For XAT , CMAT , SNAP , MAT , IIFT Exam

INFLATION AND BUSINESS CYCLE

INFLATION

- Inflation is a consistent and appreciable rise in the general price level. In other words, inflation is the rate at which the general level of prices for goods and services is rising and consequently the purchasing power of currency is falling.
- The rate of inflation is measured on the basis of price indices which are of two kinds— Wholesale Price Index (WPI) and Consumer Price Index (CPI).

Types of Inflation (Based on demand and supply)

Demand-Pull Inflation

- Demand and supply play a crucial role in deciding the inflation levels in the society at all points of time. For instance, if the demand is high for a product and supply is low, the price of the products increases

Cost-Push Inflation:

- When the cost of raw materials and other inputs raises inflation results. Increase in wages paid to labour also leads to inflation.

Types of Inflation (On the basis of speed)

Creeping Inflation or Low Inflation

- Creeping inflation is slow-moving and very mild. The rise in prices will not be perceptible but spread over a long period.
- Low inflation or Creeping inflation takes place in a longer period and the range of increase is usually in 'single-digit'.
- This type of inflation is in no way dangerous to the economy. This is also known as mild inflation

Walking Inflation:

- When prices rise moderately and the annual inflation rate is a single digit (3% - 9%), it is called walking or trolling inflation.

Running Inflation:

- When prices rise rapidly like the running of a horse at a rate of speed of 10% - 20% per annum, it is called running inflation

Galloping Inflation

- This is a 'very high inflation' running in the range of double-digit or triple-digit (20%,100%,200 per cent in a year)

Hyperinflation

- This form of inflation is 'large and accelerating' which might have the annual rates in million or even trillion. In such inflation not only the range of increase is very large, but the increase takes place in a very short span of time, prices shoot up overnight.

Types of inflation (on the basis of inducement)

Credit inflation

- When banks are liberal in lending credit, the money supply increases and thereby rising prices.

Currency inflation

- The excess supply of money in circulation causes rise in price level.
- This type of inflation is caused by the printing of currency notes

Deficit induced inflation

- The deficit budget is generally financed through printing of currency by the Central Banks. As a result, prices rise

Tax induced inflation

- Increase in indirect taxes like excise duty, custom duty, GST and sales tax may lead to rise in price (Ex. petrol and diesel). This is called **tax induced inflation.**

Scarcity induced inflation

- The scarcity of goods happen either due to a fall in production (Ex. farm goods) or due to hoarding and black marketing. This also pushes up the price.

Profit induced inflation

- When the firms aim at higher profit, they fix the price with a higher margin. So prices go up

Causes of Inflation

The main causes of inflation are as follows:

Increase in Money Supply

- Inflation is caused by an increase in the supply of money which leads to increase in aggregate demand. The higher the growth rate of the nominal money supply, the higher is the rate of inflation.

Increase in Consumer Spending:

- The demand for goods and services increases when they are given credit to buy goods on hire-purchase and installment basis.

Increase in Exports

- When exports are encouraged, domestic supply of goods decline. So prices rise.

Repayment of Public Debt

- Whenever the government repays its past internal debt to the public, it leads to increase in the money supply with the public. This tends to raise the aggregate demand for goods and services.

Deficit Financing

- Deficit financing may lead to inflation.
- Deficit refers to the difference between expenditure and receipts. In public finance, it means the government is spending more than what it is earning. Due to deficit financing money supply increases & the purchasing power of the people also increase. This raises aggregate demand in relation to aggregate supply, thereby leading to an inflationary rise in prices.

Cheap Money Policy

- Cheap money policy means making money available to trade and industry at a cheaper interest rate
- Cheap money policy leads to an increase in the money supply which raises the demand for goods and services in the economy

Increase in Disposable Income

- Disposable Income is also known as Disposable personal income. It is the individual's income after the payment of income tax

  Disposable Income = Personal income – Direct Tax
- When the disposable income of the people increases, it raises their demand for goods and services.

Black Assests, Activities and Money

- The existence of black money and black assets due to corruption, tax evasion, etc., increases the aggregate demand. People spend such money, lavishly. Black marketing and hoarding reduce the supply of goods. These trends tend to raise the price level further

Effects of Inflation

On Debtors and Creditors:

- During inflation, debtors are the gainers while the creditors are losers. The reason is that the debtors had borrowed when the purchasing power of money was high and now repay the loans when the purchasing power of money is low due to rising prices.
- The opposite effect takes place when inflation falls (i.e., deflation).

On Employment

- Inflation increases employment in the short-run, but becomes neutral or even negative in the long run

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.
- Inflation increase exchange rates and makes all the imports costlier

On Export

- With inflation, exportable items of an economy gain competitive prices in the world market. Due to this, the volume of export increases, and thus export income increases in the economy.
- A high rate of inflation will hit hard the export industry in the economy. The cost of production will rise and the exports will become less competitive in the international market.
- Inflation can heavily impact the imports and exports of a country

On Trade Balance

- In the case of a developed economy, inflation makes trade balance favorable, while for the developing economies inflation is unfavorable for their balance of trade. This is because of composition of their foreign trade.
- If compulsory imports are more inflation act as a disadvantage

Fixed-income Groups

- The fixed incomes groups are the worst hit during inflation because their incomes being fixed do not bear any relationship with the rising cost of living. Examples are wage, salary, pension, interest, rent etc.

