Inflation

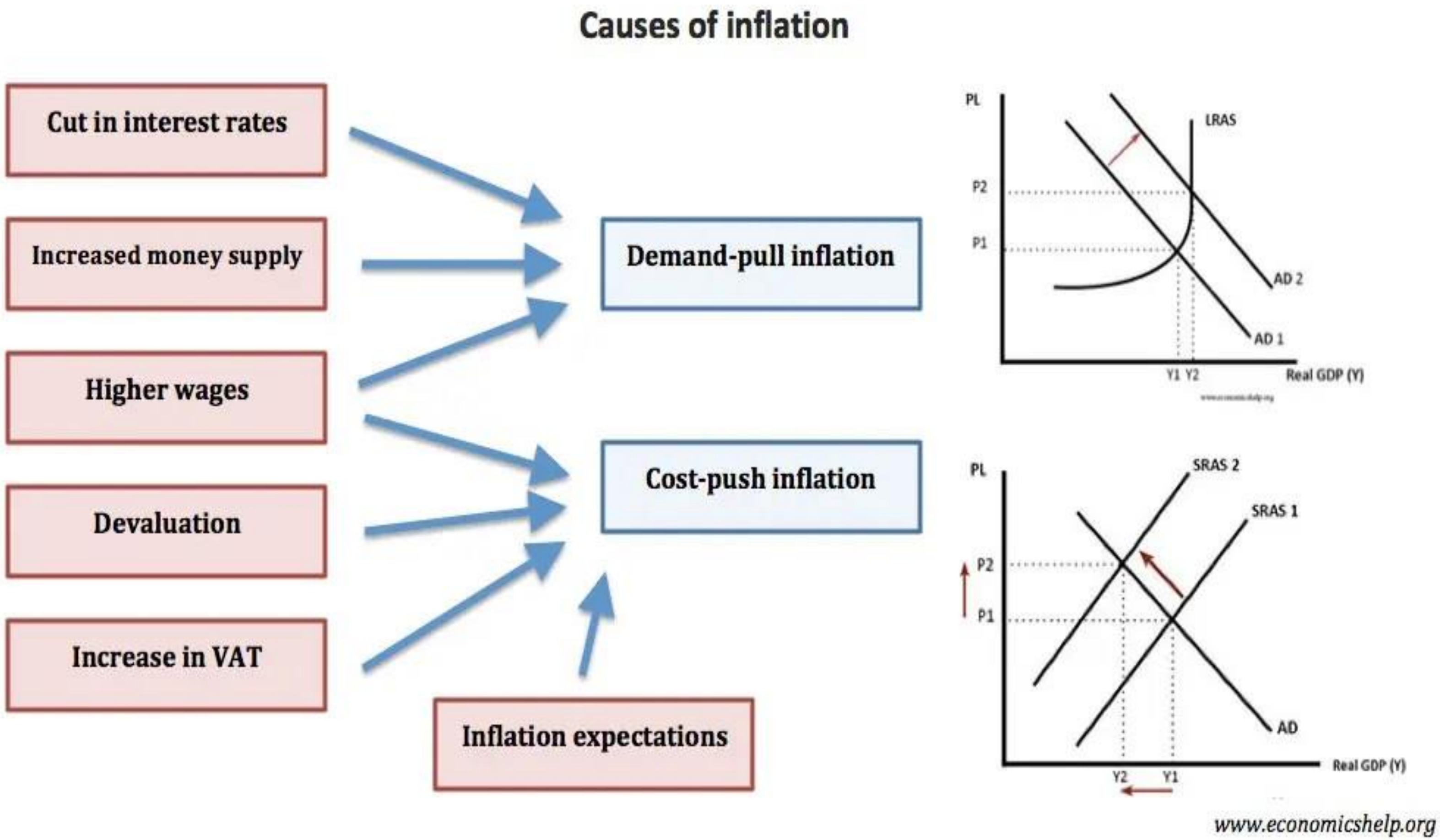
Concept /Causes /Remedies

What Is Inflation?

- Inflation is a quantitative measure of the rate at which the average price level of a basket of selected goods and services in an economy increases over some period of time. It is the rise in the general level of prices where a unit of currency effectively buys less than it did in prior periods. Often expressed as a percentage, inflation thus indicates a decrease in the purchasing power of a nation's currency.

Main causes of inflation

- **1.Demand-pull inflation** – aggregate demand growing faster than aggregate supply (growth too rapid)
- 2. **Cost-push inflation** – For example, higher oil prices feeding through into higher costs.
- 3. **Devaluation** – increasing cost of imported goods, and also the boost to domestic demand.
- 4. **Rising wages** – higher wages increase firm’s costs and increase consumers’ disposable income to spend more.
- 5. **Expectations of inflation** – causes workers to demand wage increases and firms to push up prices.


