Important Terms used in Inflation

Inflationary Gap

The excess of total government spending above the national income (i.e., fiscal deficit) is known as inflationary gap. This is intended to increase the production level, which ultimately pushes the price up due to extra creation of money during the process.

Deflationary Gap

The shortfall in total spending of the government (i.e., fiscal surplus) over the national income creates deflationary gaps in the economy. This is a situation of producing more than the demand and the economy usually heads for general slowdown in the level of demand. This is also known as the **output gap.**

Inflation Tax

Inflation erodes the value of money and the people who hold currency suffer in this process. As the government have authority of printing currency and circulating it into the economy (as they do in case of deficit financing), this act functions as an income to the governments. This is a situation of sustaining government expenditure at the cost of people 's income. This looks as if inflation is working as a tax .That is how the term inflation tax is also known as **seigniorage** .It means, inflation is always the level to which the government may go for deficit financing –level of deficit financing is directly reflected by the rate of inflation.

It could also be used by the governments in the form of prices and incomes policy under which the companies pay inflation tax on the salary increases above the set level prescribed by the government.

Inflation Spiral

An inflationary situation in an economy which results out of a process of wage and price interaction '**when wages press prices up and prices pull wages up' i**s known as the inflationary spiral. It is also known as the **wage –price spiral.** This wage price interaction was seen as a plausible cause of inflation in the year 1935 in the US economy, for the first time.

Inflation Accounting

A term popular in the area of corporate profit accounting .Basically, due to inflation the profit of firms /companies gets overstated .When a firm calculates its profits after adjusting the effects of current level of inflation, this process is known as inflation accounting .such profits are the real profit of the firm which could be compared to a histone rate of inflation (inflation of the base year), too.

Inflation Premium

The bonus brought by inflation to the borrowers is known as the inflation premium. The interest banks charge on their lending is known as the nominal interest rate, which might not be the real cost of borrowing, paid by the borrower to the bank. To calculate the real cost a borrower is paying on its loan, the nominal rate of interest is adjusted with the effect of inflation and thus the interest rate we get is known as the real interest rate .Real interest is always lower than the nominal interest rate ,if the inflation is taking place –the difference is the inflation premium.

Rising inflation premium shows depleting profits of the lending institutions. At times, to neutralize the effects of inflation premium, the lender takes the recourse to increase the nominal rate of interest. In recent times, it was done by the Indian banks in July 2003 to ward off their depleting profits when inflation had crossed the 7 per cent level –the level of inflation was threating to deplete even the capital base of the banks. Since then the RBI has been following a tighter credit policy as inflation was going beyond the upper limit of its healthy range (i.e 4-5 per cent in the Indian case).

Prepared by: Dr. Md.Moazzam Nazri

Assistant Professor

Faculty of Commerce

Karim City College, Jamshedpur

Email:moazzam.nazri@gmail.com