Investors

- The investors, who generally invest in fixed interest yielding bonds and securities, have much to lose during inflation. On the contrary those who invest in shares stand to gain by rich dividends and appreciation in value of shares.

Effects on Production

- When inflation is very moderate, it acts as an incentive to traders and producers. The profit due to rising prices encourages and induces business class to increase their investments in production, leading to generation of employment and income

On Exchange Rate

- The currency with the higher inflation rate then loses value and depreciates, while the currency with the lower inflation rate appreciates on the Forex market.

Measures to Control Inflation

- Some of the important measures to control inflation are as follows:
  1. Monetary Measures
  2. Fiscal Measures
  3. Other Measures.

Monetary Measures

- The most important method of controlling inflation is monetary policy of the Central Bank of the country.
- They are (i) Increase in Bank rate (ii) Sale of Government Securities in the Open Market (iii) Higher Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) (iv) Consumer Credit Control and (v) Higher margin requirements (vi) Higher Repo Rate and Reverse Repo Rate.
- Monetary policy can only be helpful in controlling inflation due to demand-pull factors.

Fiscal Measures

- Fiscal policy is now recognized as an important instrument to tackle an inflationary situation.
- The major anti-inflationary fiscal measures are the following:

1. Reduction of Government Expenditure
2. Public Borrowing
3. Enhancing taxation.
4. Surplus budgets
5. Increase in savings

Other Measures

1. To Increase Production→ One of the foremost measures to control inflation is to increase the production
2. Wage and Price Controls→ Wage and price controls help in controlling wages as the price increases

OTHER IMPORTANT TERMS

Deflation

- The essential feature of deflation is falling prices, reduced money supply and unemployment. Though falling prices are desirable at the time of inflation, such a fall should not lead to the fall in the level of production and employment. But if prices fall from the level of full employment both income and employment will be adversely affected.

Stagflation

- Stagflation is a combination of stagnant economic growth, high unemployment and high inflation.

Disinflation

- Disinflation is the slowing down the rate of inflation by controlling the amount of credit available to consumers without causing more unemployment. Disinflation may be defined as the process of reversing inflation without creating unemployment or reducing output in the economy

INFLATION IN INDIA

- India calculates its inflation on two price indices; these are
  1. The wholesale price index (WPI)
  2. The consumer price index (CPI).
- WPI is measured on a weekly basis. The first index of wholesale prices commenced in India for the week of January 10, 1942. The base year of WPI is revised periodically. The current WPI base year is 2011-12 based on the prices of 697 commodities.
- India has been measuring inflation at the consumer prices also besides at the wholesale prices. But in place of a single consumer price index, India managing with four different set of the CPIs due to the socio-economic differentiations found among the consumers. These are: CPI-IW (Industrial Worker), CPI-UNME (Urban Non-Manual Employees), CPI-RL (Rural Labourers) and CPI-AL (Agricultural Labourers).

BUSINESS CYCLE

- The economic activity in a capitalist economy will have its periodic ups and downs. The study of these ups and downs is called the study of Business cycle or Trade cycle or Industrial Fluctuation.

Meaning of business Cycle

- A business cycle refers to oscillations in aggregate economic activity particularly in employment, output, income, etc. It is due to the inherent contraction and expansion of the elements which energize the economic activities of the nation. The fluctuations are periodical, differing in intensity and changing in its coverage.
- The four different phases of the business cycle are referred to as (i) Boom (ii) Recession (iii) Depression and (iv) Recovery

Boom

- A strong upward fluctuation in the economic activities is called boom.
- The full employment and the movement of the economy beyond full employment are characterized as boom period. During this period, there is hectic activity in the economy. Money wages rise, profits increase and interest rates go up. The demand for bank credit increases and there is all-round optimism.

Recession

- The turning point from boom condition is called recession. This happens at higher rate, than what was earlier. Generally, the failure of a company or bank bursts the boom and brings a phase of recession. Investments are drastically reduced, production comes down and income and profits decline. There is panic in the stock market and business activities show signs of dullness. Liquidity preference of the people rises and money market becomes tight.

Depression

- During the depression, the level of economic activity becomes extremely low. Firms incur losses and closure of business becomes a common feature and the ultimate result is unemployment. Interest prices, profits and wages are low. The agricultural class and wage earners would be worst hit. Banking institutions will be reluctant to advance loans to businessmen.
- Depression is the worst phase of the business cycle. The extreme point of depression is called as "trough", because it is a deep point in business cycle. Keynes advocated that autonomous investment of the government alone can help the economy to come out from the depression.

Recovery

- This is the turning point from depression to revival towards an upswing. It begins with the revival of demand for capital goods. Autonomous investments boost the activity. The demand slowly picks up and in due course the activity is directed towards the upswing with more production, profit, income, wages and employment. Recovery may be initiated by innovation or investment or by government expenditure