B.A.2nd Sem

Paper: Introductory Macro Economics

Unit 3: Inflation and its social costs; hyperinflation.

Question 4: What are the casuses of Inflation?

Ans: The prime cause of inflation is the emergence of excess demand. The emergence of excess demand in the economy can be attributed to the following factors.

1. Increase in demand for goods and services
2. Decrease in the supply of goods and services
3. Other factors

Now we will discuss them briefly

1. **Increase in Demand**: The following factors are responsible for the increase in demand for goods and services-
2. **Increase in money supply**: The increase in money supply creates excess demand for goods and services. Increased money supply helps to increase personal income and this creates excess effective demand for goods and services.
3. **Increase in public expenditure**: An increase in public expenditure consequent upon the outbreak of war or development activities causes an increase in the demand for goods and services in the economy.
4. **Increase in private expenditure**: In a good business conditions private entrepreneurs start investing more and more funds in new business enterprises. This gives rise to an increase in demand for the factors of production and increases in factor prices. This increase in factor prices increases the expenditure on consumption goods.
5. **Deficit financing:** Increasing amount of deficit financing by the government helps to increase the supply of money in the economy.
6. **Rapid growth of population:** A rapidly growing population increases the effective demand and thus raise the prices and creates inflationary situation.
7. **Black money:** Black money is spent on luxurious goods and this increase the demand for goods.
8. **Increase in exports:** An increase in foreign demand for the home products reduces the stock of commodities available for home consumption. Naturally there is a shortage of commodities and prices are raised.
9. **Reduction in taxation:** The reduction in taxation offered by the government results an increase in the purchasing power in the hands of public which again increases the price level.
10. **Bank credit:** Increasing amount of bank credits from commercial bank for unproductive activities also assist to create inflationary situation in an economy.
11. **Factors responsible for decrease in supply-**
12. **Insufficient supplies of factors of production:** The economy of a country may be faced with scarcity of factors such as skilled labour, adequate technology, raw materials, capital equipments, labour strikes etc. which creates shortage of commodities and creates inflation.
13. **Hoarding by traders and consumers:** There is a tendency on the part of traders to hoard essential commodities for profit earning purposes at the time of shortages and rising price. This type of artificial scarcity increases the price level.
14. **Lack of proper distribution system:** Due to lack of proper distribution system of essential commodities inflationary situation occurs.
15. **Other causes**-
16. **Increase in wage rate and price of raw materials:** Cost of production increases due to increased wage rate and price of raw materials. Increasing production cost helps to generate inflationary situation.
17. **Reduction of imports:** Due to shortage of foreign exchange, government compels to reduce the import of essential commodities. This helps to increase the price level for these goods.
18. **Devaluation:** Devaluation is another important cause of inflation.
19. **Inflation** also takes place due to corrupted administrative system and emergency period.