Difference between inflation and deflation

a) Explain what is meant by inflation and deflation, clearly distinguish

between them.

Introduction

Inflation is commonly understood as a situation of substantial and rapid general increase in the level of prices and consequent deterioration in the value of money over a period of time. Different economists have defined inflation differently. We may, thus, enlist a few important definitions as under which would give us a comprehensive idea about this intricate problem. Harry Johnson defines inflation as a sustained rise in prices. Crowther, similarly, defines inflation as “ a state in which the value of money is falling, i. e., prices are rising”.

Deflation is just the opposite of inflation. It is essentially a matter of falling prices. Deflation, according to Prof. Paul Einzig, “ is a state of disequilibrium in which a contraction of purchasing power tends to cause, or is the effect of, a declining of the price level”. Deflation is the sate of falling prices when the output of work by productive agents increases relatively to money income. Deflation arises when the total expenditure of the community is not equal to the value of output at existing prices. Consequently, the value of money goes up, and prices fall. In short, deflation is a condition of falling prices, accompanied by a decreasing level of employment, output and income.

Inflation versus Deflation

Both Inflation and Deflation are socially bad, but inflation may be considered to be the lesser of the two evils. Inflation is unjust in its effects on the following counts:

1. Inflation redistributes income in the favour of the rich and the profiteer class at the cost of the poor masses – the wage-earners and consumers.

2. Through its redistributive effects, inflation increases the inequality of income in the community by widening the gulf between higher income groups and lower income groups. The rich become richer and the poor become poorer during inflation.

3. Inflation is regressive in effect in the sense that it hits hard those who are already weak and cannot protect themselves. It is specially the middle class which suffers most due to inflation.

4. Inflation is unjust because it affects different classes of people in society in different ways and different degrees . if inflation were to affect everyone in the society in exactly the same manner and to the same degree, it would not alter the economic and social relationships in the community. But inflation takes away wealth from some people and transfers to others arbitrarily without taking into consideration the sound maxim of social equity.

5. Inflation is also unjust because it breaks public morale. From the point of view of social ethics, inflation is always demoralizing; it introduces the spirit of gambling. It promotes speculation, hoarding, and diverts business skill and efficiency from productive purposes to speculative purposes.

6. Inflation erodes real savings by deterioration in the value of money.

7. Inflation creates money illusion and generates artificial prosperity, which is not permanent.

On the other hand, Deflation is inexpedient and, therefore, not advisable. It is considered inexpedient for the following reasons;

1. Deflation means falling prices in general which adversely affect the marginal efficiency of capital. Consequently, investment volume tends to contract causing unemployment to increase.

2. Deflation paves the way for depression. In a depressionary phase, economic activity contracts, scale of production is curtailed, output shrinks, no newinvestment if forthcoming; on the contrary, investment is curtailed.

3. By reducing aggregate income, it also pauperizes every group in society. It inflicts on society the harsh punishment of mass unemployment. Volume of employment falls, money income of the community diminishes and, therefore, even though people’s purchasing power is increased due to falling prices, they are unable to buy goods in the required quantity. Thus, aggregate demand falls, profit falls producers suffer heavy losses and curtail investment and output further, leading to a further decline in employment and income.

This clearly shows that through inflation is unjust, it is better than deflation. Prof. Keynes showed a preference for inflation, because it is the lesser of the two evils.

The following points bring out the fact that inflation is a lesser evil:

1. Inflation, though it redistributes income and wealth in the community in an unjust manner, does not reduce the national income of the community. Deflation, on the other hand, reduces the national income of the community and pauperizes society as a whole.

2. Deflation increases the level of unemployment in the economy, whereas inflation at least implies that all factors are employed in some way or another. Inflation is a post-full employment phenomenon; deflation is an under-employment phenomenon aggravating the problem of unemployment.

