"बेटी बचाओ, बेटी पढ़ाओ"

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Faculty of Education and Methodology

Faculty Name- JV'n Dr. Md Meraj Alam

Program- BA (Hons) Economics 2nd Semester

Course – Macroeconomics II

Digital session name – Effects of Inflation – Part 1

Inflation affects different people differently. This is because of the fall in the value of money. When prices rise or the value of money falls, some groups of the society gain, some lose and some stand in between. Broadly speaking, there are two economic groups in every society, the fixed income group and the flexible income group.

People belonging to the first group lose and those belonging to the second group gain. The reason is that price movements in the case of different goods, services, assets, etc. are not uniform. When there is inflation, most prices are rising, but the rates of increase of individual prices differ much. Prices of some goods and services rise faster, of others slowly, and of still others remain unchanged. We discuss below the effects of inflation on redistribution of income and wealth, production, and on the society as a whole.

1. Effects on Redistribution of Income and Wealth:

There are two ways to measure the effects of inflation on the redistribution of income and wealth in a society. First, on the basis of the change in the real value of such factor incomes as wages, salaries, rents, interest, dividends and profits.

Second, on the basis of the size distribution of income over time as a result of inflation, i.e. whether the incomes of the rich have increased and that of the middle and poor classes have declined with inflation. Inflation brings about shifts in the distribution of real income from those whose money incomes are relatively inflexible to those whose money incomes are relatively flexible.

The poor and middle classes suffer because their wages and salaries are more or less fixed but the prices of commodities continue to rise. They become more impoverished. On the other hand, businessmen, industrialists, traders, reals estate holders, speculators, and others with variable incomes gain during rising prices.

The latter category of persons becomes rich at the cost of the former group. There is unjustified transfer of income and wealth from the poor to the rich. As a result, the rich roll in wealth and indulge in conspicuous consumption, while the poor and middle classes live in abject misery and poverty.

But which income group of society gains or losses from inflation depends on who anticipates inflation and who does not. Those who correctly anticipate inflation, they can adjust their present earnings, buying, borrowing, and lending activities against the loss of income and wealth due to inflation.

They, therefore, do not get hurt by the inflation. Failure to anticipate inflation correctly leads to redistribution of income and wealth. In practice, all persons are unable to anticipate and predict the rate of inflation correctly so that they cannot adjust their economic behaviour accordingly. As a result, some persons gain while others lose. The net result is redistribution of income and wealth.

The effects of inflation on different groups of society are discussed below:

(1) Debtors and Creditors:

During periods of rising prices, debtors gain and creditors lose. When prices rise, the value of money falls. Though debtors return the same amount of money, but they pay less in terms of goods and services. This is because the value of money is less than when they borrowed the money.

Thus the burden of the debt is reduced and debtors gain. On the other hand, creditors lose. Although they get back the same amount of money which they lent, they receive less in real terms because the value of money falls. Thus inflation brings about a redistribution of real wealth in favour of debtors at the cost of creditors.

(2) Salaried Persons:

Salaried workers such as clerks, teachers, and other white collar persons lose when there is inflation. The reason is that their salaries are slow to adjust when prices are rising.

(3) Wage Earners:

Wage earners may gain or lose depending upon the speed with which their wages adjust to rising prices. If their unions are strong, they may get their wages linked to the cost of living index. In this way, they may be able to protect themselves from the bad effects of inflation. But the problem is that there is often a time lag between the raising of wages by employees and the rise in prices.

So workers lose because by the time wages are raised, the cost of living index may have increased further. But where the unions have entered into contractual wages for a fixed period, the workers lose when prices continue to rise during the period of contract. On the whole, the wage earners are in the same position as the white collar persons.

(4) Fixed Income Group:

The recipients of transfer payments such as pensions, unemployment insurance, social security, etc. and recipients of interest and rent live on fixed incomes. Pensioners get fixed pensions. Similarly the rentier class consisting of interest and rent receivers get fixed payments. The same is the case with the holders of fixed interest bearing securities, debentures and deposits.

All such persons lose because they receive fixed payments, while the value of money continues to fall with rising prices. Among these groups, the recipients of transfer payments belong to the lower income group and the rentier class to the upper income group. Inflation redistributes income from these two groups towards the middle income group comprising traders and businessmen.

(5) Equity Holders or Investors:

Persons who hold shares or stocks of companies gain during inflation. For when prices are rising, business activities expand which increase profits of companies. As profits increase, dividends on equities also increase at a faster rate than prices. But those who invest in debentures, securities, bonds, etc. which carry a fixed interest rate lose during inflation because they receive a fixed sum while the purchasing power is falling.

(6) Businessmen:

Businessmen of all types, such as producers, traders and real estate holders gain during periods of rising prices. Take producers first. When prices are rising, the value of their inventories rise in the same proportion. So they profit more when they sell their stored commodities. The same is the case with traders in the short ran. But producers profit more in another way.

Their costs do not rise to the extent of the rise in the prices of their goods. This is because prices of raw materials and other inputs and wages do not rise immediately to the level of the price rise. The holders of real estate's also profit during inflation because the prices of landed property increase much faster than the general price level.

(7) Agriculturists:

Agriculturists are of three types: landlords, peasant proprietors, and landless agricultural workers. Landlords lose during rising prices because they get fixed rents. But peasant proprietors who own and cultivate their farms gain. Prices of farm products increase more than the cost of production.

For prices of inputs and land revenue do not rise to the same extent as the rise in the prices of farm products. On the other hand, the landless agricultural workers are hit hard by rising prices. Their wages are not raised by the farm owners because trade unionism is absent among them. But the prices of consumer goods rise rapidly. So landless agricultural workers are losers.

(8) Government:

The government as a debtor gains at the expense of households who are its principal creditors. This is because interest rates on government bonds are fixed and are not raised to offset expected rise in prices. The government, in turn, levies less taxes to service and retire its debt. With inflation, even the real value of taxes in reduced. Thus redistribution of wealth in favour of the government accrues as a benefit to the tax-payers.

Since the tax-payers of the government are high- income groups, they are also the creditors of the government because it is they who hold government bonds. As creditors, the real value of their assets declines and as tax-payers, the real value of their liabilities also declines during inflation. The extent to which they will be gainers or losers on the whole is a very complicated calculation.

Conclusion:

Thus inflation redistributes income from wage earners and fixed income groups to profit recipients, and from creditors to debtors. In so far as wealth redistributions are concerned, the very poor and the very rich are more likely to lose than middle income groups.

This is because the poor hold what little wealth they have in monetary form and has few debts, whereas the very rich hold a substantial part of their wealth in bonds and have relatively few debts. On the other hand, the middle income groups are likely to be heavily in debt and hold some wealth in common stock as well as in real assets.

Course Outcome: The goal of this paper will be to expose the students to the basic principles of macroeconomics. The emphasis will be on thinking like an economist and course will illustrate how economic concepts can be applied to analyse real-life situations. In this course, the students are introduced to money and interest, theories of inflation, rate of interest, trade cycle and growth models.