MACRO ECONOMICS
6th Semester (HONOURS)
UNIT : 5 Inflation And Unemployment

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Meaning of inflation : inflation is defined as a sustained rise in the general price level of goods and services over time. It is caused by disequilibrium between aggregate supply and aggregate demand . the price rise should be persistent over the period of time to be said as inflation

Inflation is measured by price index . a price index is a weighted average of prices of number of goods and services ;therefore it does not represent the price of single item .

There are two types of price indices :

1. **Wholesale price index (WPI)**
2. **Consumer price index (CPI)**

Types Of Inflation :

Depending upon the rate of increase in price level , inflation may be classified into following categories :

A. On the basis of causes :

1. **Currency inflation :** this type of inflation is caused by the printing of currency notes .
2. **Credit inflation :** being profit making institutions , commercial banks sanction more loans and advances to the public than what the economy needs . such credit expansion leads to a rise in price level .
3. **Deficit induced inflation :** the budget of the govt. reflects a deficit when expenditure exceeds revenue. To meet this gap , the govt. may ask the central bank to print additional money . since pumping of additional money is required to meet the budget deficit , any price rise may be called as the deficit induced inflation .
4. **Deman pull inflation :** an aggregate increase in demand over the available output leads to a rise in the price level . such inflation is called demand pull inflation (DPI).
5. **Cost push inflation :** inflation in an economy may arise from the overall increase in the cost of production . this type of inflation is known as cost – push inflation (CPI).Cost of production may rise due to an increase in the price of raw materials , wages etc.

B. On the basis of speed or intensity :

1. **Creeping inflation :** it is a situation when price level is increasing at a mild rate . a very low inflation took place over the period of time . some economists says that creeping inflation if good for growing economy .
2. **Moderate inflation :** when the general price level increases slowly and steadily then it is called as moderate inflation .moderate inflation is believed to be necessary condition for economic growth .
3. **Galloping inflation** : this is situation of very high inflation running in double or triple digit i.e 50% , 100% , 200% etc. the value of money loses very fast . in 1970s and 1980s many latin American countries experienced such type of inflation .
4. **Hyperinflation :** hyperinflation is a situation when a nations experiences very high and accelerating inflation where annual rate of inflation runs into millions or trillions in a very short period of time . in such a state the value of currency erodes quickly and people lose confidence in domestic currency .

Causes of inflation :

Having understood the inflation meaning and types , let's take a quick look atvthe factors that cause inflation :

1. **Primary causes :** in an econpmy , when the demand for a commodity exceeds its supply , then the excess demand pushes the price up . on the other hand , when the factor prices increase , the cost of production rises too .this leads to an increase in the price level as well .
2. **Increase in public spending :** in an modern economy , govt. spending is an important element of the total spending . it is also an important determinant of aggregate demand .usually , in lessesr developed economies , the govt. spending increases which invariably creates inflationary pressure on the economy .
3. **Deficit financing of govt. spending :** there are times when the spending of govt. increases beyond what taxation can finance . therefore , in order to incur the extra expenditure , the govt. resorts to deficit financing . for example : it prints more money and spends it . this , in turn adds to inflationary pressure.
4. **Population growth :** as the population grows , it increases the total demand in the market ,further , excessive demand creates inflation .
5. **Hoarding :** hoarders are people or entities who stockpile commodities and do not release them to the market . therefore , there is an artificially created demand excess in the economy . this also leads to inflation .
6. **Genuine shortage :** it is possible that at certain times , the factors of production are short in supply . this affects production . therefore , supply is less than demand , leading to an increase in prices and inflation .
7. **Exports :** in an economy , the total production must fulfil the domestic as well as foreign demand . if it fails to meet these demands , then exports create inflation in the domestic economy .

8. **Trade union :** trade union work in favour pf the employees . as the prices increase , these unions demand an increase in wages for workers . this invariably increases the cost of production and leads to a further increase in prices .
9. **Tax reduction :** while taxes are known to increase with time , sometimes , governments reduce taxes to gain popularity among people. The people are happy because they have more money in their hands .however , if the rate of production does not increase with a corresponding rate , then the excess cash in hand leads to inflation .
10. **The imposition of indirect taxes :** taxes are the primary source of revenue for a government . sometimes , governments impose indirect taxes like excise duty , VAT , etc. on businesses . As these indirect taxes increase the total cost for the manufacturers and / or sellers , they increase the price of the product to have a minimal impact on their profits .

<u>What is the relationship between inflation and interest rates ?</u>

Inflation and interest rates are often linked and frequently referenced in macroeconomics. Inflation refers to the rate at which prices for goods and services rise . and the interest rate or the amount charged by a lender to a borrower , is based on the federal funds ratye that is determined by the federal reserve . (sometimes called "the Fed").
By setting the target for the federal funds rate , the Fed has at its disposal a powerful tool that it uses to influence the rate of inflation . this tool enables the Fed to expand or contract the money supply as needed to achieve target employment rates , stable prices , and stable economic growth .
There always exist an inverse relationship between interest rates and rate of inflation . in general , when interest rates are low , the economy grows and inflation increases, conversely , when the interest rates are high , the economy slows and inflation decreases .

<u>What is Unemployment ?</u>

Unemployment occurs when a person who is actively searching for employment is unable to find work . unemployment is often used as a measure of the health of the economy . the most frequent measure of unemployment is the unemployment rate , which is the number of people in the labour force .

<u>Types of Unemploment :</u>

1. **Frictional unemployment :** such unemployment exists in almost every economy all the time . this type of unemployment occurs due to the normal working of the economy . As John Beardshaw has rightly put it , " it is inevitable in a developing economy thst people will from time to time change jobs and may perhaps be unemployed for some weeks as they wait to take up the next job".
2. **Seasonal unemployment :** this type of unemployment occurs due to the seasonal nature of some industries .in some industries the demand for goods and services

fluctutates seasonally . for example: hotels , restaurants , and ice cream factories are fully staffed by employees during the summer but many of those workers are laid off during the winter .

3. **Residual unemployment :** in every country , there is always a residue of unemployment , due to frictional and seasonal causes, which planners and policy makers cannot reduce. In addition there are some people who are not willing to work but get their names registered with employment exchanges in order to receive compensation from the government .
4. **Technological unemployment :** there is no doubt that improvements in technology have reduced the demend for labour . however , one may expect with some degree of opyimism that in the long run improvements in technology and the resultant increases in productivity will create jobs by leading to an expansion of the economy .
5. **Structural unemployment :** this type of unemployment occurs due to a change in the structure of the economy . for example – the setting up of large mechanised manufacturing units in india led to the decline of handicrafts . most artisans were displaced because they did not have sufficient marketable skill .
6. **General or cyclical unemployment :** all of those types of unemployment considered so far are the result of changes in the economy . this type of unemployment arises from the trade cycle and is sometimes referred to as mess unemployment .
7. **Hidden unemployment :** this form of unemployment is sometimes known as disguised unemployment . it can take several forms . for example – during , a temporary fall in demand , employers may retain on their payrolls a great number of employees than they can provide work for .

Definition of "Philips curve" :-

The inverse relationship between unemployment rate and inflation when graphically charted is called the Philip curve . William Philips pioneered the concept first in his paper "the relation between unemployment and rate of change of money wage rates" in the united kingdom 1861-1957 ; in 1958 . this theory is now proven for all major economies of the world.

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