3. It is easy to control inflation by a clear money policy, coordinated by appropriate fiscal policy, but it is difficult to recover from deflation. Once a deflationary tendency starts, it increases business pessimism, the marginal efficiency of capital diminishes, and investment is contracted, and ultimately a severe depression sets in. Monetary policy becomes helpless here, and no amount of increase in the money supply can revive the price level and business expectations or marginal efficiency or capital in the economy during depression. On the other hand, an inflationary spiral can be reflated by controlling credit and money supply.

4. Prof. Keynes felt that a mild inflation could stimulate economic development. In his opinion, poverty in the midst of plenty can be overcome by raising the price level through the injection of more purchasing power by way of deficit financing of public investment programs.

Thus most economists including Prof. Keynes preferred inflation to deflation. But, at the same time Prof. Keynes recognized the dangers of inflation and suggests that it should not go out of control, since hyperinflation can be extremely bad.

b) Explain the problems associated with inflation.

The Problems Associated with Inflation

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There are a number of ways in which high rates of inflation impact on the lives of those people living and working in LDCs such as Zambia.

Rising prices causes worsening poverty as the essentials for survival become more expensive and thus less attainable to those with low incomes. In an economy where unemployment and underemployment is increasing, family incomes are less able to purchase the basic requirements such as staple foodstuffs.

Rising prices creates uncertainty. In a climate of uncertainty both domestic and foreign entrepreneurs will be reluctant to invest. This will slow down the potential for economic growth.

Low savings is a factor contributing to the cycle of poverty. During periods of inflation households that do have surplus funds are reluctant to save. Inflation erodes the real value of saving and hence there is less incentive to forego current consumption. Decreasing levels of savings and hence of investment will lead to a decline in economic growth and development.

Inflation will lead to increases in nominal interest rates. The real value of interest payments will be eroded with inflation and thus banks and financial institutions will have to raise their nominal interest rates in order to try to persuade people to keep their money deposited with banks. Increases in interest rates will make the cost of acquiring credit higher. This will cause firms to cut back on investment.

Inflation in Zambia will make Zambian exports more expensive and less competitive in regional and world markets. This will worsen the balance of payments situation and increase their debt and dependency on donor countries.

Many of the problems connected with inflation depend upon the extent to which the inflation is anticipated correctly or not. If it is unanticipated or not anticipated correctly there may be certain distributional effects. This means that there may be some gainers and some losers. Often it is low paid fixed income workers who loose out whilst those people whose incomes are dependent upon profits who gain. Workers in state owned enterprises often loose out if the government is being pressurised to cut back on government spending whilst those workers in private sector firms may see their wages increase as sales increase.

INFLATION PROBLEMS:

Two notable problems are associated with inflation–uncertainty and haphazard redistribution. Inflation, especially inflation that varies from month to month and year to year, makes long-term planning quite difficult. Prices, wages, taxes, interest rates, and other nominal values that enter into

consumer, business, and government planning decisions can be significantly affected by inflation. Moreover, inflation tends to redistribute income and wealth in a haphazard manner–some people win and some people lose. This redistribution might not be that desired by society, failing to promote any of the basic economic goals of efficiency, equity, stability, growth, or full-employment.

Inflation of the price level is one of the more important macroeconomic issues facing economists and government leaders. The other macroeconomic issue with the same status is unemployment. Concerns over inflation have always existed in society, but they were most pronounced in the United States during the stagflation of the 1970s.

High and rising rates of inflation during the 1970s, reaching up to 14 percent, brought to the forefront the problems of inflation. The two key problems for society and the economy that are triggered by inflation areuncertainty and haphazard redistribution of income and wealth.

Uncertainty

Inflation creates uncertainty, especially when inflation is unexpected and catches people off guard or when it fluctuates widely from month to month or year to year. The reason that most people, consumers and producers alike, do not like inflation is that they are risk averse–they prefer a knowable, stable, predictable life. They would rather not have surprises, including unexpected inflation. A known, constant, or expected inflation can be easily integrated into the fabric of the economy. If someone KNOWS that prices will be increasing by 10 percent, then they can simply adjust plans accordingly.

