INDIAN ECONOMY

Inflation, unemployment and Labour Market….

Q1. What do you mean by inflation?

Ans- In general, the term inflation means increases in volume or quantity. But, in economics, inflation has a special meaning and it means rise in prices due to increase in the quantity of money. Price level may the due to many reasons. A mere increase in price cannot be termed as inflation. An increase in money supply due not always create inflation. If with the increase in money supply, the supply of output does not increase simultaneously then it leads to inflationary rise the price level.

According to Pigue, inflation occurs when `` money income is expanding more than in proportions to income-earning activity.''

Q2. What are the causes of inflation?

Ans- Inflation may be of different nature such as (i) Demand pull inflation, (ii) Excessive growth in money supply, (iii) Cost-push inflation and (iv) structural inflation. All these different types of inflation broadly show its specific causes. However, excessive growth in money growth in money supply is considered as one of the most important causes of inflation. Thus with reference to the different theories of inflation it is important to point out the basic cause of inflation that is when aggregate demand becomes excessive as compared to the supply output. Thus the causes of inflation can be analysed under two broad headings:

<u>A. Increase in demand resulting from:</u>

(i) Increase In money supply;

(ii) Increase in disposal income of the people;

(iii) Increase In the amount of aggregate spending of the community on both investment goods;

(iv) Increase in demand for goods from foreign countries and rising volume of its exports;

(v) Excessive market speculation and increasing tendency on the part of producers and trade towards hoarding and profiteering;

(vi) increase in the size of population; and

(vii) increase in the amount of salaries wages and dearness allowances.

B. Failure to attain corresponding increase in the availability of goods and services which may be due to:

(i) scarcity of land area.

(ii) deficiency in the availability of capital equipment:

(iii) scarcity in the supply of other complimentary factors of productions, viz., essential raw materials, skilled labour or technicians, shortage of power, lack of dynamic entrepreneurs ;

(iv) increasing the volume of exports for raising the foreign exchange earnings;

(v) reducing the volume of imports resulting from war or restrictions imposed on import to face and rectify adverse balance of payments situation;

(vi) natural calamity like floods, draught, famine etc. affecting agricultural production;

(vii) fall in industrial production as a result of prolonged industrial unrest;

(viii) speculative hoarding of commodities either by producers, traders and middlemen anticipating a further rise in prices; and

(ix) disruption of normal supply channel of goods and services due to exhogenous factors.

Q3. What are the causes of rising and falling inflation?

Ans- Rising and falling are two different situations which may occur in a country at different points of it may occur in different countries at the same point of time depending on the prevailing situation faced by the country concerned.

Rising inflation and its causes

Rising inflation is a state of rising prices where the rate of inflation or the rate of increase in the price level off a country started to rise continuously and it gradually leads toward sustained increase general price level. Such a situation is not at all encouraging for raising welfare level as it reduces the purchasing power of money continuously. Highly rising inflation is not conductive towards attaining development. However, slowly rising inflation encourages the investors to make more investment as it increase the chances of earning more profit.

The main causes of rising inflation are:

(i) Fast rising aggregate demand arising out of increase in money supply (deficit-included inflation) increase in community's aggregate spending, excessive speculations in the market, sustained rise in the price of imported commodities, increase in salaries and wages and increasing size of population. This is a situation which directs the economy towards demand-full inflation;

(ii) failure in the supply front resulting no corresponding increase in the production of goods and services due to deficiency in capital equipments, scarcity of other complementary factors of production, increase in exports, speculative hoarding by producers and traders, natural calamities, industrial unrest etc.

Failure inflation and its causes

Falling inflation is a state of falling prices where the rate of inflation, i.e., the rate of increase in the price level is gradually declining leading towards moderate and mild inflation. Such a situation raises the welfare of the common people as it raises the purchasing power of money. However, falling inflation may dampen the investment climate at it abolishes the chance of earning super normal profit.

