5 Inflation

During the post-war period, inflation has turned out to be the worst malady to infect the economic structures of almost all countries of the world. Rightly, therefore, it has remained a source of much controversy among the contemporary economists, politicians and the general public. The controversies are related to different aspects of inflation. In the present chapter, we shall attempt to have a clear understanding of the some important aspects of this most intriguing problem of the present day world.

1. CONCEPT OF INFLATION

There has been much disagreement among the economists over the definition of inflation and it is symptomatic of confusion that pervades the entire theory of inflation. The quantity theorists identify inflation with an *increase in the purchasing media*. For instance, **Hawtrey** associates inflation with "the issue of too much currency" and **Gregory**, with a state of "abnormal increase in the quantity of purchasing power." The essential feature of inflation is the process of rising prices. The increase in the quantity of money may only be a cause of inflation and not the inflation itself. An increase in the stock of money may not necessarily cause a rise in the price level. Moreover, the price level may have a rising tendency even though the stock of money remains constant.

Another line of thinking about the definition of inflation is that the problem essentially is a matter of *disproportionately high increase in the stock of money or money incomes compared with the change in the output of goods and services*. The economists, including Coulborn, Friedman, Paish, Kemmerer, Pigou, Goldenweiser and Emile James consider inflation as a monetary phenomenon and that it is manifested by a disequilibrium between the stock of money or money income and the physical volume of commodities and services. Whereas **Coulborn** defines inflation as "too much money chasing too few goods", **Kemmerer** writes, "Inflation is too much money and deposit currency–that is too much currency in relation to the physical volume of business being done." According to **Goldenweiser**, "inflation occurs when the volume of money actively bidding for goods and services increases faster than the available supply of goods, when the growth of national income in money units is greater than its growth in physical units." **Pigou** has explained that inflation takes place when "money income is expanding relatively to the output of work done by the productive agents for which it is the payment." **Keynes** too subscribes to the view that true inflation occurs when the aggregate demand exceeds the aggregate supply at full employment. **Emile James** has also given expression to a similar opinion–"Inflation is a self-perpetuating and irreversible upward movement of prices, caused by an excess of demand over capacity to supply." This set of definitions regards the expansion of money stock or money expenditure as the cause and a rise in prices as the effect. But the German hyper-inflation of early 1920's demonstrated that the rise in prices then was of such an abnormal magnitude that the monetary authority was forced to expand the money supply. Under such conditions, therefore, the inflationary process cannot be attributed to an increase in money stock or money incomes. In addition, these definitions treat inflation as induced simply by an excess demand and neglect the more vicious aspects of the phenomenon–wages, costs of production and prices moving in a spiral.

To clear the cob-web of definitions of inflation, we must recognise that it is essentially a phenomenon related to a *process of rising prices.* Many economists including Gardner Ackley, Harry Johnson and Milton Friedman opt to define it in terms of a process of rising prices. To quote **Gardner Ackley**, "Inflation is a persistent and appreciable rise in the general level or average of prices." In this connection, we must be clear about one thing. The existence of high prices is not inflation. It is only a process of rising prices that is termed as inflation. **Crowther** says that inflation is a "state in which the value of money is falling, *i.e.*, the prices are rising." **Milton Friedman** has conceived inflation as a process of "a steady and sustained rise in prices." Similarly **Harry G. Johnson** remarks, "I define inflation as a sustained rise in prices." Brooman has, however, got certain reservations in respect of treating every rise in prices as inflation. It may be possible that a current increase in prices may be mere up-and-down phenomenon around a constant level, or the price rise may accompany a short run expansion of output as the level of capacity utilization is raised or may be a once-for-all adjustment to some change in the external situation. For instance, it might have become essential to switch to a new source of imports, since the prices at the erstwhile sources had considerably gone up. In all these cases, the element of chronic and self-perpetuating character of rising prices will be missing. So *inflation manifests itself in a chronic and self-sustaining process of rising prices.*

2. DETERMINANTS OF INFLATION

The main determinants of the process of inflation in a country are as follows :

(i) ***Increase in money supply*** : As the central bank of country increases the supply of money, the money income of the people increases. That leads to an increase in the demand for goods and services, while the supply thereof fails to increase in the same proportion. It brings about an increase in the level of prices.

(ii) ***Expansion in credit*** : If the commercial banks follow a liberal credit policy, the business firms can have easy access to credit. The increase in credit flow leads to increased demand for raw materials and capital stock. It pushes up the prices of different categories of products.

(iii) ***Increase in the velocity of money*** : Sometimes the monetary authority does not enlarge the supply of money and credit. But for different reasons the velocity of circulation of money gets increased. It means each unit of money faciliates more transactions than before. In such a situation, there is an increase in the demand for consumer and producer goods. It again leads to a rapid increase in prices.

(iv) ***Deficit financing*** : When the revenue receipts of the government fall short of the public outlay, the government resorts to deficit financing through expansion in currency or

borrowing from the central bank or commerical banks. In either of the cases, there is a net increase in the supply of money. As a consequence, the level of prices starts rising.

(v) ***Increase in consumption*** : If there is an increase in the demand for consumer goods due to a rise in disposable income and other factors but the supply of those products can not be extended, the upward price movement takes place.

(vi) ***Increase in investment*** : If there is an increase in investment spending but the output can be enlarged within a short period due to technical factors, the price level again has a tendency to move in the upward direction.

(vii) ***Increase in government expenditure***: If there is a large increase in government expenditure on defence, administration, internal security, social security and government consumption, the demand for goods and services increases, while their supply can not be increased. In such a situation, the price level starts rising sharply.

(viii) ***Increase in foreign demand*** : If there is an increase in the demand for domestically produced goods in the foreign countries, there is an increase in exports. The domestic availability of goods get reduced and, consequently, the internal price level starts rising.

(ix) ***Existence of black money*** : When there is the existence of a large amount of black money or the unaccounted money, the prices have a strong tendency to rise. The black money is often used for such activities as hoarding, black marketing and smuggling of goods, speculation, real estate transactions etc. Such uses of black money invariably create shortages of goods and the consequent rise in prices.

(x) ***Increase in population*** : The increase in population results in shortages of essential consumer goods like foodgrains and other food products, cloth, shoes and several other products and services. Thus increasing population creates strong and sustained inflationary pressures in the economy.

(xi) ***Shortage of foodgrains*** : Foodgrains are the basic requirement of the people. If the agricultural production is hit adversely by the unfavourable weather conditions, floods, drought etc., shortages of foodgrains appear. People have to meet their food needs, even if they have to pay very high prices. Thus food shortage leads to serious inflationary conditions.

(xii) **Shortage of raw materials** : If there are shortages of raw materials, production of several manufactured products declines. It brings about a rapid rise in prices.

(xiii) ***Shortage of fuel, power etc*** : If a country is faced with shortages of fuels like oil, power, coal etc., the costs of production of industrial manufactured products increase. It leads to the rise in prices of the products in the country.

(xiv) ***Increase in wages*** : If there is an increase in wage rates, the cost of production increases. It causes a rise in the prices of the products.

(xv) ***Increase in costs*** : As costs increase due to an increase in wages and prices of other industrial inputs, the prices of the finished products also get increased. This leads to strong inflationary pressures.

(xvi) ***Emphasis on heavy industries*** : If a country plans to undertake investment on a large scale upon the heavy and capital goods industries which have a long gestation period, the production fails to increase while investment expenditure continues to rise, the economy experiences sharp increase in price level.

(xvii) ***Industrial disputes*** : The existence of industrial disputes between labour and