B.Com- II | Money & Banking (Sub) | SUJEET KUMAR SUMAN R.N.C.

Q. What is inflation? Causes and effect of inflation?

Ans.

Inflation is the long term rise in the prices of goods and services caused by the devaluation of currency --- If incomes do not increase along with the prices of goods, everyone's purchasing power has been effectively reduced, which can in turn lead a slowing or stagnant economy.

According to Prof. E.W. Kemmerer- "Inflation is to much currency in relation to the physical volume of business being done."

Prof. Crowther- "A state in which the value of money is prices are rising."

* Causes of Inflation → Inflation is mainly caused by excess demand or decline in aggregate supply or output. Former leads to a rightwards shifts of the aggregate demand curve while the latter causes aggregate supply curve to shift left ward. Former is called demand-full inflation (DPI) and the latter is called cost-push inflation (CPI). Inflation is caused by multiple factors, here are few:—

(a) Money Supply → Excess currency (money) supply is an economy is one of the primary causes of inflation. This happens when the money supply circulation in a nation grows above the economic growth, therfore, reducing the value of currency.

(b) National Debt → There are a number of factors that influence national debt, which include the nations borrowing and spending. In a situation where a Country's debt increase, the respective country is left with two options, taxes can be raised internally additional money can be printed to pay off the debt.

(C) Demand-full effect → The demand-full effect states that in a growing economy, people will have more money to spend on goods and services. The increase in demand for goods and services will result in companies to raise price that consumers will bear in order to balance demand & supply.

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(d.) Cost-Push effect → This theory states that when companies face increased input costs on raw materials and wages for manufacturing consumer goods, they will preserve their profitability by passing the increased production costs to the end consumer in the formet increased prices.

(e) Exchange Rates → An economy with exposure to foreign market mostly functions on the basis of the dollar value. In a trading global economy, exchange rates play an important factor in determining the rate of inflation.

Inflation has the following effects on production activities, inflation may or may not result in an increase in production. As long as the economy does not reach the full employment stage, inflation has a favourable effect on production. Usually, as the price level increases, profit increase too. There are the following effects —

(a.) Effects of Production :- Inflation may or may not result in an increase in production. Inflation has a favourable effect on production. During, Inflation, businessman tend to raise the prices of their products to earn better profits. If the wages and production cost start rising rapidly, then this favourable effect of inflation does not last long. There is no direct correlation between prices and output.

(b.) Effects of wealth →

(i) Some people might gain at the cost of others. As the sellers will be able to sells the goods at a higher rates to its customers due to inflation.

(ii) A different set of people lose because prices rise faster than their ~~faster than prices~~ incomes during inflation.

(iii) A certein set of people gain because their money income rises faster than the prices.

(C.) Bonds and Debenture holders:-

(i) Debenture and bond holders earn fixed income on their investments.

(ii) Therefore, when the price level rising they suffer a reduction in real income.

(iii) Beneficiaries of life insurance programs also suffer bad because the real value of their saving deteriorates.

(d.) Investors:— During inflation business have an opportunity to earn goods profits. Therefore, people who invest in shares during inflation tend to gain As the business earn higher profits, they usually distributes the profit among investor and share holders too.

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