The main causes of falling inflation are:

(i) slowly rising aggregate demand arising out of control of money supply, control of aggregate spending on both consumption and investment goods, controlling speculation in the market falling exports, no hike in salaries and wages and stable population;

(ii) gradual increase in the supply of goods, services arising out of growing availability of capital equipment and other complementary factors of production, falling exports, increasing volume of imports of essential goods, control of speculative hoarding, favourable natural situation having no damages out of natural calamities and favourable industrial relations.

Thus the above mentioned factors are largely responsible for creating a situation like falling inflation in a country.

Q4.Write a note on inflation and interest rate

Or

Explain the relation between inflation and interest rate.

Ans- Inflation has its impact on interest rate. Interest rate is considered as one of the important macroeconomics variable which determines savings and investment in an economy which in turn play on important role for determining national income and employment. Interest rate links the present with the future through its effect on savings and investment. Thus it is imperative on our part to understand the relation between interest rate and inflation. In order to understand the relation between interest rate and inflation, distinction between nominal interest rate and real interest rate must be known clearly. By nominal interest rate we mean that interest rate which the bank provides to the depositors on its savings account and fixed deposits. It is also taken as the agreed nominal rate at which lenders lend money to borrowers. But the real interest rate depicts the real purchasing power of one's deposit in the bank that increases over a year. Such rate of increase in purchasing power of one's deposit depends both on nominal interest rate on a fixed deposit for one year is 8 per cent and inflation. Thus 8 per cent minus 4 per cent, that is 4 per cent is the real increase in purchasing power of your deposits and thus real interest rate is 4 per cent.

Thus, real interest rate can bee derived from nominal interest rate simply by adjusting the inflation rate that occurred in that year. Therefore, the relationship among the real rate of interest, nominal rate of interest and inflation rate can shown as:

Real interest rate= nominal interest rate-inflation rate. If we denote real interest rate by r , nominal interest by I and inflation rate by π

$$r = i - \pi$$

Q5. Write a detailed note on social cost on inflation?

Ans- Inflation is considered as a serious economic problem. If a country is experiencing inflation then it has to bear may costs. Accordingly, economists policymakers, politicians etc. became very much concerned to make necessary arrangements and also for taking steps to control inflation because of continuous public pressure. However inflation is widely debated by all the stakeholders in the economy. It is therefore, important to study the costs of inflation that a country has to face and the various agreements made on it in the following manner.

It is important to study the social costs of inflation as is not only reduces purchasing power of money income of the people but also inflicts some other costs on the society. In order to explain such costs of inflation it is imperative on our part to distinguish between the costs of anticipated(expected) inflation and unanticipated (i.e., Unexpected) inflation.

<u>A. Social costs of Anticipated or Expected inflation</u>

The social costs of predictable inflation may be of the following nature:

***<u>1. Falling purchasing power of Money</u>*-** There is common perception among thee people that inflation reduces purchasing power of money and thus their money would be able to command lesser members of goods. But is it really true? If due to inflation we need to pay higher prices for the goods and servives then the seller gets higher income as they also charges higher prices for their goods and services. Under that circumstances it seems that if nominal incomes could keep pace with the prevailing inflation rate then fall in purchasing power of money is just a fallacy.

<u>2. Shoe-leather costs-</u> Another social cost of inflation is the shoe-leather which occurs mostly due to inflation cost of holding money in terms of currency which rises with the increase in inflation rate. A higher rate of inflation leads to a higher nominal interest rate, known as fisher effect, which in turn, attracts people to lower real balances (holdings of currency) on an average for transaction purpose in order to earn more interests on their bank deposits.

***3. Menu costs*- ** The third type of social cost of anticipated inflation is menu costs, i.e., a term derived from a restaurant's cost of printing a new menu book. Here the cost of inflation mostly arises as high inflation induces firms to change their prices more often. Changing prices of their commodities sometimes become costly as it may require printing and distribution of a new catalogue, price list etc.

