A 7. TYPES OF INFLATION

There are four main types of inflation with four different causes. The term inflation is usually used to indicate a rise in the general price level , though one can speak of inflationary movements in any single price or group of prices.

The most important inflation is called demand-pull or excess demand inflation. It occurs when the total demand for goods and services in an economy exceeds the available supply, so the prices for them rise in a market economy. Historically this has been the most common type and at times the most serious. Every war produces this type of inflation because demand for war materials and manpower grows rapidly without comparable shrinkage elsewhere. Other types of inflation occur more readily in conjunction with demand-pull inflation.

Another type of inflation is called cost-push inflation. The name suggests the cause--costs of production rise, for one reason or another, and force up the prices of finished goods and services. Often a rise in wages in excess of any gains in labor productivity is what raises unit costs of production and thus raises prices. This is less common than demand-pull, but can occur independently as well as in conjunction with it.

A third type of inflation could be called pricing power inflation, but is more frequently called administered price inflation. It occurs whenever businesses in general decide to boost their prices to increase their profit margins. This does not occur normally in recessions but when the economy is booming and sales are strong. It might be called oligopolistic inflation, because it is oligopolies that have the power to set their own prices and raise them when they decide the time is ripe. One can at such times read in the newspapers that business is just waiting a bit to see how soon they might raise their prices. An oligopolistic firm often realizes that if it raises its prices, the other major firms in the industry will likely see that as a good time to widen their profit margins too without suffering much from price competition from the few other firms in the industry.

The fourth type is called sectoral inflation. The term applies whenever any of the other three factors hits a basic industry causing inflation there, and since the industry hit is a major supplier of many other industries, as for example steel is, or oil is, that raises costs of the industries using say steel or oil, and forces up prices there also, so inflation becomes more widespread throughout the economy, although it originated in just one basic sector.

What sorts of policies might each type of inflation call for? Sectoral inflation takes us back to which of the other 3 caused the inflation there.

For oligopolistic inflation, make sure there is no collusion which anti-trust law makes illegal. It is likely not possible to induce oligopolies to be more price competitive with each other, so the only way to get the benefit os price competition to restrain oligopolistic inflation is to increase import competition if that is a possibility.

Since cost-push inflation is often wage increases exceeding increases in labor productivity, the problem is whether it is possible or desirable to restrain such wage increases. The fact of the matter is, many wage rates now leave the worker or the worker & family in poverty. It would be difficult to argue that those wages should not rise to what is called a living wage level even though that may cause price increases for all who already have higher incomes. But what about other wage earners. Should all of them, or all whose wages are above average (but still below that of others) be restrained somehow from wage increases that exceed the gains in their own labor productivity? If nobody else is restrained and profits are ballooning, would that be fair?

Some European economies have wrestled with this problem more than others. They have sometimes come up with what is called an incomes policy, essentially a bargain between business and labor that neither wages nor profits shall gain more than the other for some agreed period, and that both shall be relatively restrained. University of Minnesota economist Walter Heller at one time proposed what he called wage-price guidelines for the same purpose, and others have suggested tax policies to enforce such bargains between labor and business. Europe's bargains often broke down because business conditions improved and profits grew more than was in the bargain and labor refused to restrain itself as much as originally agreed to. There is presently no agreed upon policy to deal with cost-push inflation.

Demand pull inflation can appropriately and successfully be dealt with by a sufficiently aggressive macro-economic policy: tight monetary and fiscal policies to cut out the excess demand. Tight money & high interest rates to cut borrowing and slow or stop increases in the money supply, and running a government budget surplus if necessary to reduce incomes and purchasing power. It is usually not employed vigorously enough to do the job, but it always could be and stop this type of inflation. But if applied to any of the other types of inflation it would likely create or increase unemployment and would not get at the root cause of that inflation.

Another angle to be mentioned is that these several types of inflation can all work at the same time. A familiar term is a wage-price spiral, where demand pull likely starts inflation, labor demands and gets wage increases to catch up to the rising cost of living, which increase their incomes and adds more demand-pull. That is a good time for oligopolies to raise prices, and any of these hitting key sectors ads further inflation.

Such an inflation can become cumulative and produces what is called hyperinflation or run-away inflation. Prices may rise so fast that when labor gets paid it quits work and rushes to the stores to buy things needed before their prices rise even further. At the extreme some countries with such inflation have in the end had to repudiate their currency and start anew with another money which they issue more sparingly to stop the inflation.

No one in their right mind would ever risk hyperinflation, so the problem is to know how much inflation can be allowed without running the risk of hyperinflation. That will vary country by country and situation by situation, and no one knows the answer anytime. So the risk should not be run.

But slow inflation does not pose the risk for this country. Inflation of 3% a year even increases business profits and stimulates business because it buys materials and labor at one price level and by the time its products are on the market they can be sold at a slightly higher price level. The problem is to keep inflation from creeping upwards from that rate. And if it is continuous for a lifetime, people who struggle to save as much as they can for retirement find that the purchasing power of their savings is being reduced by 3% a year.

We will see in the next essay in this series that both inflation and inflation policies hurt somebody, so inflation policy hangs upon decisions about who can best bear the effects of inflation and the effects of each anti-inflation policy, and this involve an ethical judgment, not an economic judgment.