**Inflation, types and causes**

According to many classical writers, inflation is a situation when too much money chases too few goods and services. **Inflation is measured by the Consumer Price Index (CPI), wholesale price index (WPI).**

Inflation may be defined as ‘a sustained upward trend in the general level of prices’ and not the price of only one or two goods. G. Ackley defined inflation as ‘a persistent and appreciable rise in the general level or average of prices’. In other words, inflation is a state of rising prices, but not high prices.

Therefore, there is an imbalance between the money supply and the Gross Domestic Product (GDP). There are many types of inflation like demand-pull inflation, cost-push inflation, supply-side inflation. But Inflation can be divided into two broad types:

1. **Open inflation** – when the price level in an economy rises continuously and
2. **Repressed inflation** – when the economy suffers from inflation without any apparent rise in prices.

According to Keynes, inflation is an imbalance between the aggregate demand and aggregate supply of goods and services. Therefore, if the aggregate demand exceeds the aggregate supply, then the prices keep rising.

Let’s measure inflation rate. Suppose, in December 2007, the consumer price index was 193.6 and, in December 2008, it was 223.8. Thus, the inflation rate during the last one year was

223.8- 193.6/ 193.6 x 100

= 15.6%

As inflation is a state of rising prices, deflation may be defined as a state of falling prices but not fall in prices. Deflation is, thus, the opposite of inflation, i.e., a rise in the value of money or purchasing power of money. Disinflation is a slowing down of the rate of inflation.

**Types of Inflation:**

As the nature of inflation is not uniform in an economy for all the time, it is wise to distinguish between different types of inflation. Such analysis is useful to study the distributional and other effects of inflation as well as to recommend anti-inflationary policies. Inflation may be caused by a variety of factors. Its intensity or pace may be different at different times. It may also be classified in accordance with the reactions of the government toward inflation.

Thus, one may observe different types of inflation in the contemporary society:

**A. On the Basis of Causes:**

**(i) Currency inflation:** This type of inflation is caused by the printing of currency notes.

**(ii) Credit inflation:** Being profit-making institutions, commercial banks sanction more loans and advances to the public than what the economy needs. Such credit expansion leads to a rise in price level.

**(iii) Deficit-induced inflation:** The budget of the government reflects a deficit when expenditure exceeds revenue. To meet this gap, the government may ask the central bank to print additional money. Since pumping of additional money is required to meet the budget deficit, any price rise may then be called the deficit-induced inflation.

**(iv) Demand-pull inflation:**

**Demand-pull inflation** results from an excess of aggregate demand relative to aggregate supply. For example, consider a popular product where demand for the product outstrips supply. The price of the product would increase. The theory in demand-pull inflation is if aggregate demand exceeds [aggregate supply](https://www.investopedia.com/terms/a/aggregatesupply.asp), prices will increase economy wide.

**(v) Cost-push inflation**

It results from general increases in the costs of the [factors of production](https://www.investopedia.com/terms/f/factors-production.asp). These factors—which include capital, land, labor, and entrepreneurship—are the necessary inputs required to produce goods and services. When the cost of these factors rise, producers wishing to retain their profit margins must increase the price of their goods and services. When these [production costs](https://www.investopedia.com/terms/p/production-cost.asp) rise on an economy wide level, it can lead to increased consumer prices throughout the whole economy, as producers pass on their increased costs to consumers. Consumer prices, in effect, are thus pushed up by production costs.

**B. On the Basis of Speed or Intensity:**

**(i) Creeping or Mild Inflation:**

If the speed of upward thrust in prices is slow but small then we have creeping inflation. What speed of annual price rise is a creeping one has not been stated by the economists? To some, a creeping or mild inflation is one when annual price rise varies between 2 p.c. and 3 p.c. If a rate of price rise is kept at this level, it is considered to be helpful for economic development. Others argue that if annual price rise goes slightly beyond 3 p.c. mark, still then it is considered to be of no danger.

**(ii) Walking Inflation:**

If the rate of annual price increase lies between 3 p.c. and 4 p.c., then we have a situation of walking inflation. When mild inflation is allowed to fan out, walking inflation appears. These two types of inflation may be described as ‘moderate inflation’.

Often, one-digit inflation rate is called ‘moderate inflation’ which is not only predictable, but also keep people’s faith on the monetary system of the country. Peoples’ confidence gets lost once moderately maintained rate of inflation goes out of control and the economy is then caught with the galloping inflation.