***4. Inflation induced tax distortions*-** Another cost of inflation is the inflation induced tax distortions which arises because tax code do not consider the effects of inflation. Classic example of such distortions can be seen when tax law fail to del with inflation in case of tax on capital gains.

5. Macro economic inefficiency in Resource Allocation- Another cost of inflation is reflected as and when firms having menu costs normally change their prices of product quite infrequently with the changes in price. Thus, as a result of inflation relation prices of products of a firm usually vary during a year as compared to the overall price level creating distortions in production. This leads to Macro-economic inefficiencies in allocation of resources

***6. Inconvenience of living*-** Another important social cost off inflation is the inconvenience of living in the world where prices are changing continuously and thereby brings changes in the value of money. Money is used as a yardstick for measuring the value of economic transactions. Thus, when a country is experiencing inflation, value of money changes and thus yard stick also changes.

***7. Social cost of unanticipated inflation*-** In comparison to the cost of anticipated inflation, the cost of unanticipated inflation is harmful and substantial. Unanticipated inflation arbitrarily re-distributes wealth among individuals. As a result of inflation the value of bonds purchased by an individual in the early period becomes much lesser in present time because of erosion of value.

Q6.What do you mean by Unemployment?

Ans- Unemployment is defined as a situation when there are a large number of able-bodied persons of working age in a country who cannot find remunerative work at the current wage levels inspite of their willingness to work.

Unemployment is a chronic problem almost common to each and every country of the world. Unemployment is a serious problem. It indicates a situation where the total number of job vacancies is quite less than the number of job seekers. It is a situation where the unemployment persons do not find any meaningful or gainful job in spite of having willingness and capacity to work.

Q7. Write short notes on?

a. Natural rate of unemployment?

Ans- Natural rate of unemployment is the summation of frictional and structural unemployment which excludes cylindrical contribution of unemployment. Thus natural rate of unemployment mostly arises due to labour market frictions and structural changes that is taking place in a free market economy. It is considered as the lowest rate of unemployment that a stable can expect to achieve, given that some minimum extent of frictional and structural unemployment is inevitable. Thu the natural rate of unemployment is that rate off unemployment in the labour market where the current number of unemployed is equal to the number of jobs available in the market. These unemployed workers remain unemployed for frictional and structural reasons although equivalent number of jobs are available for them. As for example, it is a situation where fresh entrants spend a good amount of time for searching a job and to get it. Thus it is observed that full employment used to prevail despite the existence of natural rate of unemployment which is mostly unavoidable in a changing economy.

b. Frictional Unemployment?

Ans- In an economy where some minimum amount of unemployment prevails among workers who voluntarily quit their earlier jobs and are searching new and better jobs or looking for employment for the first time. They are not in position to get a jobs immediately because of prevailing frictions such as lack of market information related to availability of jobs and lack of adequate mobility on the part of the workers. One important feature of this frictional unemployment is that number of jobs vacancies available in the economy are almost equal to that of frictionally unemployed prison.

C. Wait Employment:- Wait employment is a kind of frictional unemployment. It usually refers to the effects of existence of some sectors where we find that employed workers are normally paid more than that the market clearing equilibrium wage. This type of employment not only restrict the amount of extent of unemployment in the high wage sector, but it usually attracts workers from other sectors who wait in the market and tryto get jobs there. The main problem of wait unemployment theory is that such workers will likely “wait” while having jobs, so that they need not be counted as unemployed.

D. Structural Employment:- structural employment is a kind of unemployment which mostly occur due to mismatch between the skills that workers in the economy can offer and the skills demanded of workers by employers. This situation is also known as skills gap. Structural unemployment normally occurs in a growing economy. Thus the striking feature of structural unemployment is that here the unemployed workers lack necessary skills required by the expanding industries. Such structural unemployment is often brought about by technological changes which make the job skills of many workers of present times as obsolete.

