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(Autonomous)



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DEPARTMENT OF COMMERCE WITH
INFORMATION TECHNOLOGY

MANAGERIAL ECONOMICS
Inflation and Deflation

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Introduction

Inflation occurs when the price of goods and services increases, while deflation occurs when a country's price of goods and services decreases. Inflation and deflation are two opposite sides of the coin.

Maintaining a balance between inflation and deflation is essential, as rapid shifts can lead to economic instability. The Reserve Bank of India (RBI) monitors price changes and manages inflation or deflation through monetary policy tools, such as adjusting interest rates. This blog will help in understanding both inflation and deflation, exploring their causes, effects on the economy and your personal finances, and how you can strategically plan your investments, especially for retirement, to navigate these economic shifts.

INFLATION

Inflation is the rate at which the prices of goods and services of daily use, such as food, housing, clothing, transport, recreation, consumer staples, etc., increase. It's measured by tracking the average change in a selected basket of commodities and services prices. Most central banks try to limit inflation to ensure their economies function efficiently. In India, inflation is calculated and reported by the Ministry of Statistics and Programme Implementation (MoSPI).

Example:

If the price of 1 kg of apples was ₹100 in 2019 and increased to ₹110 in 2020, the price rose by ₹10. This translates to a 10% increase over the original price.

Inflation works on the same principle as the example. Prices of a group of goods and services are compared to those in a base year, and the **percentage increase in the total cost of this basket represents the inflation rate.**

CAUSES OF INFLATION

Inflation is caused by multiple factors, here are a few:

Money Supply

Excess currency (money) supply in an economy is one of the primary cause of inflation. This happens when the money supply/circulation in a nation grows above the economic growth, therefore reducing the value of the currency.

National Debt

There are a number of factors that influence national debt, which include the nations borrowing and spending. In a situation where a country's debt increases, the respective country is left with two options:

Taxes can be raised internally.

Additional money can be printed to pay off the debt.

CAUSES OF INFLATION

Demand-Pull Effect

The demand-pull effect states that in a growing economy as wages increase within an economy, people will have more money to spend on goods and services. The increase in demand for goods and services will result in companies raising prices that the consumers will bear in order to balance supply and demand.

Cost-Push Effect

This theory states that when companies face increased input cost on raw materials and wages for manufacturing consumer goods, they will preserve their profitability by passing the increased production cost to the end consumer in the form of increased prices.

Exchange Rates

An economy with exposure to foreign markets mostly functions on the basis of the dollar value. In a trading global economy, exchange rates play an important factor in determining the rate of inflation.

EFFECTS OF INFLATION

Reduced Purchasing Power: As prices rise, the same amount of money buys fewer goods and services, decreasing people's purchasing power.

Currency Value Declines: The value of each currency unit falls, making everyday expenses costlier and impacting the overall cost of living.

Higher Cost of Living: A high inflation rate increases living expenses, which can slow down economic growth.

Positive Side of Moderate Inflation: A controlled inflation rate (around 2–3%) is generally healthy—it can lead to higher wages, improved corporate profits, and sustained economic momentum.

DEFLATION

Deflation is the **decline in the prices of goods and services**, occurring when the rate of inflation falls below 0%. It is measured by tracking the average change in the prices of a selected basket of commodities and services over time. Deflation often happens naturally when the **money supply in an economy is limited**. This **decrease in prices can signal weakening demand and deteriorating economic conditions**. Deflation is also normally linked with significant unemployment and low productivity levels of goods and services. In India, deflationary trends are monitored by the Ministry of Statistics and Programme Implementation (MoSPI).

Example:

If the cost of a movie ticket was ₹200 in 2019 and dropped to ₹180 in 2020, the price decreased by ₹20. This means there was a 10% decline from the original price.

Deflation works on the same principle as the example. Prices of a group of goods and services are compared to those in a base year, and the percentage decrease in the total cost of this basket represents the deflation rate.

CAUSES OF DEFLATION

Deflation is caused by multiple factors, here are a few:

Structural Changes in Capital Markets:

When companies selling similar products compete, they often lower prices to gain an advantage, which can contribute to deflation.

Increased Productivity:

Advances in technology and innovation boost production efficiency, reducing the cost of goods and services and sometimes leading to lower prices across the economy.

Decrease in Currency Supply:

A reduction in the amount of money circulating in the economy can lower prices, making goods and services more affordable but also signaling reduced spending power.

EFFECTS OF DEFLATION

Deflation may have the following impacts on an economy:

Reduction in Business Revenues:

During deflation, businesses often have to lower their product or service prices to stay competitive, which causes their revenues to decline.

Lowered Wages and Layoffs:

Companies may cut wages and lay off employees to manage falling revenues. This reduces consumers' spending power, further slowing the economy.