Social Cost of Inflation

. Impact of inflation on society is called social cost of inflation i.e. impact of inflation on economy. Social cost of inflation may be divided in to two parts

A. **Perfectly anticipated inflation (The cost of expected inflation)**

B. **Imperfectly anticipated inflation (The cost of unexpected inflation)**

A. **Perfectly anticipated inflation (The cost of expected inflation): In this case the growth rate of inflation steady is expected and predictable. In this situation we can see following effects of inflation.**

(a) **Falling Purchasing Power:** when inflation rate is increases automatically purchasing power decreases. As for example a person purchases 100 units in Rs 10,000. If inflation rate is increased by 10 percent then he will have to pay Rs 11,000 for 100 units. In other words, we can say that he can now purchase 91 units in Rs 10,000. Thus, the purchase quantity is reduced by 9 units.

(b) **Shoe-leather cost:** As we know a higher inflation rate leads to a higher nominal interest rate, which in turn leads to lower real money balances. If people are to hold lower money balances on average, they must make more frequent trips to the bank to withdraw money—for example, they might withdraw $50 twice a week rather than $100 once a week. The inconvenience of reducing money holding is metaphorically called the **shoe leather cost** of inflation, because walking to the bank more often causes one's shoes to wear out more quickly.

(c) **Menu- cost: Regularly increases** inflation induces firms to change their posted prices more often. Changing prices is sometimes costly: for example, it may require printing and distributing a new catalog. These costs are called **menu costs,** because the higher the rate of inflation, the more often restaurants have to print new menus.

(d) **Cost of relative price viability:** Impact of fluctuation of inflation makes on different sources. If inflation increases this impact will be upon goods, transportation cost, wages rent, unemployment etc.

(e) **Tax Distorting:** When inflation rate increases then tax burden also increases. As o example A person purchases 100 units@ 200 each and pays CGST @5%Rs1000.Now if inflation rate is increased by 10%then purchasing price will be Rs220 each unit and now @5% for 100 units CGST will have to pay Rs. 1100.Hence on account of increase of inflation by 10% additional burden of tax will be Rs.100

(f) **Inconvenience Financial Planning:** A changing price level complicates personal financial planning. One important decision that all households face is how much of their income to consume today and how much to save for retirement. A dollar saved today and invested at a fixed nominal interest rate will yield a fixed dollar amount in the future. Yet the real value of that dollar amount—which will determine the retiree's living standard—depends on the future price level. Deciding how much to save would be much simpler if people could count on the price level in 30 years being similar to its level today.

B. Imperfectly anticipated inflation (The cost of unexpected inflation): In this case inflation rate may be higher or lower than the expected of inflation. Unexpected inflation has an effect that is more pernicious than any of the costs of steady, anticipated inflation: it arbitrarily redistributes wealth among individuals. There are following effects of unexpected inflation.

(a) **Effect on Decision making:** Inflation also impacts a firm's stock and bond values because interest rates are directly affected by inflation expectations. As a result, understanding inflation is critical to managing a firm's financial resources and directly impacts financial decision-making.
(b) **Effect on wealth:** Investors can underestimate the damaging **effect inflation** can have on their **wealth**. Increases in the cost of living reduce the spending power of money. **Inflation** can be good for holders of assets, if their values rise faster than the general level of **inflation**
(c) **Problem of fixed income:** Unexpected inflation also hurts individuals on fixed income groups. Suppose an employee and firm often agree on a fixed nominal pension when the employee retires (or even earlier). Because the pension is deferred earnings, the employee is essentially providing the firm a loan: the employee provides labour services to the firm while young but does not get fully paid until old age. Like any creditor, the employee is hurt when inflation is higher than anticipated. Like any debtor, the firm is hurt when inflation is lower than anticipated.
(d) **Effect on Debtors and Creditors:** Most loan agreements specify a nominal interest rate, which is based on the rate of inflation expected at the time of the agreement. If inflation turns out differently from what was expected, the *ex post* real return that the debtor pays to the creditor differs from what both parties anticipated. On the one hand, if inflation turns out to be higher than expected, the debtor gains and the creditor loses because the debtor repays the loan with less valuable dollars. On the other hand, if inflation turns out to be lower than expected, the creditor gains and the debtor loses because the repayment is worth more than the two parties anticipated.
(e) **Effect on Producers and Customers:** On account of increase in inflation producer will get profit while customer will suffer from loss because of customer will have to pay more money. In reverse case producer will get loss and customers will get profit

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