Inflation : Causes and Types

Continuous increase in prices of goods and services is called inflation. There are four main types of inflation, categorized by their speed. They are creeping, walking, galloping, and hyperinflation. There are specific types of asset inflation and also wage inflation. Some experts say demand-pull and cost-push inflation are two more types, but they are causes of inflation.

Creeping Inflation

Creeping or mild inflation is when prices rise 3% a year or less. In several cases it has been observed that when prices increase 2% or less, it benefits economic growth. This kind of mild inflation encourages commoners to buy more as they expect a price rise in near future. That boosts demand. Consumers buy now to beat higher future prices. As consump[tion demand increases, producers are encouraged to produce more. Investment increases , which will have a multiplier effect on income generation. Thus mild inflation drives economic expansion. For that reason, the Federal Reserve of America sets 2% as its target inflation rate.

Walking Inflation

When prices of services and goods increase more robustly than creeping inflation, it is called walking inflation. This inflation is stronger, more destructive. When inflation is between 3-10% a year, it is called walking inflation. It is harmful to the economy because it speeds up economic growth too fast. People start to buy more than they need to avoid future much higher prices. This increased buying drives demand even further so that suppliers can't keep up with the increasing demand. As aresult of supply deficiency, prices of the goods and services hike up more fiercely. As a result, goods and services go out of reach of the commoners.

Galloping Inflation

When annual inflation rises to 10% or more, it destruct the whole economic system. Money loses value so fast that business and employees' income can't keep up with costs and prices. Foreign investors avoid the country, the country lacks the required capital. The economy becomes unstable, and government leaders lose credibility. Galloping inflation must be prevented at all costs.

Hyper Inflation

Hyperinflation is when prices flares up more than 50% a month. It is very rare. In fact, most examples of hyperinflation have been witnessed 0when governments print money to pay for wars. Examples of hyperinflation include Germany in the 1920s, Zimbabwe in the 2000s, and Venezuela in the 2010s. The last time America experienced hyperinflation was during its civil war.

Excessive demand creates this sort of disastrous inflation. Instead of tightening the money supply to stop inflation, the government might continue to print more money. With too much currency sloshing around, prices skyrocket. Once consumers realize what is happening, they expect higher rate of inflation to continue in near future. They buy more now to avoid paying a higher price later. That excessive demand aggravates inflation. It's even worse if they stockpile goods and create shortages.[4]

Key features of Hyper inflation

1. When prices soar over 50% in one month, the economy is experiencing hyperinflation.
2. This is often caused by a government that prints more money than its nation's GDP can support.
3. Hyperinflation tends to occur during a period of economic turmoil or depression.
4. Demand-pull inflation can also cause hyperinflation. Soaring prices cause people to hoard, creating a rapid rise in demand chasing too few goods. The hoarding may create shortages, aggravating the rate of inflation.
5. Countries that have suffered horrendous inflation rates are Germany, Venezuela, Zimbabwe, and the United States during the Civil War. Venezuela is still trying to cope with hyperinflation in the present day.

Effects

To keep from paying more tomorrow, people begin hoarding. That stockpiling creates shortages. It starts with durable goods, such as automobiles and washing machines. If hyperinflation continues, people hoard perishable goods, like bread and milk. These daily supplies become scarce, and the economy falls apart.

People lose their life savings as cash becomes worthless. For that reason, the elderly are the most vulnerable to hyperinflation. Soon, banks and lenders go bankrupt since their loans lose value. They run out of cash as people stop making deposits.

Hyperinflation sends the value of the currency dipping in foreign exchange markets. The nation's importers go out of business as the cost of foreign goods becomes very expensive. Unemployment rises as companies collapse. Then government tax revenues fall and it goes through terrific trouble in providing basic services. The government prints more money to pay its bills, worsening the hyperinflation.

Two groups can make gain from hyperinflation. The first beneficiaries are those who took out loans and find that higher prices make their debt worthless and at some time it may virtually wiped out. Exporters are also winners, because the falling value of the local currency makes exports cheaper compared to foreign competitors. Additionally, exporters receive hard foreign currency, which increases in value as the local currency falls.

Examples of economies suffered hyper inflation

Germany

The most well-known example of hyperinflation was during the Weimar Republic in Germany in the 1920s. Through World War I, the amount of German paper marks increased by a factor of four. By the end of 1923, it had increased by billions of times. From the outbreak of the war until November 1923, the German Reichs Bank issued 92.8 quintillion paper marks. In that period, the value of the mark fell from about four to the dollar to one trillion to the dollar.[78]

At first, this fiscal stimulus lowered the cost of exports and increased economic growth.

When the war ended, the Allies loaded Germany with another 132 billion marks in war reparations. Production collapsed, leading to a shortage of goods, especially food. Because there was excess cash in circulation, and few goods, the price of everyday items doubled every 3.7 days. The inflation rate was 20.9% per day. Farmers and others who produced goods did well, but most people either lived in abject poverty or left the country.

