JAYOTI VIDYAPEETH WOMEN'S UNIVERSITY, JAIPUR

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NAAC Accredited University

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 2

Effects on Production:

When prices start rising, production is encouraged. Producers earn wind-fall profits in the future. They invest more in anticipation of higher profits in the future. This tends to increase employment, production and income. But this is only possible up to the full employment level.

Further increase in investment beyond this level will lead to severe inflationary pressures within the economy because prices rise more than production as the resources are fully employed. So inflation adversely affects production after the level of full employment.

The adverse effects of inflation on production are discussed below:

(1) Misallocation of Resources:

Inflation causes misallocation of resources when producers divert resources from the production of essential to non-essential goods from which they expect higher profits.

(2) Changes in the System of Transactions:

Inflation leads to changes in transactions pattern of producers. They hold a smaller stock of real money holdings against unexpected contingencies than before. They devote more time and attention to converting money into inventories or other financial or real assets. It means that time and energy are diverted from the production of goods and services and some resources are used wastefully.

(3) Reduction in Production:

Inflation adversely affects the volume of production because the expectation of rising prices along with rising costs of inputs brings uncertainty. This reduces production.

(4) Fall in Quality:

Continuous rise in prices creates a seller's market. In such a situation, producers produce and sell sub-standard commodities in order to earn higher profits. They also indulge in adulteration of commodities.

(5) Hoarding and Black-marketing:

To profit more from rising prices, producers hoard stocks of their commodities. Consequently, an artificial scarcity of commodities is created in the market. Then the producers sell their products in the black market which increase inflationary pressures.

(6) Reduction in Saving:

When prices rise rapidly, the propensity to save declines because more money is needed to buy goods and services than before. Reduced saving adversely affects investment and capital formation. As a result, production is hindered.

(7) Hinders Foreign Capital:

Inflation hinders the inflow of foreign capital because the rising costs of materials and other inputs make foreign investment less profitable.

(8) Encourages Speculation:

Rapidly rising prices create uncertainty among producers who indulge in speculative activities in order to make quick profits. Instead of engaging themselves in productive activities, they speculate in various types of raw materials required in production.

3. Other Effects:

Inflation leads to a number of other effects which are discussed as under:

(1) Government:

Inflation affects the government in various ways. It helps the government in financing its activities through inflationary finance. As the money income of the people increases, the government collects that in the form of taxes on incomes and commodities. So the revenues of the government increase during rising prices.

Moreover, the real burden of the public debt decreases when prices are rising. But the government expenses also increase with rising production costs of public projects and enterprises and increase in administrative expenses as prices and wages rise. On the whole, the government gains under inflation because rising wages and profits spread an illusion of prosperity within the country.

(2) Balance of Payments:

Inflation involves the sacrificing of the advantages of international specialisation and division of labour. It adversely affects the balance of payments of a country. When prices rise more rapidly in the home country than in foreign countries, domestic products become costlier compared to foreign products. This tends to increase imports and reduce exports, thereby making the balance of payments unfavourable for the country. This happens only when the country follows a fixed exchange rate policy. But there is no adverse impact on the balance of payments if the country is on the flexible exchange rate system.

(3) Exchange Rate:

When prices rise more rapidly in the home country than in foreign countries, it lowers the exchange rate in relation to foreign currencies.

(4) Collapse of the Monetary System:

If hyperinflation persists and the value of money continues to fall many times in a day, it ultimately leads to the collapse of the monetary system, as happened in Germany after World War I.

(5) Social. Inflation is socially harmful:

By widening the gulf between the rich and the poor, rising prices create discontentment among the masses. Pressed by the rising cost of living, workers resort to strikes which lead to loss in production. Lured by profit, people resort to hoarding, black-marketing, adulteration, manufacture of substandard commodities, speculation, etc. Corruption spreads in every walk of life. All this reduces the efficiency of the economy.

(6) Political:

Rising prices also encourage agitations and protests by political parties opposed to the government. And if they gather momentum and become unhandy they may bring the downfall of the government. Many governments have been sacrificed at the alter of inflation.

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.