Theories of Inflation

Demand Pull and Cost Push

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MEANING AND DEFINATION

Inflation means persistent rise in general price level.

In the words of Shapiro, inflation is simply a persistent and appreciable rise in general price level. According to Coulbourn, “Inflation is the stage of too much money chasing too few goods”.

Keynesian view of Inflation

1 semi inflation before full employment

2 open or full inflation after full employment

TYPES OF INFLATION

1. Open inflation
2. Suppressed inflation
3. War time inflation
4. peace time inflation

ON THE BASIS OF RATE OF INFLATION

1. creeping inflation
2. Walking inflation
3. Running or galloping inflation
4. Hyper inflation

Theories of inflation

1. Demand pull inflation
2. Cost push inflation

Demand pull or monetary theory of inflation

Demand pull or excess demand inflation is the traditional and most common type of inflation. it is a situation in which aggregate demand at the existing price level far exceeds aggregate supply. Goods maybe in short supply either because resources are fully utilized or production cannot be increased rapidly to meet the increasing demand. In the words of Shapiro, according to demand pull inflation, the general price level rises because the demand for goods and services exceeds the supply available at existing prices.

Causes of demand pull

1 **Quantity theory of money or monetary theory of inflation**:-

The monetarist emphasize the role of money as the principal cause of demand pull inflation. Inflation is always a monetary phenomenon associated with Fisher's equation of exchange.

$$MV=PT$$

Here V and T remains constant and price level varies proportionately with the supply of money.