Venezuela

The most recent example of hyperinflation is in Venezuela. Prices rose 41% in 2013, and by 2018 inflation was at 65,000%. In 2017, the government increased the money supply by 14%. It is promoting a new cryptocurrency, the "petro," because the bolivar lost almost all its value against the U.S. dollar. It can't afford the cost of printing new paper currency.

In response, people began using eggs as currency. A carton of eggs was worth 250,000 bolivars compared to 6,740 bolivars in January 2017. Unemployment rose to over 20%, similar to the U.S. rate during the Great Depression.

How did Venezuela create such a mess? Former President Hugo Chávez had instituted price controls for food and medicine. But mandated prices were so low it forced domestic companies out of business. In response, the government paid for imports. In 2014, oil prices dropped down, eroding revenues to the government-owned oil companies. When the government ran out of cash, it started printing more.

As of 2019, Venezuela's foreign debt was about $100 billion. The annual inflation rate for consumer prices was at 15,000% percent in early 2020. With the continued collapse of its economy, the country is facing a monumental problem of debt repayment. At this moment, it is the only country in the world suffering from true hyperinflation.

Zimbabwe

Zimbabwe had hyperinflation between 2004 and 2009. The government printed money to pay for the war in the Congo. Also, droughts and farm removal restricted the supply of food and other locally produced goods. As a result, hyperinflation was worse than in Germany. The inflation rate was 98% a day, and prices doubled every 24 hours. It finally ended when the country changed its currency to the U.S. dollar.

United States

The only time the United States suffered hyperinflation was during the Civil War when the Confederate Government printed money to pay for the war. If hyperinflation were to reoccur in America, the Consumer Price Index would measure it..

The Federal Reserve (the Central Banking System of United States of America) prevents hyperinflation in America with monetary policy. The Fed's primary job is to control inflation while avoiding recession. It does this by tightening or relaxing the money supply, which is the amount of money allowed into the market.

Tightening the money supply reduces the risk of inflation while loosening it increases the risk of inflation.

The Fed has an inflation target of 2% per year. That's the core inflation rate, which leaves out volatile oil prices and gas prices. They move up and down rapidly depending on commodities trading. The CPI also removes food prices from the core inflation rate. If the core inflation rate exceeds 2%, the Fed will raise the fed funds rate (The **interest rate** at which banks and other depository institutions lend money to each other, usually on an overnight basis). It will use its other monetary policy tools to tighten the money supply and lower prices again. If the banks start to lend too much, the Fed can quickly raise its reserve requirement and lower the money supply. The other countries also try to follow tightening of monetary policy to curb excessive inflation rate. Governments can also go for fiscal policy The government can increase taxes (such as income tax and VAT) and cut spending. This improves the government's budget situation and helps to reduce demand in the economy. Both these policies reduce inflation by reducing the growth of aggregate demand. If economic growth is rapid, reducing the growth of Aggregate Demand can reduce inflationary pressures without causing a recession. If inflation is caused by wage inflation (e.g. powerful unions bargaining for higher real wages), then limiting wage growth can help to moderate inflation. Lower wage growth helps to reduce cost-push inflation and helps to moderate demand-pull inflation.

In a period of hyperinflation, conventional policies may become unsuitable. Expectations of future inflation within the nation may be hard to change. During times of hyper inflation, when currency becomes valueless, people lost confidence in a currency, it may be necessary to introduce a new currency or use another like the dollar.

Stagflation

Stagflation can be defined as a phenomenon of economic stagnation combined with inflation , which can cause severe crisis. This type of inflation is a sort of of economic adversity, combining poor economic growth, high unemployment, and severe inflation all in one. Although recorded instances of stagflation are rare, the phenomenon occurred as recently as the 1970s, when it gripped the United States and the United Kingdom causing disappointment of both nations' central banks. Stagflation poses a particularly scary challenge to central banks because it increases the risks associated with fiscal and monetary policy responses. Whereas central banks can usually raise interest rates to combat high inflation. But tightening monetary policy in a period of stagflation could increase the risk of further increasing unemployment. Conversely, central banks are limited in their ability to decrease interest rates in times of stagflation because doing so could cause inflation to rise even further. As such, stagflation acts as a kind of check-mate against central banks, leaving them with no moves left to make. Stagflation is arguably the most difficult type of inflation to manage.

The dual mission of the Central Bank is to keep prices stable and maximize employment. The strategy for achieving this mission is called monetary policy. Modern monetary policy is heavily influenced by Friedman's theories. Economist Milton Friedman was one of the first to predict the stagflation of the 1970s. Friedman understood that the Federal Reserve can exercise incredible power to increase or decrease inflation in the U.S. In Friedman's worldview, inflation happens when the Fed (The Central Banking Sytem of America) allows too much money to circulate in the economy. When the economy is growing, the Fed raises interest rates to limit the amount of money in circulation. When the economy slows, the Fed lowers interest rates to encourage borrowing and increase the amount of money in circulation. The goal is to strike a precarious balance where the economy grows at a healthy rate without allowing inflation to get out of control.

