COSTS OF INFLATION (for Sem 2, DSC-2 and GE course 2 in Eonomics)

COSTS OF EXPECTED INFLATION

- A higher inflation rate leads to a highernominal interest rate, which in turn leads to lower real money balances. If peoplehold lower money balances on average they must make more frequent trips to banks.The associated cost is metaphorically called the **shoeleather cost** of inflation, becausewalking to the bank more often causes one shoes to wear out more quickly.

- In case of high inflation firms need tochange their prices more often. Changing prices is sometimes costly and it may require printing and distributing a new catalog. These costs arecalled **menu costs**.

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- Another cost of inflation results from the tax laws. Many provisions of the taxcode do not take into account the effects of inflation. Inflation can alter individual'stax liability, often in ways that lawmakers did not plan. For example suppose you buy some stock today and sell it a year from nowat the same real price. The government should not levy a tax,because you have earned no real income from this investment. If there is no inflation, there would indeed be a zero tax liability. But suppose the rate of inflationis 12 percent and you initially paid Rs100 per share for the stock; for the real price tobe the same a year later, you must sell the stock for Rs112 per share. In this casesince the taxlaw, ignores the effects of inflation, it would seem that you have earned Rs12 per sharein

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income, and the a taxwould be imposedon this capital gain. The problem is thatthe tax code measures income in terms of nominal rather than the real capital gain. Thus inflation distorts how taxes are levied.

- Another cost of inflation is the problem of living in a world with a changingprice level. Money is the yardstick with which we measure economic transactions. When there is inflation, that yardstick is changing in length. In case of inflation value of rupee will change overtime and we need to correct for inflation when comparing nominal figures from different times.

COSTS OF UNEXPECTED INFLATION

The costs of unexpected inflation are more than those of expected inflation:
Unexpected inflation often redistributes wealth among individuals. For example let us see what happens in case of long term loans. Most loanagreements specify a nominal interest rate, which is based on the expected rate of inflationat the time of the agreement. If inflation turns out to be different fromwhat was expected, the *ex post* real return that the debtor pays to the creditordiffers from what was anticipated. If inflation turnsout to be higher than expected, the debtor wins and the creditor loses becausethe debtor repays the loan with less valuable rupees. On the other hand, if inflationturns out to be lower than expected, the creditor wins and the debtor losesbecause the repayment is worth more than the two parties anticipated.
Unanticipated inflation also hurts individuals with fixed wages or pension.

Reference: Macroeconomics, N.G Mankiw., Eight Edition Chapter 5

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