E. Cyclical Unemployment:- This type of unemployment mostly arises due to deficiency in effective demand in a country. This type of unemployment is also known as demand deficient unemployment. Advanced capitalist countries usually suffers from this type of unemployment. During the phase of recession or depression this type of unemployment increases considerably. Due to the deficiency in effective demand, producers and businessmen cannot sell their entire output leading to unfulfillment of their profit expectations.

Q8. What do you mean by labour market?

Ans- By the term labour market we mean market for labour. Thus, labour market refers to the supply and demand for labour, in which employees or workers create the supply and the employers create its demand. Labour market is an important component of any economy and it is intricately tied in with other markets for capital, goods and services. Moreover, labour markets or job markets function actively through the interaction of workers and employers. Labour economies includes both suppliers of labour services (workers) and demanders of labour services (employers) and thereby it makes attempt to understand the resulting pattern of wages, employment and income.

Q9. Write a note on labour market and its interaction with production system?

Ans- It is quite important to analyse the labour market and their interaction with the production system and such interaction can be analysed with the help of two models. These two models can explain the position and slope of the aggregate supply curve in the short run. These two models are:

1. The sticky wage model.

2. The worker misperception model.

1. The Sticky Wage Models

This model observed that nominal wage are sticky or rigid in the short run. Thus, it indicates that nominal wage do not change when economic conditions change in the country. Thus the reason may be implicit agreements or long term contracts or social norms.

It is also seen that when price level rises, real wages falls. This makes labour cheaper and that results firms to demand more labour. Employment of more labour results more output. Thus a direct relationship is established between the price level and the output level. This establishes an upward rising aggregate supply curve.

Assumption. The following are the two assumptions of the model

(i) Workers and firms bargain over and thereby set the nominal wage.

(ii) Employment is determined by the quantity of labour that is demanded by firms.

The sticky wage model shows that as price level rises from P_1 to P_2 real wages falls which leads to increase in employment. This increase in employment also leads to rise in output. Thus the aggregate supply curve shown in this model is an upward sloping curve.

The worker misperception model

Another group of economists observed that when actual prices doffer from expected price then supply of labour gets affected and thereby it affects the output level.

