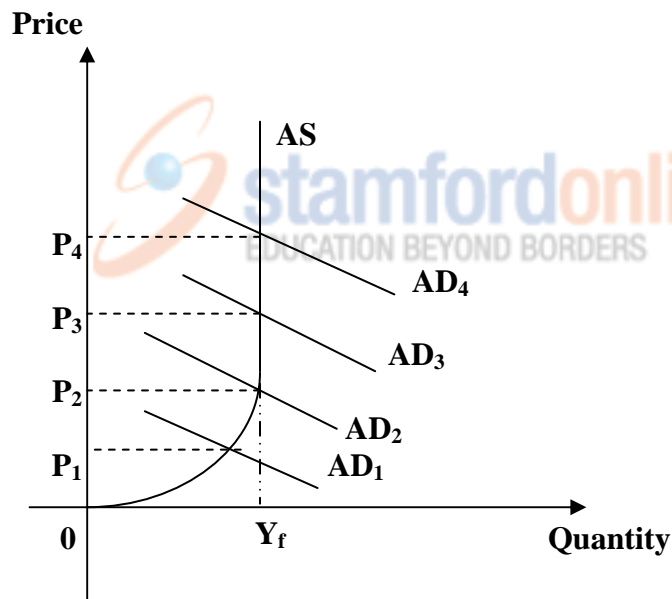


WEEK 9: INFLATION

Ordinarily, inflation means high prices. Specifically, it refers to a situation in which prices of most goods and services are rising persistently, running ahead of the output. When the volume of purchasing power is persistently running ahead of the output of goods and services, the prices tend to keep on rising. In other words, it is a situation in which the supply of money exceeds the amount of goods and services available. Consequently, prices will rise and the value of money will fall. Therefore, inflation can be defined easily as a situation in which there is a persistent and excessive increase in the general price level. In Coulborn's words, inflation is a case of too much money chasing too few goods. Inflation can be illustrated through demand and supply curve as shown below:



Inflation occurs when $AD > AS$, i.e. when the total demand exceeds the maximum supply (full employment of resources). Consequently, it will cause the price to rise as demand increases.

CAUSES OF INFLATION

1. *Cost-push inflation*

Cost-push inflation occurs when the increasing costs of production push up the general level of prices.

Thus, there is inflation from the supply side of the economy. Cost-push inflation may be caused by:

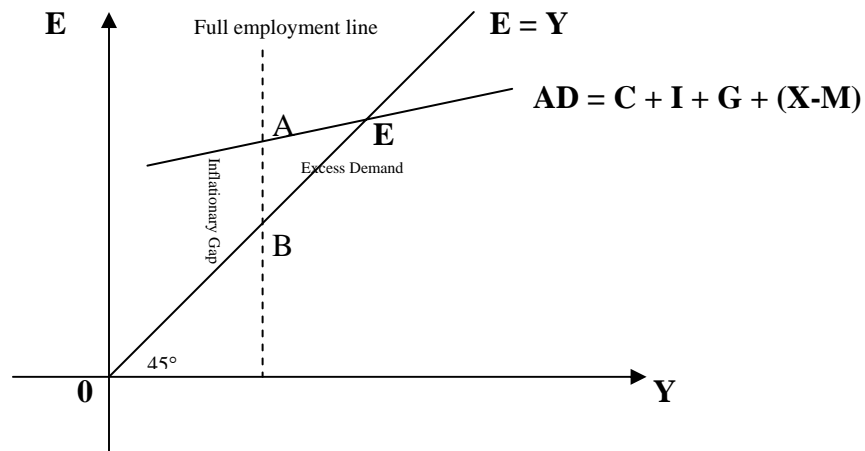
- a. Increase in cost of production such as labour, capital, land, etc.
- b. Imported inflation. The cost of essential imports rise regardless of whether or not they are in short supply. For example, America is experiencing inflation. When we import goods or raw materials from America, the price will definitely high. Therefore, the prices we charge on these goods which are imported from America will be at higher levels and this causes inflation.
- c. Mark-up pricing. Many large firms fix their prices on a unit cost plus profit basis. This makes prices more sensitive to supply than to demand influences. This means that prices tend to rise automatically with rising costs, whatever the state of the economy.