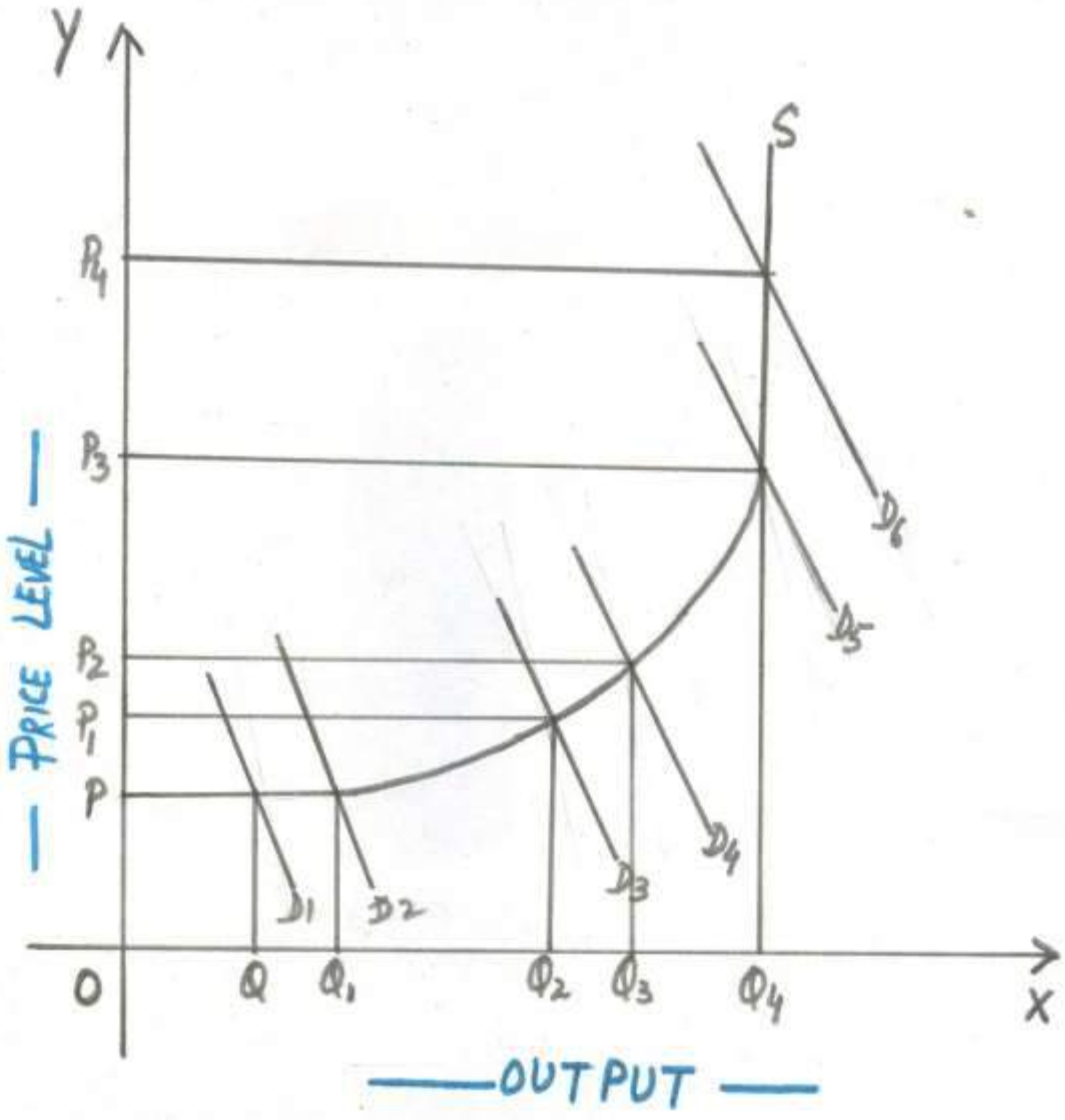
2 **Keynesian theory**:-

He emphasize the increase in aggregate demand as the source of demand pull inflation. Sources of demand includes consumption, investment and govt. expenditure, when the value of aggregate demand exceeds the value of aggregate supply at the full employment level, the inflationary gap arises. The larger the gap, more rapid will be the inflation.

3 **Modern quantity theory of money by Friedman**:-

"Inflation is always and everywhere a monetary phenomenon resulting from more rapid expansion in the quantity of money than in total output".

DEMAND PULL INFLATION



Inflationary Gap

- Keynes Explains demand Pull Inflation in the form of Inflationary Gap. He refers to the "excess of anticipated expenditure over the available output at base prices". In his article how to pay for the war (1940)

  The difference between the quantity of money to be spend on consumption goods and the actual availability of such goods is called Inflationary Gap.

  In the words of Kurihara, "An excess of anticipated expenditure over available output at base price is called Inflationary Gap".

Inflationary Gap

Particulars	Amount (Rs. Crore)
National Income	100
Taxes	-20
Disposable Income	80
Gross National Output	
War Purchases	90
Available Output	-20
Inflationary Gap	70
	(80-70) = 10

Cost push inflation

It is caused by wage increases by unions and profit increase by employers. it is also known as New inflation. The basic cause of cost push inflation is the rise in money wages more rapidly then the productivity of labour. In This situation, there is rise in prices on the One hand and fall in output and employment On the other.

