UNIT - III

INFLATION

1. What do you mean by inflation?

Ans:- Inflation ~~ref~~ is the rate at which the general ~~tat~~ level of prices ~~of~~ for goods and services rises, leading to a decrease in purchasing power over ~~time~~ time. ~~It is~~ measured as the percentage change in the price index over a specified period ~~of as~~ often calculated monthly or annually. Inflation can occur for various reasons such as increased demand, supply chain dis-ruptions or monetary policies that increase the money supply.

2. What do you mean by deflation?

Ans:- Deflation refers to a situation in which there is ~~is~~ a sustained decrease in the general price level of goods and services within an economy leading to an increase in the pur-chasing power of money. It occurs when the supply of goods and services ex-ceeds the demand for them, resulting in lower prices. ~~Where~~ While falling prices may seem beneficial to the consumer initially, deflation can have severe economic consequences.

3. What is stagflation?

Ans:- Stagflation is an economic phenomenon characterized by stagnant economic growth, high unemployment. The combination of stagnant growth and rising prices creates a challenging environment for policy makers. Stagnation typically arises from a variety of factors including supply shocks, excessive government intervention or structural imbalances within an economy.

4. What are the causes of deflation?

Ans:- Following are the causes of deflation:

(1) Decrease in consumer demand:
When consumers spend less on goods

and services, businesses may lower prices to stimulate demand, leading to ~~fet~~ deflation.

(ii) Technological advancements: Improvements in technology can lead to increased productivity and lower production costs, causing prices to fall.

(iii) Decrease in money supply: If the central bank reduces the money supply or implements tight monetary policies, it can result in deflation.

(iv) Excess capacity: When there is more production capacity than demand for goods and services, businesses may lower prices to clear excess inventory, contributing to deflation.

(v) Debt deflation: High levels of debt repayment obligations can lead to decreased spending and investment, causing prices to fall.

(vi) Globalization: Increased competition from global markets can put downward pressure on prices as businesses strive to remain competitive.

(vii) Asset price deflation: A collapse in asset prices, such as real estate or stocks, can reduce household wealth and consumer spending, leading to deflationary pressures.

(viii) Government austerity measures: Fiscal policies aimed at reducing government spending or increasing taxes can decrease aggregate demand, contributing to deflation.

5. What are the causes of stagflation?

Ans:-

(i) Supply shocks : Sudden increases in the prices of essential commodities, like oil, raise production costs and trigger inflation.

(ii) External factors : Geo-political tensions, natural disasters, or disruptions in global supply chains can disrupt production and fuel stagflation.

(iii) Excessive government intervention : Heavy regulations, taxes, or subsidies can distort market mechanisms and hinder productivity growth.

(iv) Wage - price spirals : Workers demanding higher wages to offset inflation can lead to a cycle of rising production costs and further inflation.

(v) Structural imbalances : Mismatches between labor skills and job demands, or inefficiencies in key sectors, can hinder economic growth while fueling inflation.

(vi) Monetary policy mistakes: Inappropriate monetary policies, such as excessive money printing, can lead to currency devaluation and inflation without stimulating real economic growth.

(vii) Fiscal policy mismanagement: Large government deficits financed by money creation can increase demand without corresponding increases in supply, leading to inflation.

(viii) Expectations: If businesses and consumers anticipate further inflation, they may adjust their behaviour in ways that exacerbate stagflation.

6. What are the consequences / outcomes of deflation in an economy?

Ans:- (i) Reduced consumer spending: Deflation can lead to a decrease in consumer spending as individuals delay purchases in anticipation of lower prices in the future, which can further weaken economic activity.

(ii) Increased debt burden: Deflation increases the real value of debt, making it more difficult for borrowers to repay loans, leading to higher default rates and financial instability.

(iii) Lower business investment: Businesses may postpone investments in new projects or expansions due to the expectation of falling prices and reduced profitability, contributing to economic stagnation.

(iv) Rising unemployment: Deflationary pressures can lead to layoffs as businesses cut costs to maintain profitability, resulting in higher unemployment rates and reduced household incomes.

(v) Decline in asset prices: Deflation can cause a decrease in the value of assets such as real estate, stocks and commodities, reducing household wealth and further dampening economic activity.

(vi) Decreased wage growth: Falling prices can lead to lower wage growth as employers face reduced revenue and profit margins, exacerbating income inequality and reducing consumer purchasing power.

(vii) Debt deflation spiral: Deflation can create a self-reinforcing cycle where falling prices lead to lower incomes, increased debt burdens, and further pressure.

(viii) Negative real interest rates: Deflation can result in real interest rates becoming unexpectedly high, discouraging borrowing and investment and hindering economic recovery.