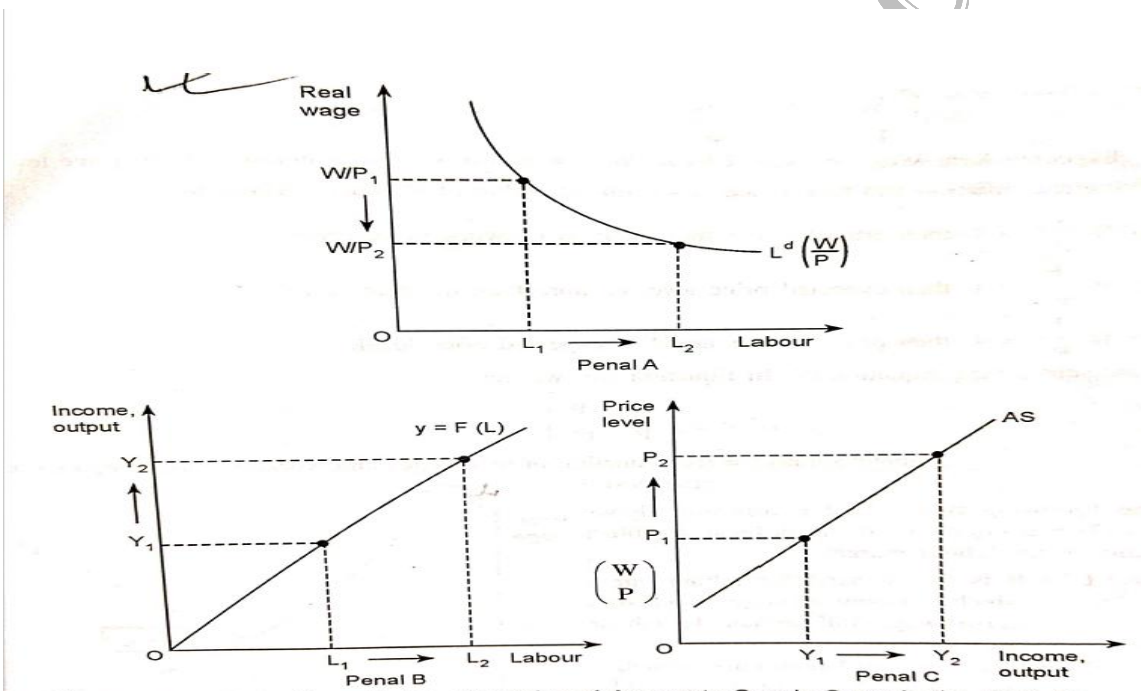


Fig. 15.1. The Sticky Wage Model—Derivation of Aggregate Supply Curve in the short run.

Assumption. The following are the two assumption of this second model:

(i) Wages are flexible and thereby it can quickly adjust to balance demand and supply of labour

(ii) Unanticipated movement in the level of price normally affect supply of labour as workers temporarily confuse between real and nominal wages.

The fig. shows that L^d curve and L^s curve intersects at point Q where demand for labour (L^d) becomes equal to supply of labour (L^s), i.e., [$L^d = L^s$]. At this point Q, real wage is determined at W and p and the volume of labour demanded and supplied is OL. Thus at thus point Q, there is equilibrium in the labour market in the short run.

Here also the result is: $Y=\overline{Y} + \alpha (P-P$

Thus we have seen that with the help of these two aforesaid models we could analyse the labour markets and their interaction with the production system effectively. These two models the also explained the position and slope of the aggregate supply curve in the short run.

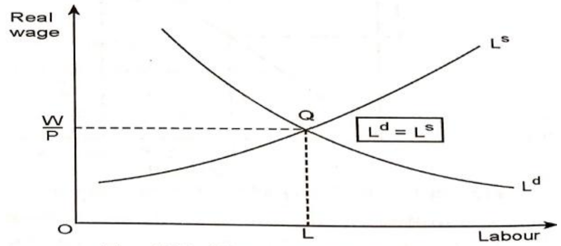


Fig. 16.2. Worker misperception model showing labour market equilibrium

Q10. Write a note on Philip curve?

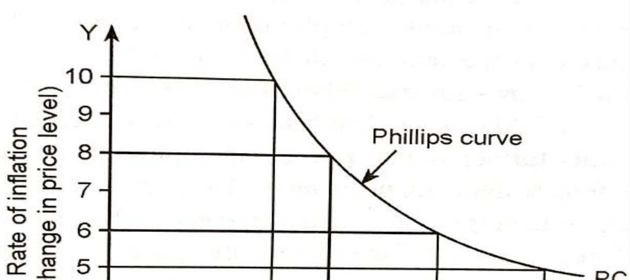
OR

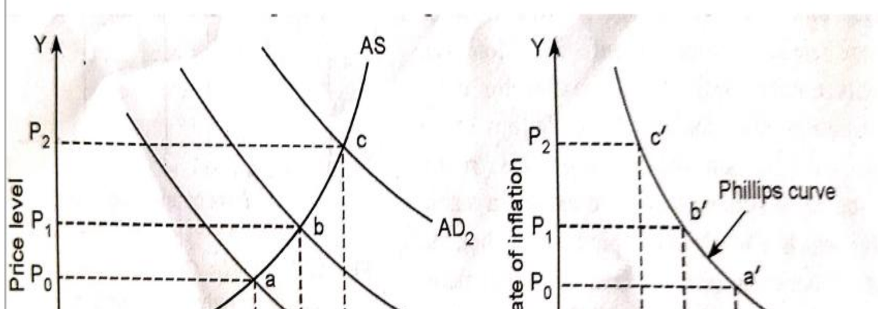
Explain the implication of Philip Curve on Inflation Unemployment trade off

