INFLATION

Inflation is defined as a rise in the general price level. In other words, prices of many goods and services such as housing, apparel, food, transportation, and fuel must be increasing in order for inflation to occur in the overall economy. If prices of just a few types of goods or services are rising, there isn't necessarily inflation.

Definitions

- Inflation is a situation of rising prices in the economy.
- A more exact definition of inflation is a sustained increase in the general price level in an economy. Inflation means an increase in the cost of living as the price of goods and services rise.
- The rate of inflation measures the annual percentage change in the general price level.

Features of Inflation

- 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.
- Inflation is classified into three types: Demand-Pull inflation, Cost-Push inflation, and Built-In inflation.
- Most commonly used inflation indexes are the Consumer Price Index (CPI) and the Wholesale Price Index (WPI).
- Inflation can be viewed positively or negatively depending on the individual viewpoint and rate of change.
- Those with tangible assets, like property or stocked commodities, may like to see some inflation as that raises the value of their assets.
- People holding cash may not like inflation, as it erodes the value of their cash holdings.

- Ideally, an optimum level of inflation is required to promote spending to a certain extent instead of saving, thereby nurturing economic growth.

Causes of Inflation

Rising prices are the root of inflation, though this can be attributed to different factors. In the context of causes, inflation is classified into two types: Demand-Pull inflation, Cost-Push inflation.

1.Demand-Pull Effect

Demand-pull inflation occurs when the overall demand for goods and services in an economy increases more rapidly than the economy's production capacity. It creates a demand-supply gap with higher demand and lower supply, which results in higher prices. For instance, when the oil producing nations decide to cut down on oil production, the supply diminishes. It leads to higher demand, which results in price rises and contributes to inflation.

Additionally, an increase in money supply in an economy also leads to inflation. With more money available to individuals, positive consumer sentiment leads to higher spending. This increases demand and leads to price rises. Money supply can be increased by the monetary authorities either by printing and giving away more money to the individuals, or by devaluing (reducing the value of) the currency. In all such cases of demand increase, the money loses its purchasing power.

2. Cost-Push Effect

Cost-push inflation is a result of the increase in the prices of production process inputs. Examples include an increase in labor costs to manufacture a good or offer a service or increase in the cost of raw material. These developments lead to higher cost for the finished product or service and contribute to inflation.

Pros and Cons of Inflation

Inflation can be construed as either a good or a bad thing, depending upon which side one takes, and how rapidly the change occurs.

For example, individuals with tangible assets, like property or stocked commodities, may like to see some inflation as that raises the value of their assets which they can sell at a higher rate. However, the buyers of such assets may not be happy with inflation, as they will be required to shell out more money.

People holding cash may also not like inflation, as it erodes the value of their cash holdings. Inflation promotes investments, both by businesses in projects and by individuals in stocks of companies, as they expect better returns than inflation.

However, an optimum level of inflation is required to promote spending to a certain extent instead of saving. If the purchasing power of money remains the same over the years, there may be no difference in saving and spending. It may limit spending, which may negatively impact the overall economy as decreased money circulation will slow overall economic activities in a country. A balanced approach is required to keep the inflation value in an optimum and desirable range.

High, negative or uncertain value of inflation negatively impacts an economy. It leads to uncertainties in the market, prevents businesses from making big investment decisions, may lead to unemployment, promotes hoarding as people flock to stock necessary goods at the earliest amid fears of price rise and the practice leads to more price increase, may result in imbalance in international trade as prices remain uncertain, and also impacts foreign exchange rates.