EduTap

# INFLATION AND ITS EFFECTS

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# Inflation & its Effects


## 1. Inflation

A rise in the general level of prices; a sustained rise in the general level of prices; persistent increases in the general level of prices; an increase in the general level of prices in an economy that is sustained over time; rising prices across the board—is inflation. These are some of the most common academic definitions of inflation. If the price of one good has gone up, it is not inflation; it is inflation only if the prices of most goods have gone up.

Inflation occurs when the average price level (that is, prices in general) increases over time. This does not mean that all prices increase the same, nor that all prices necessarily increase. Some prices might increase a lot, others a little, and still other prices decrease or remain unchanged. Inflation results when the average of these assorted prices follows an upward trend.

While short-term bouts of inflation can be triggered by anything that would cause aggregate demand to increase more than aggregate supply, long-term inflation can be sustained only through increases in the money supply. The price level, and any "inflation" of the price level, depends directly on the amount of money in circulation. On the flip side of this relationship, inflation leads to a continual erosion in the purchasing power of money.

## 2. Effects of Inflation

There are **multi-dimensional effects of inflation** on an economy both at the **micro and macro levels**. It redistributes income, distorts relative prices, destabilises employment, tax, saving and investment policies, and finally it may bring in recession and depression in an economy. A brief and objective overview of the effects of inflation is given below:

### 2.1.1 On Creditors and Debtors

Inflation redistributes wealth from creditors to debtors, i.e., **lenders suffer and borrowers benefit** out of inflation. The opposite effect takes place when inflation falls (i.e., deflation).

### 2.1.2 On Aggregate Demand

**Rising inflation indicates rising aggregate demand** and indicates **comparatively lower supply and higher purchasing capacity** among the consumers. Usually, higher inflation **suggests the producers to increase their production** level as it is generally considered as an indication of higher demand in the economy.

### 2.1.3 On Investment

**Investment in the economy is boosted by the inflation (in the short-run)** because of two reasons: (i) **Higher inflation indicates higher demand** and suggests entrepreneurs to expand their production level, and (ii) **Higher the inflation, lower the cost of loan**

### 2.1.4 On Income

Inflation affects the income of individual and firms alike. **An increase in inflation, increases the 'nominal' value of income**, while the **'real' value of income remains the same.** Increased price levels erode the purchasing power of the money in the short-run, but in the long-run the income levels also increase (making the nominal value of income going upward). It means, **in a given period of time income may go up due to two reasons, viz., inflationary situation and increased earning**. The concept 'GDP Deflator' (GDP at current prices divided by GDP at constant prices) gives the idea of 'inflation effect' on income over a given period.

### 2.1.5 On Saving

**Holding money does not remain an intelligent economic decision** (because money loses value with every increase in inflation) that is why **people** visit banks more frequently and **try to hold least money with themselves** and put **maximum with the banks in their saving accounts** (to minimise the loss in value of money with interest earned on it, provided bank is paying positive interest on saving account). This is also known as the **shoe leather cost of inflation** (as it consumes the precious time of the people visiting the bank frequently tagging their shoe). It means that **saving rate increases**. But this happens as a short-term effect of inflation. **In the long-run, higher inflation depletes the saving rate in an economy**. Just the opposite situation arises when inflation falls or shows falling traits with decreasing saving, in the short-run and increasing saving in the long-run, respectively.

### 2.1.6 On Expenditure

Inflation affects both the forms of expenditures —consumption as well as investment. **Increased prices make our consumption levels fall as goods and services we buy get costlier.** We see a tendency among the people to cut their consumption levels aimed at neutralising the impact of price rise— making consumption expenditure fall. Exact opposite happens once prices head downward. On the other hand **inflations makes 'investment' expenditure increase as a result of decreased cost of money/finance** (inflation brings benefit to borrower—known as 'inflation premium'). In times of price fall just opposite happens.

### 2.1.7 On Tax

On tax structure of the economy, inflation creates two distortions:

(i) **Tax-payers suffer while paying their direct and indirect taxes**. As **indirect taxes** are imposed ad valorem (on value), **increased prices of goods** make **tax-payers to pay increased indirect taxes** (like cenvat, vat, etc., in India). Similarly, **due to inflation, direct tax** (income tax, interest tax, etc.) **burden** of the tax-payers also increases as **tax-payer's gross income moves to the upward slabs** of official tax brackets (but the real value of money does not increase due to inflation; in fact, it falls). This problem is **also known as bracket creep**—i.e., **inflation-induced tax increases**. Some economies (as in the US and many European countries) have indexed their tax provisions to neutralise this distortion on the direct tax payers.

(ii) The extent to which tax collections of the government are concerned, inflation increases the nominal value of the gross tax revenue, while real value of the tax collection does not compare with the current pace of inflation as there is a lag (delay) in the tax collection in all economies.

But governments get an advantage on their interest burden, on their borrowings as inflation benefits borrowers. This benefit, however, depends upon the contemporary levels of fiscal deficit and the total national debt.

In the case of a government incurring high fiscal deficit (increased borrowing, printing currency), inflation functions as a tax, i.e., inflation tax via which the government fulfils its expenditure by cutting down the expenditure and consumption of the people.

### 2.1.8 On Exchange Rate

**With every inflation the currency of the economy depreciates** (loses its exchange value in front of a foreign currency) provided it follows the flexible currency regime. Though **it is a comparative matter**, there might be inflationary pressure on the foreign currency against which the exchange rate is compared.

### 2.1.9 On Export

With inflation, **exportable items of an economy gain competitive prices in the world market**. Due to this, the **volume of export increases** (keep in mind that the value of export decreases here) and thus export income increases in the economy. It means **export segment of the economy benefits** due to inflation. Importing partners of the economy exert pressure for a stable exchange rate as their imports start increasing and exports start decreasing

### 2.1.10 On Import

**Inflation gives an economy the advantage of lower imports and import-substitution as foreign goods become costlier**. But in the case of compulsory imports (i.e., oil, technology, drugs, etc.) the economy does not get this benefit and loses more foreign currency instead of saving it.

### 2.1.11 On Trade Balance

In the case of a **developed economy, inflation makes trade balance favourable**, while for the **developing economies inflation is unfavourable for their balance of trade**. This is because of composition of their foreign trade. The **benefit to export** which inflation brings in to a developing economy is **usually lower than the loss it incurs due to its compulsory imports** which become costlier due to inflation.

### 2.1.12 On Employment

**Inflation increases employment in the short-run**, but becomes neutral or even negative in the long run (see the Phillips Curve and the NAIRU in the earlier sections).

### 2.1.13 On Wages

**Inflation increases the nominal (face) value of wages**, while their real value falls. That is why there is a negative impact of inflation on the purchasing power and living standard of wage employees. To neutralise this negative impact the Indian government provides dearness allowance to its employees twice a year.

### 2.1.14 On the Self-employed

Inflation has a neutralizing impact on the self-employed people in the long-run. But in the short-run they also get affected as the economy as a whole gets affected.

### 2.1.15 On the Economy

All the segments discussed above belong to an economy, but we must know the overall short-term and long-term impacts of inflation on an economy.

## 3. Concept Check

**Q. The condition of a continually rising price level is defined as**

(a) Stagflation

(b) Stagnation

(c) Disinflation

(d) Inflation

(e) Deflation

**Answer: D**

**Q. When a country is experiencing a fall in inflation growth, it is termed as**

(a) Deflation

(b) Disinflation

(c) Stagflation

(d) Reflation

(e) None of the above

**Answer: B**