Ans- While giving explanations for the Philips curve, we must admit that both Keynesians and monetarist agreed to the existence of the Philips curve. The explanation of Philips curve given by the Keynesian economists is definitely simple which is graphically analysed in Fig 16.4 keynesian economists argued that the aggregate supply curve is upward sloping mostly for two reasons. Firstly, with the increase in output by firms, diminishing return to variable factors, especially to labour, will result fall in marginal physical product (MMPL) of labour. As the money wage rate (W) remains given and fixed, such fall in marginal physical product of labour results the rise in the marginal cost (MC) of production

Thus with the fall in MPP of labour , wage rate remaining fixed, the marginal

Cost will definitely increase. The second reason for the rise in marginal cost is the hike in wage rate with the increase in employment and output. While analysing the relationship between inflation and unemployment, Philips also considered such relationship between the rate of increase in wage rate and unemployment rate.





Q11. Write a note on adaptive expectations and rational expectations?

Ans- Milton friedman in his theory of adaptive expectations challenged the concept of stable downward sloping Philips curve. According to friedman, though their exsist a trade of between rate of inflation and unemployment in this short run but it does not remain stable in the long run as it shifts both leftward or rightward. Milton friedmen's theory adaptive expectations suggests expectation about the future rate of inflation play an important role in an economy. According to Friedman, people form their expectations on the basis of previous period rate of inflation, and then change or adapt their expectations at that point of time only when the actual inflation turn out to be different from their expected rate. Thus, according to friedman, their may exist a trade of between rates of inflation and unemployment in the short run but trade of does not exists in the long run.

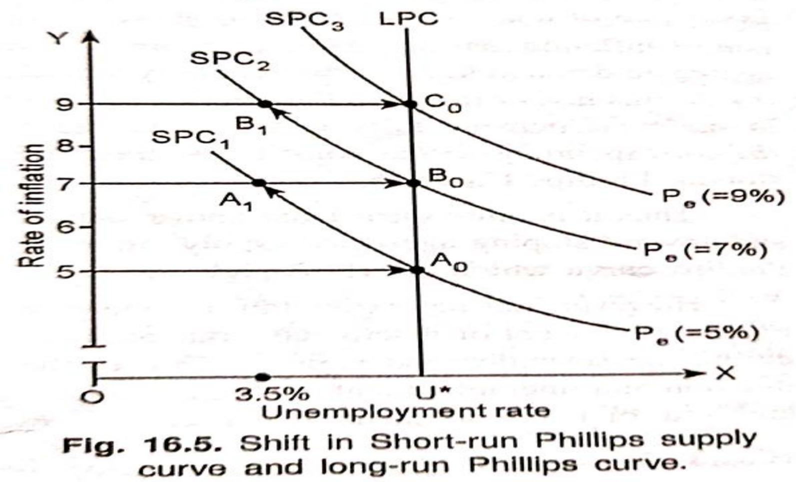


Fig. 16.5. Shift in Short-run Phillips supply curve and long-run Phillips curve.

Rational expectations:- Rational expectations theory is considered as the corner stone of recently developed macro economic theory which is also known as New classical macro economics. The rational expectations theory stated that there is no lag in the adjustment process of nominal wages as a result of price level. The advocates of the theory are of the view that nominal wages are adjusted, very quickly to any expected variation in the price level and thus their does not exist any type of Philips curve which reflect rate of between rate of inflation and unemployment. Thus with the rise in the aggregate demand there is no fall in unemployment rate. Thus whatever inflation is resulted from rise in aggregate demand is fully and correctly anticipated by workers and business firms followed by revised wage agreement considering rise in prices. Thus FIG: shows as the price level rises, the level of real output and employment remain stable at the natural level.