In the 1960s, in an effort to maximize employment at all costs, the Fed lowered interest rates and flooded the American economy with money. This led to increased demand for goods and services and rising prices. When it was clear in the 1970s that inflation was spiraling out of control, the Fed and the federal government took the erroneous approach of pumping more money into the system even as real economic output dropped. This fit Friedman's formula for inflation: “too much money chasing too few goods”.

It wasn't until 1979, with the appointment of new Fed chairman , Fed put Friedman's monetary policy theory into practice . Interest rates were raised and the flow of money into the economy was barred. It meant high unemployment and a significant recession in the early 1980s, but inflation returned to normal levels and the economy eventually stabilized.

To successfully avoid stagflation during a recession, economists associated with the Central Banking system of a nation need to accurately predict both the short- and long-term performance of the economy. They have the difficult job of identifying the turning point , when the country emerges from recession so that they can slowly pull money out of circulation. This requires perfect timing. If the

Central Bank raises interest rates too soon, it could miss the point of restarting the economy. If it waits too long, the economy can become overheated with extra cash, causing prices to rise and inflation to soar, which would result in stagflation.

Wage Inflation:

When the wages of the labourers rise continuously, it is defined as wage inflation. There is wage inflation when the workers' pay rises faster than the cost of living. This can happen, when there is shortage of labour. As the demand for labour is greater that supply of labour, the price of labour increases. On the otherhand, when unemployment rate is too low, labour union can interact and negotiate for higher prices for the labourers. Though wage increased can be seen as a positive aspect from the social point of view, it is one of the major elements of cost push inflation.

Asset Inflation:

Asset inflation occurs when the prices of assets and capital goods increase without disturbing the prices of the consumer goods. Asset inflation can be seen as a sharp price hike in the prices of gold, silver, oil or real estate assets. Usually, when there is a drop in the domestic currency price or people lose their confidence in domestic currency, they start hoarding gold or other assets. This results in the hike of prices like gold, shares or real estate assets. Usually asset inflation is not linked in any way with demand pull or cost push inflation.

Controlling Inflation :

Inflation, the continuous price increase becomes a major problem at the macro level for a nation to control. There are several instruments to control inflation. But all these instruments are associated with some sorts of risks like unemployment, decrease in consumption, forced wage reduction, and decrease in public spending, increase of tax burden on the commoners. Let us discuss the tools in theory, which can be used by the monetary authority by following monetary policies or the Government sector by fiscal tools.

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1. **Monetary policy** – Higher interest rates reduce demand in the economy, leading to lower economic growth and lower inflation. When the interest

rate is increased, it will decrease the investment demand. As the aggregate demand is reduces, it will have a downward pressure on the price rise.

2. **Control of money supply** – Monetarists argue there is a close link between the money supply and inflation, therefore controlling money supply can control inflation. Reduction in money supply will automatically reduce the cash balances in the hands of the commoners, which will decrease their ability to pay and reduce inflation.
3. **Supply-side policies** – These are structural and infrastructural development policies. These policies on a long term basis would increase the competitiveness and efficiency of the economy. This will gradually put downward pressure on long-term costs and lead to decrease in the prices of the products.
4. **Fiscal policy** – The nation can follow contraction of fiscal policies, which will involve imposition of higher rate of income tax and reduction of Government investment. These will force the commoners to decrease their spending and consumption demand , which may reduce inflation rate. On the otherhand, the decrease in Government spending will automatically decrease in income of the commoners involved with the Government projects, and will reduce employment of the downtrodden involved with the Government schemes. These things can reduce spending, demand and inflationary pressures. These controlling policies can result is social distress and unrest.
5. **Wage controls – Policies** trying to control wages could, in help to reduce inflationary pressures by reducing consumption demand. But this policy may have a demoralizing impact on the wage earners and reduce their energy to work. This will have a impact on income generation in the long run and result in social stability. However, apart from the 1970s, it has been rarely used.

Monetary Policy:

In a period of rapid economic growth, demand in the economy could be growing faster than its capacity to meet it. This leads to inflationary pressures as firms respond to shortages by putting up the price. We can term this demand-pull inflation. Therefore, reducing the growth of aggregate demand (AD) should reduce inflationary pressures.

The Central bank could **increase** interest rates. Higher rates make borrowing more expensive and saving more attractive. This should lead to lower growth in consumer spending and investment. See more on higher interest rates.

A higher interest rate should also lead to a higher exchange rate, which helps to reduce inflationary pressure by:

- Making imports cheaper. (lower price of imported goods)
- Reducing demand for exports.
- Increasing incentive for exporters to cut costs.

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