However, unexpected or changing inflation creates uncertainty and makes long-range planning exceedingly difficult.

For example, a significant amount of household, business, and government activity involves long-term commitments–such as:

Borrowing the funds used to purchase cars and homes.

Investing in multi-year capital construction projects.

Anticipating tax or revenue collections

Planning expenditure budgets.

Not knowing, or not correctly anticipating, inflation makes such commitments difficult and financially disastrous. Households and business can be forced into bankruptcy. Governments can encounter serious fiscal problems.

A worker who agrees to a multi-year employee contract with automatic wage increases anticipating a 2 percent inflation rate will have a falling living standard if the inflation rate ends up being 12 percent.

A business that implements the production of a new good expecting a 3 percent inflation-induced increase in material prices is likely to see few profits or large losses if the inflation rate is 13 percent.

A school district that borrows construction funds for 10 years at a 16 percent interest rate expecting a 10 percent inflation rate will be financially strapped over the ensuing decade if the inflation rate is only 5 percent.

Haphazard Redistribution

Inflation can haphazardly redistribute income and wealth in ways that society might not want. Of course, the redistribution of income and wealth has always been an inherent part of the economy. Society redistributes income from rich to poor, poor to rich, workers to nonworkers, or a host of other ways. For example, income generated by the owners of productive resource is has always been transferred to others with little or no ownership of productive resources (such as young, old, or disabled). However, inflation is likely to redistribute income according to its own criteria.

While inflation is an increase in the average price level, ALL prices do NOT increase at the same rate. When this happens, the owners of resource used in the production of goods with above average price increases also get relatively more income. Resource owners involved in the production of goods with below average price increases (even declining prices) get relatively less income. The end result is that income and wealth are redistributed from some resource owners to others.

Suppose, for example, that the overall inflation rate is 10 percent. However, health care prices rise by 20 percent while food prices do not change.

Labor and other resource owners in the health care industry end up with 20 percent more income that they can spend on production that is only 10 percent more expensive. Their real income, wealth, and living standards increase.

In contrast, labor and other resources in the food industry are forced to pay 10 percent higher prices, but they have the same amount of income. Their real income and wealth decreases.

The result is that income and wealth has been redistributed from food resources to health care resources.

One of the most noted areas of inflation-induced redistribution is between borrowers and lenders in the financial markets. When borrowers and lenders correctly anticipate inflation that transpires over the life of a loan, then they can set the interest rate to ensure that the purchasing powerof the money loaned is equal to the purchasing power of the money repaid.

However, income and wealth are redistributed between borrowers and lenders when inflation is not correctly anticipated.

If inflation is more than expected, then the purchasing power of the repayment is less than the original loan, so income and wealth are redistributed from lenders to borrowers.

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Suppose, for example, Duncan Thurly borrows $10, 000 from a OmniBank to buy a car. In one year he will repay the bank $11, 000, the $10, 000 principal plus $1, 000 in interest, which is based on a 10 percent interest rate. Duncan and the OmniBank agree to the terms of this loan, especially the 10 percent interest rate, based on expectations that the inflation rate will be zero.

What would happen, however, if the inflation rate ends up being 5 percent? Because inflation erodes the purchasing power of money, the $11, 000 Duncan repays the bank is worth less with inflation that it would have been worth without. The bank is actually receiving only about $10, 475 worth of purchasing power. Duncan, in contrast, is repaying this loan with money that is less valuable. He is only giving up $10, 475 worth of goods and services by repaying the loan. The net result is that income and wealth have been effectively redistributed from the OmniBank to Duncan.

The redistribution, however, could go in the opposite direction. If Duncan and OmniBank came to the loan agreement expecting that the inflation rate would be 5 percent and it ended up being less, then income and wealth would have been redistributed from Duncan to OmniBank. The purchasing power of the money repaid would be greater than it need be.