Other measures:

In addition to above fiscal and monetary measures, following measures can be adopted for controlling inflation:
(i) Increase in Production: By increasing production the inflationary pressure can be reduced. In-crease in production increases the supply of goods, which helps in establishing prices.

(ii) Price control and Rationing System: The government can control the rise in prices by prohibiting any unwarranted price rises or by putting a ceiling on prices of selected commodities. The government can also impose price control along with rationing of the commodities.

(iii) Export-Import Control: By restricting exports and promoting imports, government can increase the supply of goods in the country. This helps in controlling the rise in prices.

(iv) Improvement of Distribution System: The public distribution system in the country should be strengthened. So that the commodities are made available at reasonable prices.