Inflation & Trade Cycle

Inflation:

- Too much of Money chasing too few Goods"
- A state of abnormal decrease in the Quantity of purchasing power"

Meaning of Inflation:

- Inflation is a consistent and Appreciable raise 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.

Types of Inflation:

- On the basis of speed
- Creeping inflation
- Walking Inflation
- Running inflation
- Galloping inflation or hyperinflation.

Creeping Inflation:

- Creeping inflation is slow-moving and very mild.
- The rise in prices will not be perceptible but Spread over a long period.
- This type of Inflation is in no way dangerous to the Economy.
- This is also known as mild inflation or moderate 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:

- Galloping Inflation or hyperinflation points out to unmanageably high inflation rates that run into two or three digits.
- By High inflation the percentage of the same is almost 20% to 100% from an Overall perspective.

Demand-Pull Vs Cost-Push inflation:

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.

Skewflation

- It is the skewed rise in the price of some items while remaining item prices remain the same. E.g. Seasonal rise in the price of onions.

Stagflation

- The situation of rising prices along with falling growth and employment. Inflation accompanied by an economic recession.
- A combination of Inflation and unemployment (usually in the time of Recession).

Disinflation:

- Reduction in the rate of inflation.

Deflation:

- General fall in the level of prices.

Depression:

- Economic depression is a sustained, long-term downturn in economic activity.

Phillips Curve

- Inverse relationship between unemployment and inflation.
- Accordingly, as levels of unemployment decrease, inflation increases.

Inflation Indices: WPI VS CPI

Wholesale Price Index (WPI)

Base Year: 2011-12

- Measures the average change for bulk sale before the retail level.

- Most widely used inflation indicator.
- Covers only goods
- Manufactured products (64%) > Primary Articles (23%) > Fuel and Power (13%)
- Published by Office of Economic Adviser (OEA), Ministry of Commerce and Industry

Consumer Price Index (CPI)

- **Base Year:** 2011-12
- Measures the change in the retail price in the prices of commodities of goods and services with reference to a base year.
- RBI has adopted CPI Combined (Rural +Urban) as its key measure of inflation.
- Both goods and services
- Food and Beverage - 45.86
- Miscellaneous - 28.32
- Housing - 10.07
- Fuel and light - 6.84
- Clothing and Footwear - 6.53
- Pan, tobacco and intoxicants - 2.38
- CPI for Industrial Workers (IW) by the Ministry of Labor and Employment (MoLE).
- The base year for CPI (IW) is changed from 2001 to 2016 CPI for Agricultural Laborer (AL) by the MoLE.
- CPI for Agricultural Workers (CPI-AL) and Rural workers (CPI-RL) base year is 1986-87.
- **CPI for Rural Laborer (RL):** by the Ministry of Labor and Employment.
- **CPI (Rural/Urban/Combined):** by National Statistics Office (NSO), MoSPI.

Index of Industrial Production (IIP)

- **Base Year:** 2011-12
- Measures the growth rates in different industry groups of the economy.
- It is a key economic indicator of the manufacturing sector of the economy.

- **Index of 8 core industries are:** Refinery Products > Electricity > Steel > Coal > Crude Oil > Natural Gas > Cement> Fertilizers.
- These 8 industries command 40.27% weight in the overall IIP. weight in the overall IIP.
- Different Sectors Manufacturing (77.63%) > Mining (14.37%) > Electricity (7.9%)
- The IIP index is computed and published by the Central Statistical Organization (CSO) on a monthly basis.

Inflation Targeting

- It is a monetary policy where the central bank sets a specific inflation rate as its goal and adjusts its monetary policy to achieve that rate.
- The RBI and Government of India signed a Monetary Policy Framework Agreement in 2015.
- Inflation targeting indicates the primacy of price stability as the key objective of monetary policy.
- RBI would aim to contain consumer price inflation within 6 % and within 4% with a band of (+/-) 2%.

Wage-Price Spiral:

- Wage-price spiral is used to explain the cause and effect relationship between Rising wages and rising prices or inflation.
- Other types of inflation (on the basis of Inducement)

Currency inflation:

- The excess supply of money in circulation causes rise in Price level.

Credit inflation:

- When banks are Liberal in lending credit, the money Supply increases and thereby rising Prices.

Deficit induced inflation:

- The deficit Budget is generally financed through Printing of currency by the Central Bank. As a result, prices rise.

Profit induced inflation:

- When the Firms aim at higher profit, they fix the Price with higher margin. So, prices go up.

Scarcity induced inflation:

- Scarcity of goods happens either due to fall in Production (eg. Farm goods) or due to Hoarding and black marketing.
- This Also pushes up the price. (This has Happened is Venezula in the year 2018).

Tax induced inflation:

- Increase in Indirect taxes like excise duty, custom Duty and sales tax may lead to rise in Price (eg. Petrol and diesel). This is also called taxflation.

