SOCIAL COST OF INFLATION

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Faculty name-PRITI KUMARI
Email id-pritikumari090@gmail.com

BASIC CONCEPT OF INFLATION

- Inflation is a quantitative measure of the rate at which the average price level of abasket of selected goods and services in an economy increases over some period of time. It is the rise in the general level of prices where a unit of currency effectively buys less than it did in prior periods. Often expressed as a percentage, inflation thus indicates a decrease in the purchasing power of a nation's currency.
- Inflation can be contrasted with deflation, which occurs when prices instead decline.

COST PUSH AND STRUCTURAL INFLATION

- 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.
- Structural inflation is created by Sbottleneaks

DEMAND PULL INFLATION

- 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.

SOCIAL COST OF INFLATION

- **Expected Inflation:**
- Consider first the case of expected inflation. One cost of expected high inflation is the distortion of the inflation tax on the amount of money people hold. A higher inflation rate leads to a higher nominal interest rate which, in turn, leads to lower real balances. If people are to hold lower money balances on average, they must make more frequent trips to the bank to withdraw money. The inconvenience of reducing money holding is called the shoe-leather cost of inflation.
- A second cost of inflation arises because high inflation induces firms to change their prices more often. Changing prices is sometimes costly: for example it may require printing and distribution of a new catalogue. These costs are called menu costs, because the higher the rate of inflation, the more often restaurants have to print new menus.

EXPECTED INFLATION

- A third cost of inflation arises because firms facing menu costs change prices infrequently: thus, the higher the rate of inflation, the greater the variability in relative price. Since market economics rely on relative prices to allocate resources efficiently, inflation leads to microeconomic inefficiencies.
- A fourth cost of inflation results from the tax laws. Many provisions of the tax code do not take into account the effects of inflation. Inflation can alter individual's tax liability, often in the ways that lawmakers did not intend.
- A fifth cost of inflation is the inconvenience of living in a world with a changing price level. Money is the yardstick with which we measure economic transactions. When there is inflation, that yardstick is changing in length. For example, a changing price level complicates personal financial planning.
- Another important point is that money invested in present age will yield fixed rate of return but value of money may fall to a greater level because of inflation.

UNEXPECTED INFLATION

- Unexpected inflation has an effect that is more pernicious than any of the cost discussed under anticipated inflation. It arbitrarily redistributes income and wealth among individuals. We can see how this works by examining long- term loans. Loan agreements specify a nominal interest rate, which is based on the expected rate of inflation.
- If actual inflation turns out differently from what was expected, the ex post real return that the debtor pays to the creditor differs from what both parties anticipated. If inflation is higher than expected, the debtor wins and the creditor loses because the debtor repays the loan with less valuable money. On the other hand, if inflation is lower than expected, the creditor wins and debtor loses because the repayment is worth more than anticipated.
- Unanticipated inflation also hurts individuals on pension and salaried class as well because D.A is calculated against a basket of goods only

IMPACT ON POOR PEOPLE AND FIXED WAGE EARNERS

- Inflation has biggest social cost on poor people and daily wage earners because they get a fixed wage based on their work and if the wage rate is not revised according to inflation rate it may hurt poor people and fixed wage earner most.
- Shift of CPI from WPI is a better step but Central bank along with govement need to more to solve this

- THANKYOU