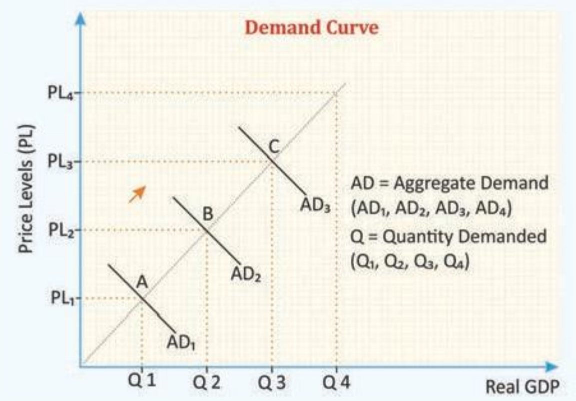
7 Inflation and Business Cycle

Inflation

- It is defined as a sustained increase in the general price level of goods and services.
- It is measured in terms of percentage change in prices over a particular time-period.
- It is different from relative price rise as 'Inflation' refers to a sustained, across-the-board price increase, whereas 'a relative price increase' is a reference to an episodic price rise pertaining to one or a small group of commodities.

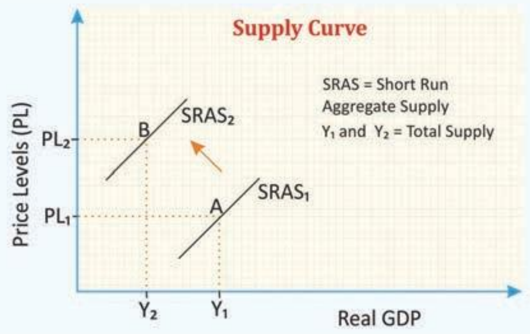
Causes of Inflation

- **Demand-Side or Demand-Pull Inflation**
  - It is a situation when aggregate demand for goods and services in the market exceeds the aggregate supply.
  - When demand for goods and services are high and supply is not adequate due to low economic output (Production), the firms increase the general price levels of goods and services.
  - **Causes of Demand Side Inflation**
    - Increased liquidity in the economy.
    - Increase in income levels and purchasing power of households.
    - Growth in population and increase in demand for goods and services.
    - Changing consumer behaviour.
  - **Macroeconomic Impacts of Demand-pull Inflation**
    - There is full employment of resources when aggregate supply is inelastic.
    - Rise in Real GDP as the economy will grow at a faster rate.
    - Fall in unemployment rate.
    - Upward revision on wages as the demand for workers will increase.
    - The upward pressure on wages may lead to wage-push inflation as higher wages increase the disposable income of workers leading to a rise in consumer spending.



- It depicts the relationship between the price of a certain commodity and the quantity demanded.
- As the quantity demanded is more (i.e. Q1 to Q2), the curve will shift upward from point A to point B with the corresponding rise in prices (i.e. from PL1 to PL2).
- It also indicates that with the increase in demand Real GDP expands.

- **Supply-Side (or Cost-Push) Inflation**
  - It develops when the factor cost or the cost of production increases with respect to the consistent demand for goods.
  - It is determined by supply-side factors, such as higher wages, higher oil prices, etc.
  - **Causes of Supply Side Inflation**
    - Rising nominal wages of labour.
    - Depreciation of exchange rates.
    - Rising food and energy prices.
    - Rising oil prices.
    - Higher production tax.
    - Structural rigidities.



- It is the correlation between the cost of a good or service and the quantity supplied for a given period.
- When supply reduces (i.e. from Y1 to Y2), the price levels will go up (i.e. from PL1 to PL2).
- It also indicates that with the reduction in supply Real GDP shrinks for a short term.

- **Macroeconomic Impacts of Cost-Push Inflation**
  - Macroeconomic impact of cost push inflation is temporary in nature.
  - It can lead to lower economic growth and often causes a fall in living standards.
  - It will cause a higher price level.
  - It lowers the Real GDP.

Types of Inflation

- **Creeping Inflation**
  - When the rise in prices is very slow (i.e., less than 3% per annum), it is called creeping inflation or mild inflation.
  - It is regarded as safe and essential for economic growth.
  - It acts as an incentive for producers to enhance production.
  - It indicates a continuous rise in demand in the economy.
- **Trotting Inflation**
  - When prices rise moderately and the annual inflation rate is in single digit (3% – 10%), it is called walking or trotting inflation.
  - Inflation at this rate is a warning signal for the government to control it before it turns into running inflation.
- **Running Inflation**
  - When prices rise rapidly at a rate of 10% – 20% per annum, it is called running inflation.
  - Its control requires strong monetary and fiscal measures, otherwise it leads to hyperinflation.
- **Galloping Inflation**
  - It is when prices rise at double or triple digit rates, such as 30 % or 100 % per year.
  - At this rate of inflation, money loses its value at a rapid rate. This level of inflation is obviously not good for the economy.
  - Businesses will hesitate to engage in long-term contracts because prices change rapidly. Investors will not make investments that yield returns that are below the inflation rate.
  - Latin American countries such as Argentina and Brazil had inflation rates of 50% to 700% per year in the 1970s and 1980s.
- **Hyper-inflation/ Runaway Inflation**
  - It is a very high and accelerating inflation rate. It brings a situation when the prices skyrocket more than 50 % a month.
  - Hyperinflation collapses the entire monetary system and at this inflationary stage, the government tends to use other stable currency.
  - Hyperinflation was experienced by a number of developing countries, such as Argentina, Brazil and Peru in the decade from 1989 to 1999 and Venezuela in 2016.
- **Bottleneck Inflation**
  - It takes place when the supply falls drastically and the demand remains at the same level.
  - It arises due to supply-side mismanagement, which is also known as structural inflation.
  - This can be put in the demand-pull inflation category.
- **Headline Inflation**
  - It measures the change in prices of a wide range of commodities including those which have price volatility, like food and oil.
  - In India, headline inflation is measured through the WPI (the latest base year 2011-12) – which consists of 697 commodities (services are not included in WPI in India).
  - It is measured on a year-on-year basis, i.e., rate of change in the price level in a given month in relation to the corresponding month of last year.
  - It is also known as point to point inflation.