1. What are the ~~cla~~ causes of inflation?

Ans:- Following are the causes of infla-
tion:

(i) Increase in population: The increase in
population results in shortages of
essential consumer goods like foodgrains
and other food products, cloth, shoes
and several other products and servi-
ces. Thus increasing population creates
strong and sustained inflationary pre-
ssures in the economy.

(ii) ~~Shortage of foodgrains~~: F.

(ii) Existence of black money: When there
is the existence of a large amount
of black money or the unaccounted
money, the prices have a strong ten-
dency to rise.

(iii) Shortage of raw materials: If there
are shortages of raw materials, pro-
duction of several manufactured pro-
ducts declines. It brings about a rapid
rise in prices.

(iv) Shortage of fuel, power etc: If a

country is faced with shortages of fuels like oil, power, coal etc., the costs of production of industrial manufactured products increase. It leads to the rise in prices of the products in the country.

(v) Increase in wages: If there is an increase ~~do~~ in wage rates, the cost of production increases. It causes a rise in the prices of the products.

(vi) Increase in costs: As costs increase due to an increase in wages and prices of other industrial inputs, the prices of the finished products also get increased. This leads to strong inflationary pressures.

(vii) Taxpolicy of the government: If the government of a country excessively takes resorts to indirect taxes such as excise duty, sales tax, electricity duty, import duties, the prices tend to increase. Thus tax policy can intensify the ~~the~~ inflationary conditions.

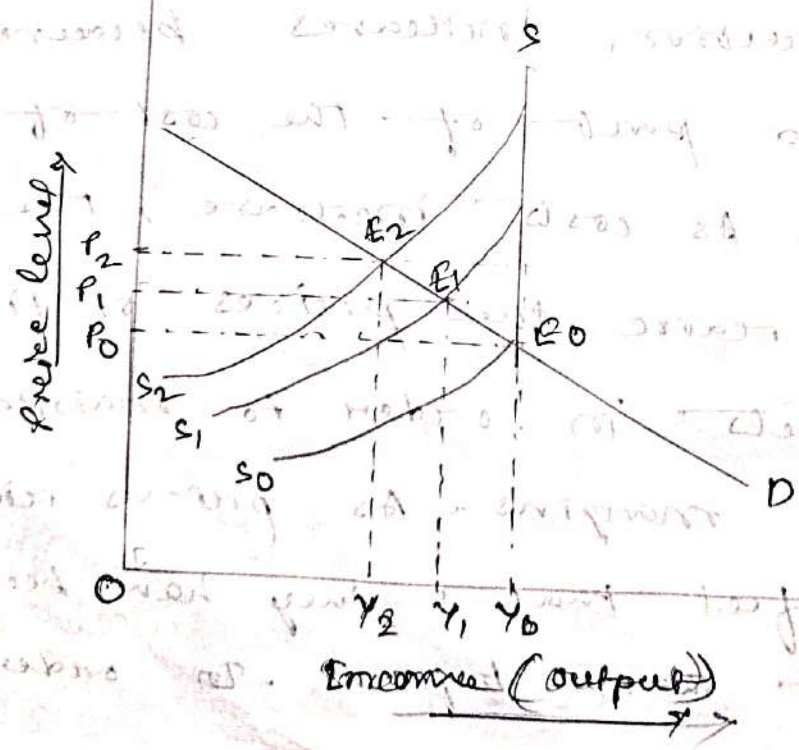
(viii) Trade policy: If the government adopts the policies to promote exports and restrict imports of commodities, the shortages appear in the home country and prices have a strong tendency to increase.

8. Write a note on cost push inflation and demand pull inflation.

Ans:- Cost - Push Theory of Inflation:

The alternative explanation of inflation is in terms of push of wages and costs.