Causes of Inflation:

- The main causes of inflation in India 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 Disposable Income:**
        - When the disposable income of the people Increases, it raises their demand for Goods and services.
        - Disposable income May increase with the rise in national Income or reduction in taxes or Reduction in the saving of the people.
    - **Increase in Public Expenditure:**
        - Government activities have been Expanding due to developmental activities and social welfare programmes.
        - This is Also a cause for price rise.
    - **Increase in Consumer Spending:**
        - The demand for goods and services Increases when they are given credit to buy goods on hire-purchase and Instalment basis.

- **Cheap Money Policy:**
    - Cheap money Policy or the policy of credit expansion also leads to increase in the money Supply which raises the demand for Goods and services in the economy.
- **Deficit Financing:**
    - In order to meet its Mounting expenses, the government Resorts to deficit financing by Borrowing from the public and even by printing more notes.
    - This raises Aggregate demand in relation to Aggregate supply, thereby leading to Inflationary rise in prices.
- **Black Assests, Activities and Money:**
    - The existence of black money and Black assests due to corruption, tax Evasion etc., increase the aggregate Demand.
    - People spend such money, lavishly.
    - Black marketing and Hoarding reduces the supply of goods.
    - These trends tend to raise the price Level further.

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.

Increase in Exports:

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

Effects of Inflation:

- The effects of inflation can be classified into two heads:
    - Effects on Production and
    - Effects on Distribution.

Effects on Production:

- When the inflation is very moderate, it acts as an incentive to traders and Producers.

- This is particularly prior to full Employment when resources are not fully utilized.
- The profit due to rising prices Encourages and induces business class to Increase their investments in production, leading to generation of employment and Income.
- However, hyper-inflation results in a serious depreciation of the value of Money and it discourages savings on the part of the public.
- When the value of money undergoes Considerable depreciation, this may even drain out the foreign capital already invested in the country.
- With reduced capital accumulation, the investment will suffer a serious Set-back which may have an adverse effect on the volume of production in the country.
- This may discourage Entrepreneurs and business men from taking business risk.
- Inflation also leads to hoarding of Essential goods both by the traders as well as the consumers and thus leading to still higher inflation rate.
- Inflation encourages investment in speculative activities rather than Productive purposes.

Effects on Distribution:

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.

Fixed-income Groups:

- The fixed Income 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.

Entrepreneurs:

- Inflation is the boon to the entrepreneurs whether they are Manufacturers, traders, merchants or businessmen, because it serves as a tonic for business enterprise.
- They Experience windfall gains as the prices of their inventories (stocks) suddenly go up.

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.

Measures to Control Inflation:

- Keynes and Milton Friedman Together suggested three measures to Prevent and control of inflation.
    - Monetary measures,
    - Fiscal measures (J.M. Keynes) and
    - Other measures.

Monetary Measures:

- These measures are adopted by the Central Bank of the country. They are
    - Increase in Bank rate
    - Sale of Government securities in the Open Market
    - Higher Cash Reserve Ratio (CRR)
    - Statutory Liquidity Ratio (SLR)
    - Consumer Credit Control and
    - Higher margin requirements
    - Higher Repo Rate and Reverse Repo Rate.

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: Reduction of Government Expenditure, Public Borrowing and Enhancing taxation.

Other Measures:

- These measures can be divided broadly into short-term and Long-term measures.
- Short-term measures can be in regard to public distribution of scarce essential Commodities through fair price Shops (Rationing).
- In India whenever Shortage of basic goods has been felt, the government has resorted to import So that inflation may not get triggered.
- Long-term measures will require accelerating economic growth especially of the wage goods which have a direct bearing on the general Price and the cost of living.
- Some Restrictions on present consumption may help in improving saving and Investment which may be necessary for accelerating the rate of economic Growth in the long run.

Meaning of Deflation, Disinflation and Stagflation:

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.

Disinflation:

- Disinflation is the slowing down the rate of inflation by controlling the amount of credit (bank loan, hire Purchase) 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.

Stagflation:

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

Trade 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 Trade Cycle:

- A Trade 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.

Definition:

- "A trade cycle is composed of Periods of good trade characterised by Rising prices and low unemployment Percentages altering with periods of bad Trade characterised by falling prices and High unemployment percentages".

Phases of Trade Cycle:

The four different phases of trade cycle is referred to as

- Boom
- Recession
- Depression
- Recovery

Phases of Trade Cycle:

Boom or Prosperity Phase:

- The full Employment and the movement of the Economy beyond full employment is Characterized as boom period.
- During This period, there is hectic activity in 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 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.
- Extreme Point of depression is called as "trough", because it is a deep point in business Cycle.
- Any person fell down in deeps could not come out from that without other's help.
- Similarly, an economy fell down in trough could not come out from this without external help.
- Keynes advocated that autonomous Investment of the government alone can help the economy to come out from the depression.

Recovery:

- After a period of depression, recovery sets in.
- This is the turning point from depression to revival towards 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 (autonomous investment).