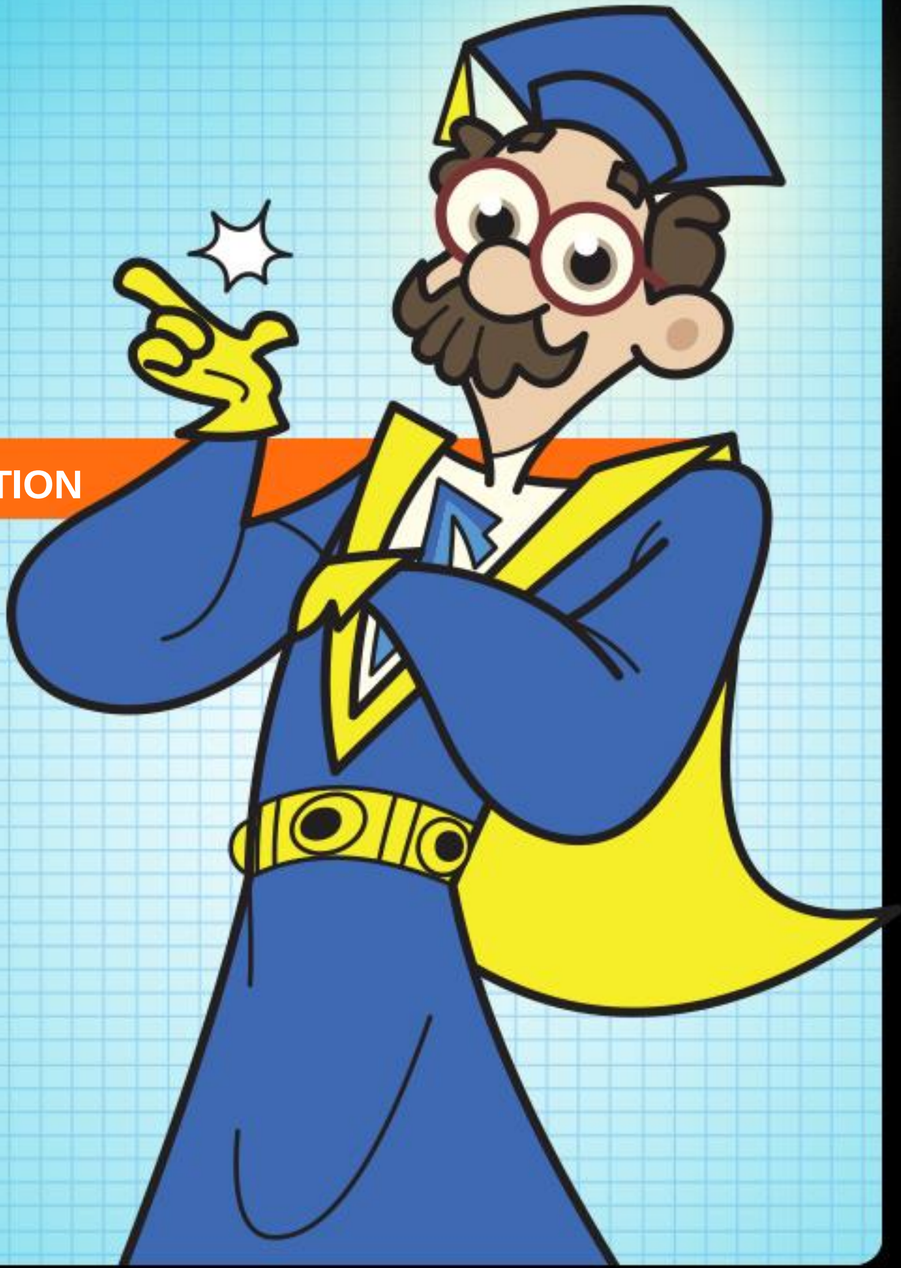
SUPPLY SIDE AND DEMAND SIDE INFLATION



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Understanding the Difference between Supply Side Inflation and Demand Side Inflation

SUPPLY SIDE AND DEMAND SIDE INFLATION

It is summer holidays and kids living in a posh building – "Inflationary Heights" are having great fun. Their parents have filled their pockets with money and the kids now have buying power. There is an ice cream parlor down the street. The man in charge of the parlor is glad for making all the children happy with his different ice cream flavors.