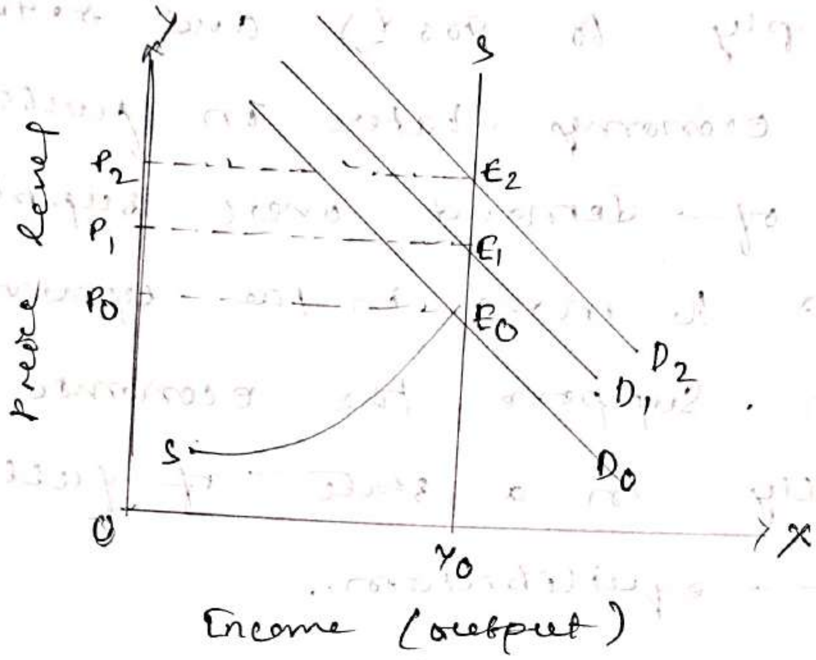
In have as: initially an increase in money by wages of the workers, the cost of production increases because wages are a part of the cost of production. As costs increase, the producers raise the prices of finished products in order to maintain their profit margins. As prices rise, workers feel that they have become worse off than before. In order to maintain their standard of living, they are forced to demand higher wages. As the higher wage claims of workers are conceded by the employers, there is again an increase in costs and prices. Thus wage-cost-price spirals continue to operate in the economy due to persistent pushes of wages and costs. Apart from the push of wages, the increase in the prices of ~~other~~ factor inputs can also initiate and perpetuate the cost push and the consequent increases in the price level.



Demand Pull Theory of Inflation:

According to the demand pull theory of inflation, the process of rising prices is initiated by the excess of demand over supply to goods and services in the economy. Later on further excess of demand over supply continues to move in the upward direction. Suppose the economic system is initially in a state of full employment equilibrium.

The excess of aggregate demand over aggregate supply causes the bidding up of prices. Thus the excess demand or demand of pull initiates the increase in price level. As prices increase, consumers and producers expect that the prices will rise even in future. They start making purchases not only for the current period but also for future. Thus there is further pull of demand and price level continues to increase. So long as the excess demand are the demand pull continues to exist the process of inflation will persist in the economy.



9. What do you mean by inflationary gap?

Ans:- An inflationary gap occurs when the actual level of real GDP exceeds the potential GDP, leading to upward pressure on prices in the economy. This situation often results in inflation as demand on ~~all~~ goods and services ~~the~~ economy's ability to produce them at a sustainable rate, centra borides may inter to mitigate inflation by tightening monetary policy.

10. What are the consequences of stagflation?

Ans: — (i) Unemployment & slow growth: Stagflation typically leads to higher unemployment rates as businesses struggle to expand amid low economic growth. This stagnation can persist for an extended period causing economic hardship for individuals and households.

(ii) Reduced purchasing power: High inflation erodes the purchasing power of consumers' incomes, leading a decrease in real wages. This can result in a decline in having standards as individuals find it harder to afford goods and services.

(iii) Uncertainty and reduced investment. Stagflation creates economic uncertainty, making it difficult for businesses to plan and in. This can lead to a decrease in business investment, further exacerbating the economic slowdown.

(iv) Policy dilemma: Policymakers face a dilemma in addressing stagflation because traditional policy tools may be ineffective. For ex. using expansionary monetary policy to stimulate economic growth could worsen inflation, while tightening monetary policy to combat inflation could further slow down economic activity.

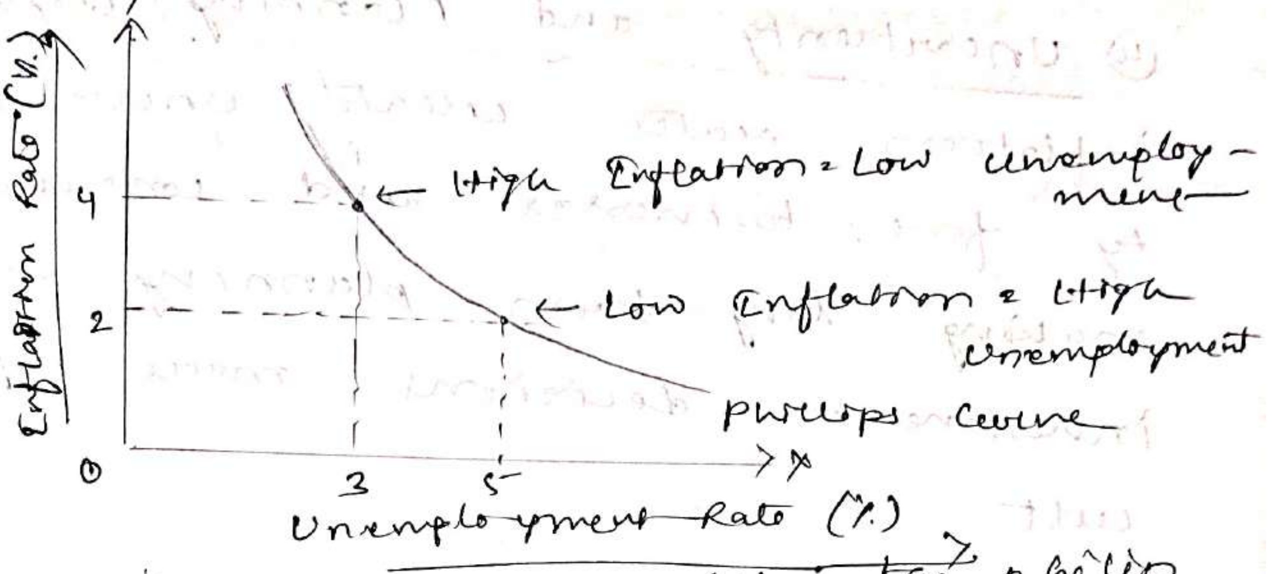
(v) Social & political unrest: Stagflation can lead to social and political unrest as individuals and groups experience financial strain and frustration with government policies. This unrest can manifest in protests, strikes or other forms of civil unrest.