Causes of cost push Inflation

1. **Wage induced inflation**

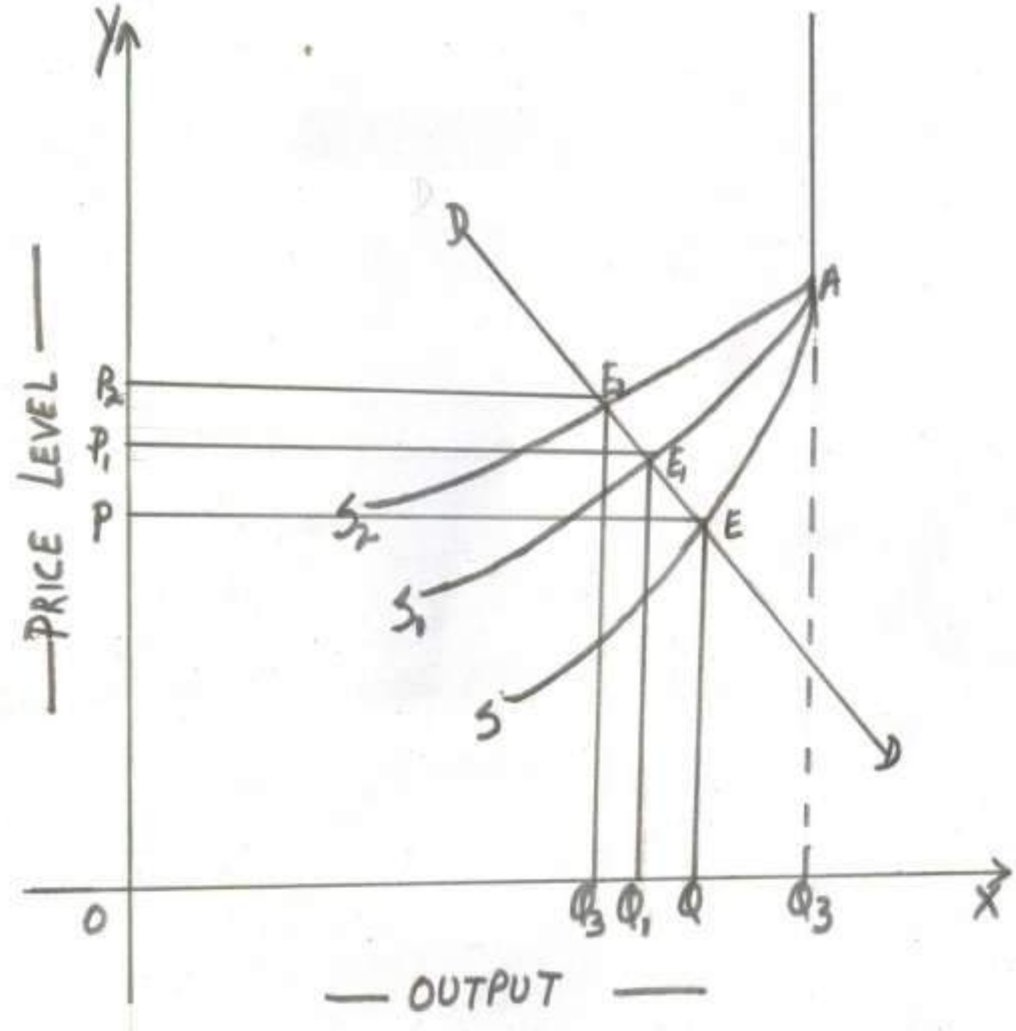
   Wage increase lead to increase in cost of production which lead to fall in supply & hence price rise.

2. **Profit induced inflation**

   Imperfect competition leads to fall in production and to increase profit producers increase prices.

3. **Increase in the cost of inputs and raw materials**

COST PUSH INFLATION



Causes of Inflation

Demand side factors

1. **Increase in public expenditure**
2. **Cheap monetary policy**

   Bank rate, Cash reserve ratio will reduce rate of interest, which lead to fall in saving, then consumption and demand increases.
3. **Deficit financing policy**

   Printing of new currency lead to increase in money supply which will increase consumption and demand.
4. **Increase in disposable income**

   Fall in tax rates lead to increase in purchasing power which increases demand.
5. **More black money**
6. **Increase in various factors like population ,investment ,exports etc.**

Supply side factors

1. Less production
2. Increase in taxes
3. Shortage of food grains
4. Lack of raw material
5. Industrial disputes
6. Productive set up
7. Bottlenecks in production

Measures to control inflation

MONETARY MEASURES

These measures are necessary to curb inflation. Central bank of the country adopt monetary policy to check price rise.

1. Control over money supply
2. Credit control policy
3. Demonetization of old currency

FISCAL MEASURES

In order to check inflation Keynes has emphasized the role of fiscal measures.

Decrease in public expenditure, increase in public debts, delay in the payment of old debts, increase in taxes and less deficit financing

OTHER MEASURES

Increase in production, proper commercial and investment policy, price control and rationing, encouragement to savings and proper wage policy.

Inflation in India

in the current scenario inflation is a daunting task. in India price rise is mainly because of supply side factors rather than demand side. Speculative factors are also playing there role in pushing the price upwards. Hoarding and profiteering also increase the price unduly. In indian scenario food price inflation is more rapid than general inflation. Here Government and RBI can control the price rise with the help of monetary and fiscal policies.

<u>CONCLUSION</u>

THERE IS NO DOUBT THAT INFLATION IS A DAUNTING TASK.BUT A MILD INCREASE IN PRICE LEVEL IS NECCESSERY.THERE ARE SEVERAL CAUSES OF PRICE INCREASE.DEMAND SIDE FACTORS EFFECT INCREASE IN DEMAND AND SUPPLY SIDE FACTORS LEAD TO FALL IN PRODUCTION,BECAUSE OF THESE TWO FACTORS PRICES TEND TO RISE.PRICE RISE CAN REDUCE PURCHASING POWER OF A CONSUMER,THAT'S WHY INFLATION SHOULD BE CONTROLLED WITH THE HELP OF MONETARY AND FISCAL POLICIES