SUPPLY SIDE AND DEMAND SIDE INFLATION

There is a nice balance between the joy of selling and buying ice cream. But this summer something happened.

The kids from Inflationary Heights start consuming double the volume of ice cream that they normally do.

SUPPLY SIDE AND DEMAND SIDE INFLATION

The parlor man soon realizes that the children from Inflationary Heights are eating more ice cream. He increases prices and the demand continues unabated. While the parlor man gets richer by the day, the other children of the area can’t afford the ice cream any longer.

SUPPLY SIDE AND DEMAND SIDE INFLATION

They decide to meet the parents of the children of Inflationary Heights. They request the parents to reduce the pocket money allowance of their children so that the price of ice cream drops.

SUPPLY SIDE AND DEMAND SIDE INFLATION

The parents are in a fix. They know that this will not be accepted by their children. But they do understand that if they reduce the allowance, their kids would have less money and consequently the demand for ice cream would drop. Thus the inflation in ice cream at the parlor could be reduced by reducing the availability of money.

SUPPLY SIDE AND DEMAND SIDE INFLATION

In a similar fashion to the parents having the option to regulate the prices of the ice cream parlor, the RBI (Reserve Bank of India) has the option to regulate the flow of money into the economy and control prices. This is called demand side inflation. This may get controlled by monetary policy measures.

SUPPLY SIDE AND DEMAND SIDE INFLATION

So what is supply side inflation?

Let's get back to the story

SUPPLY SIDE AND DEMAND SIDE INFLATION

After the meeting, one of the parents, Mr. Idea Shankar. The next day, Mr. Idea Shankar calls on a few competitors of the Ice Cream Parlor and informs them of the huge business potential in their area.

SUPPLY SIDE AND DEMAND SIDE INFLATION

He tells the competition that the children of Inflationary Heights have more cash to spend due to their higher allowance.

Within two days, four new parlors spring up in the area. Seeing this and fearing that he would lose business to competition, the parlor man immediately brings down prices. Now there are enough parlors and enough customers.

SUPPLY SIDE AND DEMAND SIDE INFLATION

In this scenario, the higher allowance does not impact prices in the parlors because there is enough supply. In fact, some of the parlors start offering discounts. All the children on the area are happy now. In fact, they can now eat more due to the discounts.

SUPPLY SIDE AND DEMAND SIDE INFLATION

The manner in which prices were regulated was by increasing the supply of ice cream, in the same manner, the government may control inflation by making the necessary provisions for increasing the supply of products and services in the economy.

SUPPLY SIDE AND DEMAND SIDE INFLATION

This is the concept of supply side inflation.

While it is easier to set up a few ice cream parlors, it is not as easy to set up many factories and services for the government as it would need land, labor and capital plus time to set up the supply.

SUPPLY SIDE AND DEMAND SIDE INFLATION

However, controlling inflation from a supply perspective is more inclusive and sustainable.

On the other hand, using monetary policy to stem inflation is short term in nature and not inclusive. Beyond a point, monetary policy ceases to be an effective tool for inflation control.

SUPPLY SIDE AND DEMAND SIDE INFLATION

To some extent, the Indian economy stands at a cross road because the role of RBI to control inflation is diminishing and the need for creating additional supply is getting imperative. Policies need to be drafted that attract entrepreneurs to invest in the economy so that they can create supply and demand by way of creating jobs. This could try and bring balance back to the economy.

SUPPLY SIDE AND DEMAND SIDE INFLATION

Hope you have understood demand side and supply side inflation

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