Causes of inflation
Cut in interest rates
Increased money supply
Higher wages
Devaluation
Increase in VAT
Demand-pull inflation
Cost-push inflation
Inflation expectations
PL
LRAS
P2
P1
AD 2
AD 1
Y1 Y2
Real GDP (Y)
PL
SRAS 2
SRAS 1
P2
P1
AD
Y2
Y1
Real GDP (Y)
www.economicshelp.org

Policies to reduce inflation

- **Monetary policy** – Higher interest rates. This increases the cost of borrowing and discourages spending. This leads to lower economic growth and lower inflation.
- **Tight fiscal policy** – Higher income tax and/or lower government spending, will reduce aggregate demand, leading to lower growth and less demand-pull inflation
- **Supply-side policies** – These aim to increase long-term competitiveness, e.g. privatization and deregulation may help reduce costs of business, leading to lower inflation.
- **Exchange rate policy-** A stronger Rupee makes imports cheaper (lower cost-push inflation) Stronger Rupee reduces domestic demand, leading to less demand-pull inflation. A stronger rupee creates incentives for firms to cut costs in order to remain competitive.
- **Wage Control**
- **Targeting Money Supply (Monetarism)**

What Is an Inflationary Gap?

- An inflationary gap is a macroeconomic concept that describes the difference between the current level of real gross domestic product (GDP) and the anticipated GDP that would be experienced if an economy is at full employment. This is also referred to as the potential GDP.
- The inflationary gap exists when the demand for goods and services exceeds production due to factors such as higher levels of overall employment, increased trade activities or increased government expenditure. This can lead to the real GDP exceeding the potential GDP, resulting in an inflationary gap.
- The inflationary gap is so named because the relative increase in real GDP causes an economy to increase its consumption, which causes prices to rise in the long run.
- Due to the higher number of funds available within the economy, consumers are more inclined to purchase goods and services. As the demand for goods and services increases but production has not yet compensated for the shift, prices rise to restore market equilibrium.

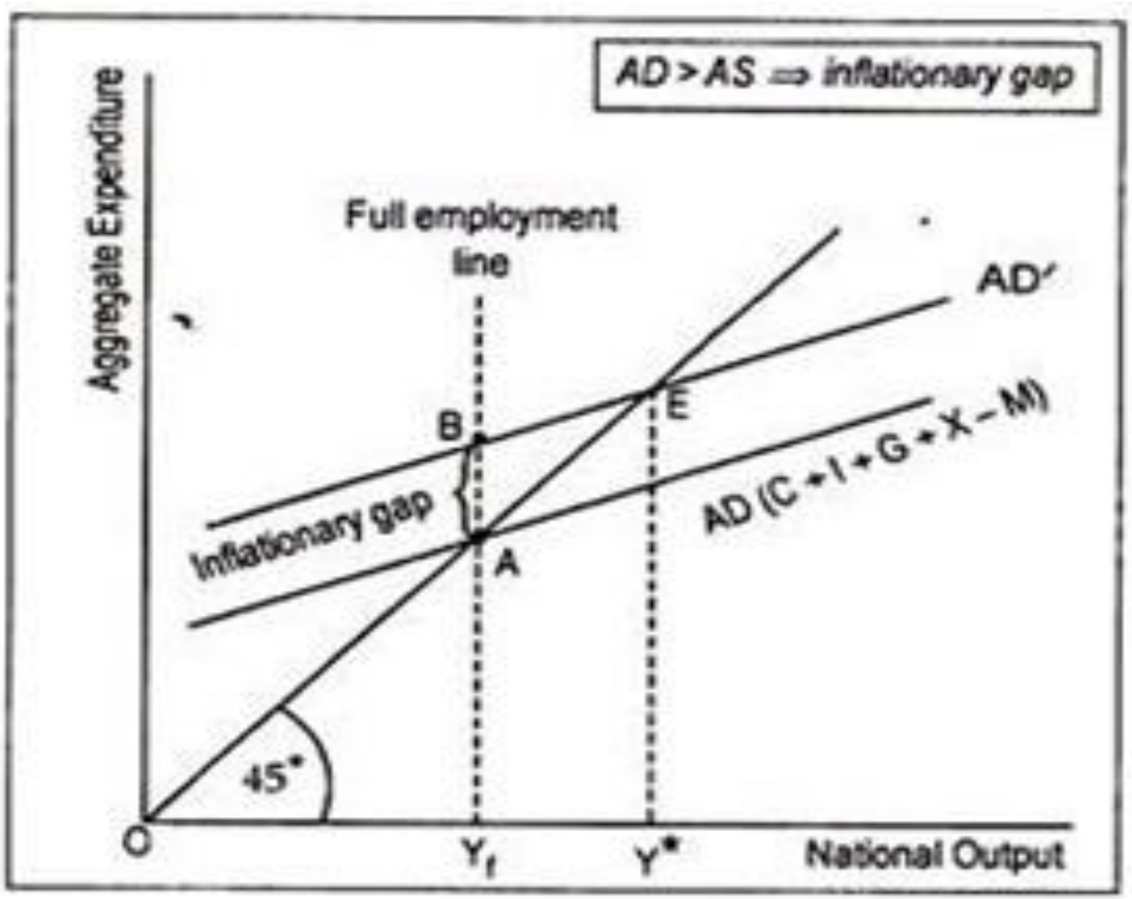


Fig. 11.5: Inflationary Gap