2. *Demand pull inflation*

Demand-pull inflation is when aggregate demand exceeds the value of output (measured in constant prices) at full employment.

The excess demand for goods and services cannot be met in real terms and therefore it is met by rises in the price of goods. Figure below shows the idea of the inflationary gap. The aggregate demand line [$C + I + G + (X - M)$] crosses the 45° line at point **E**, which is to the right of the full employment line. Thus at full employment there is excess demand of **AB**. It is this excess demand which pulls up prices. In other words, there is too much money chasing too few goods and then causes inflation.

$$AD > AS \Rightarrow \text{Inflation}$$



3. **Monetary Inflation**

Inflation is always and anywhere a monetary phenomenon in the sense that it can be caused by a more rapid increase in the quantity of money than in the quantity of output. Thus, wrote Friedman in the 1970s. This quote contains the core of monetary thinking which is that inflation is *entirely caused* by a too-rapid increase in the money stock and by nothing else. The monetary theory is based upon the identity

$$M \times V \equiv P \times T$$

- M** = money in the economy
- V** = velocity of circulation
- P** = price
- T** = transaction

This is turned into a theory by assuming that V and T are constant. Thus, we would obtain the formula

$$M \times V \equiv P \times T$$

Therefore, an increase in money stock will lead to an increase in price.

$$\uparrow M \times V \equiv \uparrow P \times T$$

EFFECT (COST AND BENEFIT) OF INFLATION

In an inflationary situation, some sectors of a society will gain and others will lose. How badly one is hurt by inflation may be measured by the amount of income and wealth that inflation takes away.

a. Fixed income earners

With a rise in the general price level, fixed income earners are able to purchase fewer goods and services than before. Unless pensions, salaries and wages are adjusted for price increases, the real income of this class of people will fall. Those who receive income derived from interests and rents whose amounts are fixed by long-term contracts are also adversely hit by inflation.

b. Individuals

With a rise in general price level, it will reduce the value of money i.e. the purchasing power of individuals decreases.

c. Debtors and Creditors

When prices rise, debtors gain but creditors lose. A fall in the value of money means the payments of debts by debtors to creditors will be, in real terms, less than what they would otherwise receive in the settlement of the debt if the value of money were stable. While the debt in the money terms has not changed in value, the real debt has declined.

d. Government

In a period of inflation, government debts are reduced in real terms.

e. Businessmen and Entrepreneurs

The entrepreneurial class gains from inflation because, while product prices are rising, production costs usually lag behind. Costs such as wages and salaries are usually fixed by agreements, which take time to revise. Rent and interest charges also remain the same.

f. Savings

With rising prices, the value of money falls. Savings in real terms decline as a result of inflation. People will be discouraged from saving. Wealth in other less liquid forms would be preferred.

g. The balance of payments and the external value of money

The purchasing power of money within a country is its internal value. The rate at which the currency of a country can be exchanged for the currencies of other countries is its external value. With persistent price increases, the internal value of money falls. A reduction in exports and an increase in imports may result and aggravate an existing balance of payments deficit.

ANTI-INFLATIONARY /CONTROL

There are three policies which can be used to control inflation:

- a. Fiscal policy
- b. Monetary policy
- c. Income and price policy

Learning Outcomes:

Students should be able to:

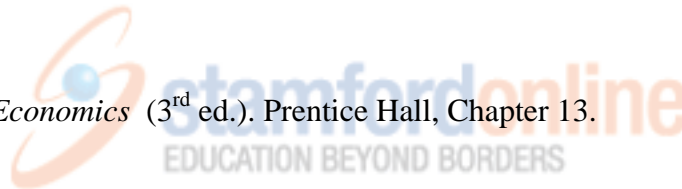
- Define and measure inflation rate
- Analyse potential costs of inflation

Main Reference

Case, K. E., & Fair, R. C. (2007). *Principles of Economics* (8th ed.). Prentice Hall, Chapter 20.

Other Reference

Sloman, J. (1993). *Economics* (3rd ed.). Prentice Hall, Chapter 13.

**Review Questions**

1. What is demand-pull inflation?
2. What is cost-push inflation?