**(iii) Galloping and Hyperinflation:** Walking inflation may be converted into running inflation. Running inflation is dangerous. If it is not controlled, it may ultimately be converted to galloping or hyperinflation. It is an extreme form of inflation when an economy gets shattered.” Inflation in the double- or triple-digit range of 20, 100 or 200 p.c. a year is labelled “galloping inflation”.

**Government’s Reaction to Inflation:**

Inflationary situation may be open or suppressed. Because of anti-inflationary policies pursued by the government, inflation may not be an embarrassing one. For instance, increase in income leads to an increase in consumption spending which pulls the price level up. If the consumption spending is countered by the government via price control and rationing device, the inflationary situation may be called a suppressed one. Once the government curbs are lifted, the suppressed inflation becomes open inflation. Open inflation may then result in hyperinflation.

## Causes of Inflation:

* Primary Causes
* Increase in Public Spending
* Deficit Financing of Government Spending
* Increased Velocity of Circulation
* Population Growth
* Hoarding
* Genuine Shortage
* Exports
* Trade Unions
* Tax Reduction
* The imposition of Indirect Taxes
* Price-rise in the International Markets

Having understood the inflation meaning, let’s take a quick look at the [factors](https://www.toppr.com/guides/business-economics-cs/theory-of-consumer-behavior/factors-of-production/) that cause inflation.

### **Primary Causes**

In an economy, when the demand for a commodity exceeds its supply, then the excess demand pushes the price up. On the other hand, when the factor prices increase, the cost of production rises too. This leads to an increase in the price level as well.

### **Increase in Public Spending**

In any modern [economy](https://www.toppr.com/guides/economics/indian-economy-1950-1990/types-of-economies/), Government spending is an important [element](https://www.toppr.com/guides/chemistry/classification-of-elements-and-periodicity-in-properties/elements/) of the total spending. It is also an important determinant of aggregate [demand](https://www.toppr.com/guides/business-economics/theory-of-demand/meaning-and-determinants-of-demand/). Usually, in lesser developed economies, the Govt. spending increases which invariably creates inflationary pressure on the economy.

### **Deficit Financing of Government Spending**

There are times when the spending of Government increases beyond what taxation can finance. Therefore, in order to incur the extra expenditure, the Government resorts to deficit financing.

For example, it prints more money and spends it. This, in turn, adds to inflationary pressure.

### **Increased Velocity of Circulation**

In an economy, the total use of money = the money supply by the Government x the velocity of circulation of money.

When an economy is going through a booming phase, people tend to spend money at a faster rate increasing the velocity of circulation of money.

### **Population Growth**

As the population grows, it increases the total demand in the market. Further, excessive demand creates inflation.

### **Hoarding**

Hoarders are people or entities who stockpile commodities and do not release them to the market. Therefore, there is an artificially created demand excess in the economy. This also leads to inflation.

### **Genuine Shortage**

It is possible that at certain times, the factors of production are short in supply. This affects production. Therefore, supply is less than the demand, leading to an increase in prices and inflation.

### **Exports**

In an economy, the total production must fulfill the domestic as well as foreign demand. If it fails to meet these demands, then exports create inflation in the domestic economy.

### **Trade Unions**

[Trade union](https://en.wikipedia.org/wiki/Trade_union) work in favor of the employees. As the prices increase, these unions demand an increase in wages for workers. This invariably increases the cost of production and leads to a further increase in prices.

### **Tax Reduction**

While taxes are known to increase with time, sometimes, [Governments](https://www.toppr.com/guides/civics/what-is-government/meaning-of-government/) reduce taxes to gain popularity among people. The people are happy because they have more money in their hands.

However, if the rate of production does not increase with a corresponding rate, then the excess cash in hand leads to inflation.

### **The imposition of Indirect Taxes**

Taxes are the primary source of revenue for a Government. Sometimes, Governments impose indirect taxes like excise duty, GST, etc. on businesses. As these indirect taxes increase the total cost for the manufacturers and/or sellers, they increase the price of the product to have a minimal impact on their profits.

### **Price-rise in the International Markets**

Some products require to import commodities or factors of production from the international markets like the United States. If these [markets](https://www.toppr.com/guides/business-economics/meaning-and-types-of-markets/market-meaning-and-classification/) raise prices of these commodities or factors of production, then the overall production cost in India increases too. This leads to inflation in the domestic market. E.g., Crude Oil.

### **Non-economic Reasons**

There are several non-economic factors which can cause inflation in an economy. For example, if there is a flood, then crops are destroyed. This reduces the supply of agricultural products leading to an increase in the [prices](https://www.toppr.com/guides/business-studies/marketing/pricing/) of the [commodities](https://www.toppr.com/guides/economics/non-competitive-market/simple-monopoly-and-commodity-market/). Investment in Gold, Real estate, stocks, mutual funds, and other assets are some of the ways to deal with Inflation.

