Knowledge Series : Inflation

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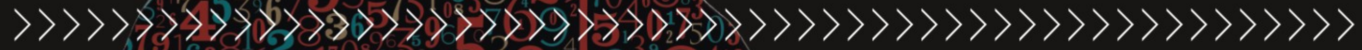
Opportunity favours the prepared mind.



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Price Shocks?

Fiscal measures?

Declining output?

Excess money supply?

Inflation

Monetary tightening?

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<<What is inflation>>

Introduction to Inflation

- Inflation is defined as **the increase in the general level of prices of goods and services from one period to another** (generally one year).
- It is measured in terms of percent change in the value of price index consisting of a basket of goods or services.
- An inflation rate of 10% means that the general level of prices of goods and services has increased by 10% over the previous period.
- In other words purchasing the same amount of goods and services will cost you 10% more than what it would have cost you in the previous period.
- Hence **Inflation can also be described as a decline in the real value of money**- a loss of purchasing power in the medium of exchange which is also the monetary unit of account

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Why do prices rise and fall

- Prices of goods and services in a free market are determined by the forces of demand and supply. Thus you cannot have constant prices unless and until you have a constant demand for these good as and services along with a constant rate of supply
- In general it is observed that demand increases faster than the supply which leads to an increases in prices over a period
- However in unusual times, when demand falls you may actually see a fall in the general level of prices, which in technical terms is called “**Deflation**”

An increase in the general level of prices implies a decrease in the purchasing power of the currency. That is, when the general level of prices rises, each monetary unit buys fewer goods and services.

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Is deflation healthy?

- **Both, a high level of inflation and deflation impact the economy adversely**
- It is believed that moderate inflation over a period of time is good for the economy because it encourages producers to increase output
- However, a high level of inflation or deflation has the opposite effect.
  - **If inflation rises to very high levels then…..**
    - **It reduces the purchasing power of the money in the hands of the people……..**
    - **Resulting in a slowing down of demand for the goods and services produced……**
    - **Which in turn compels providers of these goods and services to reduce output**
- On the other hand, a deflationary scenario makes the production of these goods or services less lucrative and so encourages producers to reduce output

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Types of Inflation

- **Demand Pull Inflation** is caused by the presence of excess money in the system which leads to increase in aggregate demand in the system. It's a classic case of "Too much Money chasing Too Few Goods"
  - This kind of inflation can be controlled by monetary measures such as high interest rates and by asking banks to maintain high cash reserves. These measures act as breaks on money supply
- **Cost Push Inflation** on the other hand has been caused by supply side constraints. The high cost of labor or raw materials may force producers to increase the prices of their goods and services. High crude oil and food prices are examples of supply shocks leading to unexpected increases in prices of their goods and services
  - This kind of inflation requires a more careful use of monetary and fiscal measures
- **Built-in inflation** is a type of inflation that resulted from past events and persists in the present. It thus might be called hangover inflation.
  - Often linked to the "price/wage spiral", as it involves workers trying to keep their wages up with prices and then employers passing higher costs on to consumers as higher prices as part of a "vicious circle."
  - In this case, inflation encourages inflation to persist, which means that the standard methods of fighting inflation using either monetary policy or fiscal policy to induce a recession are extremely expensive, i.e., meaning increase in unemployment and fall in real GDP. Hence, alternative methods such as wage and price controls may be needed as complementary to recessions in the fight against inflation.

Difference between “Core Inflation” and “Headline Inflation”.

We hear economist use the terms “Core Inflation” and “Headline Inflation”. What are these?

- “Headline Inflation” is most commonly represented by a price index consisting of a basket of different goods and services
- “Core Inflation” is what we get after removing volatile elements such as oil and food from the basket of goods and services.
- **Headline inflation is generally higher then core inflation**

How does inflation affect us?

- Inflation will affect you depending upon where you are placed financially
- People living on fixed sources of income such as retirees will feel the pinch more, as inflation eats away the value of their income day by day
- **In an inflationary scenario, a person living on borrowed money is better off as the rate of interest that he would have paid for his borrowed money would be less than the rate of inflation. Therefore inflation decreases the real value of debt**
- But when you pay back your loan in an inflationary environment your lender realizes that now he can buy a little less than what he could have bought earlier with the he lent to you

Thank You