11. Write a note on phillips curve.

Ans:- The phillip curve is an economic concept that describes the relationship between inflation and unemployment. It suggests that there is a trade off between the two which means that as unemployment decreases, inflation tends to rise and vice-versa. This relationship arises from the idea that as labour market ~~to~~ can tighten, workers ~~can~~ gain more of bargaining power, leading to wage increases. This higher wages then translates into increased cost of production for firms which in turn are passed on to ~~to~~ consumers in the form of higher prices, thus causing inflation.

Conversely, when unemployment is high, labour market competition reduces, workers bargaining power, resulting in stagnant or even declining wages.

with lower labour costs, firms can afford to lower prices leading to lower inflation rates



In summary while the phillip curve provides valuable insights into the relationship between inflation and unemployment, its simplistic assumptions and empirical challenges remind us of the complexity real world economic dynamics.

12. What are the impacts of inflation in economy?

Ans: Following are the impacts of inflation on economy:

① Purchasing Power Erosion: Inflation reduces the purchasing power of money over time, meaning that

that same amount of money buys fewer goods and services.

(ii) <u>Uncertainty and Planning</u>: High inflation creates create uncertainty for businesses and consumers, making long-term planning and investment decisions more difficult.

(iii) <u>Income Redistribution</u>: Inflation can redistribute income and wealth, with borrowers benefiting from lower real debt burdens while savers and fixed-income earners experience a decrease in real income.

(iv) <u>Interest Rates</u>: In response to inflation, central banks may raise interest rates to curb spending and reduce inflationary pressures. Higher interest rates can impact borrowing costs, investment, and consumer spending.

(v) International competitiveness : High inflation can erode a country's ~~Inf~~ international competitiveness by increasing production costs and reducing exports. This can lead to trade imbalances and a loss of market share.

(vi) Menu Costs : Inflation leads to higher costs for businesses to adjust prices, as they must frequently update price lists, menus, and ~~catag~~ catalogs, leading to inefficiencies.

(vii) Distorted Relative Prices : Inflation can distort relative prices, leading to misallocations of resources as consumers and businesses respond to changing price signals.

(viii) Savings and Investment : Inflation affects the real return on savings and investments. High inflation rates may discourage saving and long-term investment, potentially hindering economic growth.

13. Explain the monetary and fiscal policy to control inflation.

Ans:- Monetary and fiscal policies are two important tools used by governments and central banks to control inflation. Monetary policy involves actions by a central bank like adjusting interest rates or reserve requirements, to influence money supply and borrowing costs. Fiscal policy on the other hand involve government decisions on taxation and spending. To control inflation a central bank might raise interest rates to reduce borrowing and spending while the government could reduce spending or increase taxes to ~~decrease~~ demand.

Monetary Policy

Followings are the important monetary tools to control inflation:

(i) Interest rate adjustments: Central banks can raise interest rates to discourage borrowing and spending, made which helps to cool down inflationary pressure.

(ii) Reserve requirement changes: Altering the reserve requirements for banks can affect ~~of~~ the amount of money they can lend. Thereby, influencing the money supply and inflation.

(iii) Open market operations: Buying government securities injects money into the economy, potentially stimulating spending while selling securities reduces the money supply, curbing inflationary pressure.

Fiscal Policy

(a) Following are the important tools of fiscal policy:

(i) Government spending reduction: Cutting government expenditures decreases aggregate demand which can help mitigate inflation by reducing overall spending in the economy.

(ii) Taxation increase: Raising taxes reduces disposable income and consumer spending, thereby dampening inflationary pressure.

(iii) Public debt management: Governments can also manage their debt level to ensure fiscal sustainability which indirectly inflation expectations.