### **Effects of Inflation:**

People’s desires are inconsistent. When they act as buyers they want prices of goods and services to remain stable but as sellers they expect the prices of goods and services should go up. Such a happy outcome may arise for some individuals; “but, when this happens, others will be getting the worst of both worlds.”

When price level goes up, there is both a gainer and a loser. To evaluate the conse­quence of inflation, one must identify the na­ture of inflation which may be anticipated and unanticipated. If inflation is anticipated, peo­ple can adjust with the new situation and costs of inflation to the society will be smaller.

**Though no conclusive evidence can be cited, it can be asserted that following catego­ries of people are affected by inflation differ­ently:**

**(i) Creditors and debtors:**

Borrowers gain and lenders lose during inflation because debts are fixed in rupee terms. When debts are repaid their real value declines by the price level increase and, hence, creditors lose. An individual may be interested in buying a house by taking loan of Rs. 7 lakh from an in­stitution for 7 years.

The borrower now wel­comes inflation since he will have to pay less in real terms than when it was borrowed. Lender, in the process, loses since the rate of interest payable remains unaltered as per agree­ment. Because of inflation, the borrower is given ‘dear’ rupees, but pays back ‘cheap’ ru­pees. However, if in an inflation-ridden economy creditors chronically loose, it is wise not to advance loans or to shut down business.

Never does it happen. Rather, the loan-giving institution makes adequate safeguard against the erosion of real value. Above all, banks do not pay any interest on current account but charges interest on loans.

**(ii) Bond and debenture-holders:**

In an economy, there are some people who live on interest income—they suffer most. Bondhold­ers earn fixed interest income: These people suffer a reduction in real income when prices rise. In other words, the value of one’s sav­ings decline if the interest rate falls short of inflation rate. Similarly, beneficiaries from life insurance programmes are also hit badly by inflation since real value of savings deterio­rate.

**(iii) Investors:**

People who put their money in shares during inflation are expected to gain since the possibility of earning of business profit brightens. Higher profit induces own­ers of firm to distribute profit among inves­tors or shareholders.

**(iv) Salaried people and wage-earners:**

Any­one earning a fixed income is damaged by in­flation. Sometimes, unionized worker suc­ceeds in raising wage rates of white-collar workers as a compensation against price rise. But wage rate changes with a long time lag. In other words, wage rate increases always lag behind price increases. Naturally, inflation results in a reduction in real purchasing power of fixed income-earners.

On the other hand, people earning flexible incomes may gain during inflation. The nominal incomes of such people outstrip the general price rise. As a re­sult, real incomes of this income group in­crease.

**(v) Profit-earners, speculators, and black marketers:**

It is argued that profit-earners gain from inflation. Profit tends to rise during inflation. Seeing inflation, businessmen raise the prices of their products. This results in a bigger profit. Profit margin, however, may not be high when the rate of inflation climbs to a high level.

**What is Deflation?**

 **Deflation is the opposite of inflation. Deflation refers to situation, where there is decline in general price levels. Thus, deflation occurs when the inflation rate falls below 0% (or it is negative inflation rate). Deflation increases the real value of money and allows one to buy more goods with the same amount of money over time. Deflation can occur owing to reduction in the supply of money or credit. Deflation can also occur due to direct contractions in spending, either in the form of a reduction in government spending, personal spending, or investment spending. Deflation has often had the side effect of increasing unemployment in an economy since the process often leads to a lower level of demand in the economy.**

**What is Stagflation:**

**Stagflation refers to economic condition where economic growth is very slow or stagnant and prices are rising. The term stagflation was coined by British politician Iain Macleod, who used the phrase in his speech to parliament in 1965, when he said: “We now have the worst of both worlds - not just inflation on the one side or stagnation on the other. We have a sort of ‘stagflation’ situation.” The side effects of stagflation are increase in unemployment- accompanied by a rise in prices, or inflation. Stagflation occurs when the economy isn't growing but prices are going up. At international level, this happened during mid-1970s, when world oil prices rose dramatically, fueling sharp inflation in developed countries.**

**What is Hyperinflation:**

**Hyperinflation is a situation where the price increases are too sharp. Hyperinflation often occurs when there is a large increase in the money supply, which is not supported by growth in Gross Domestic Product (GDP). Such a situation results in an imbalance in the supply and demand for the money. In this this remains unchecked; it results into sharp increase in prices and depreciation of the domestic currency.**

Monetary policy :Meaning, objectives and instruments,