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Unit-3

Inflation

Persistent and considerable increase in general price level of all goods and services over a period of time.

Types

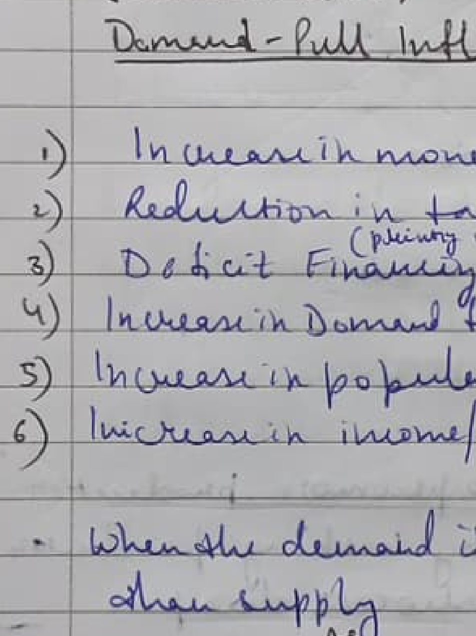
(Demand side) **Demand-Pull Inflation**

1) Increase in money supply
2) Reduction in taxes (printing more money)
3) Deficit Financing
4) Increase in Demand for exports
5) Increase in population
6) Increase in income/wages

(Supply side) **Cost-Pull Inflation**

Increase in cost of raw material
Increase in cost of other inputs
Govt Policies
fall in production
Artificial scarcity
Power shortage
Increase in rate of interest

- When the demand is more than supply



Once full employment level is reached and all resources are maximized supply becomes constant. Now if AD will increase due to increase in any factor the curve will shift upward

$AD = C + I + G + (X-M)$

$\boxed{\text{Demand Pull Inflation}}$

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Measures to Control Inflation

Demand Side Measures

1. Cut back the consumption * Essentional good's and basic necessities consumption can't be reduced
2. Tighter monetary policies
3. Contractionary Monetary Policies
4. Selling of securities in Open Market Operations i.e. Bonds to the public

Supply Side Measures

1. Upscaling the production
2. Technological Advancements
3. Imports
4. Subsidies & Rebates
5. Reduction in Taxes

(to promote production by making production process cheaper)

6. Cheaper Monetary policies

Deflation means decrease in general prices of all goods and services over a period of time.

Recession is a downward trend in the business cycle

Natural Rate Theory

- Developed by Milton Friedman as a part of the monetarist system.

- This theory is central to the question of the long-run relationships among output, unemployment and inflation.

- In the short run changes in monetary policy will determine fluctuations in output and employment

- Whereas in long run output and employment is determined by real factors i.e. capital, stock, labour size and level of technology

- According to this theory, there exists an equilibrium level of output and an accompanying rate of unemployment which is determined by the supply of factors production, technology and institutions of the economy (i.e. real factors)

- Changes in AD cause temporary movements of the economy away from natural rate

- Expansionary monetary policy move output above the natural rate and move the unemployment rate below the natural rate for a time. Which will cause price to rise.

- In short run price adjustment won't take place but in long run it will return to normal

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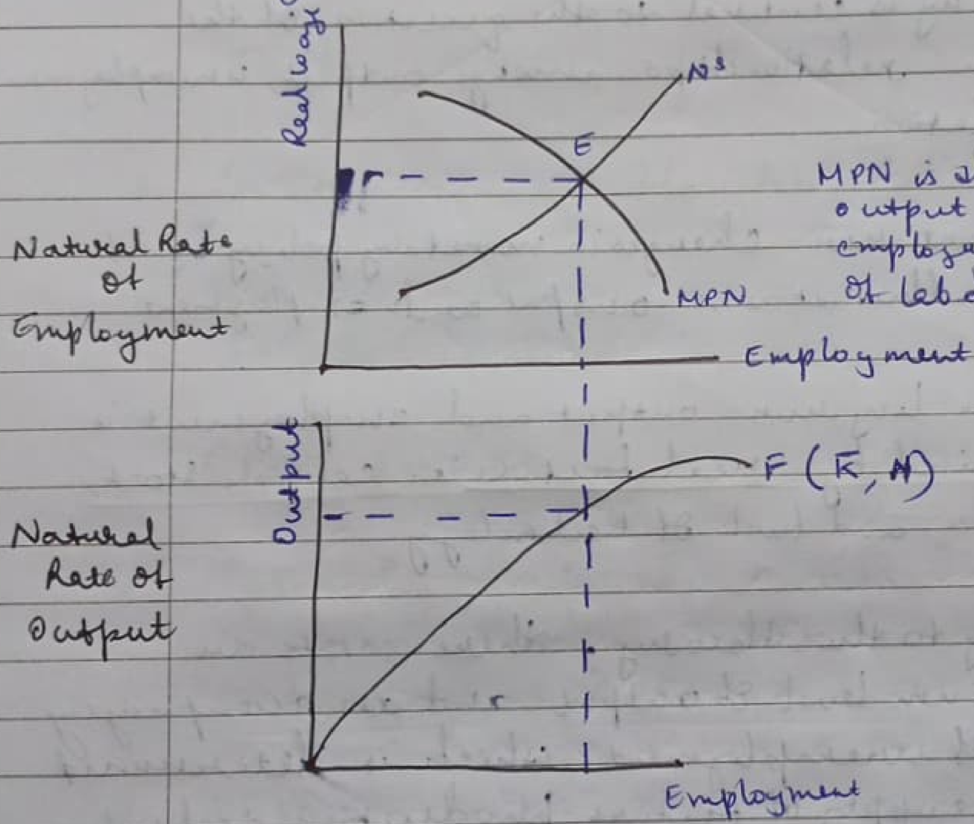
Thus, the natural rate of employment and corresponding unemployment will be such that labour demand equals labour supply at an equilibrium real wage.

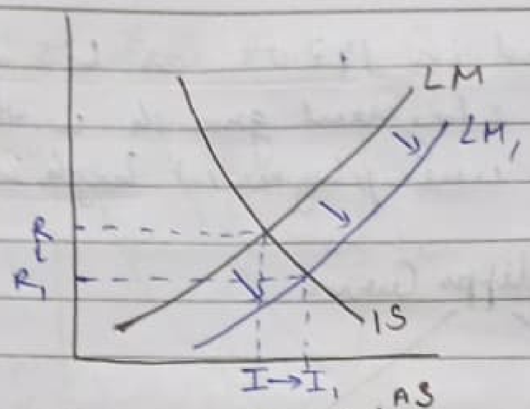


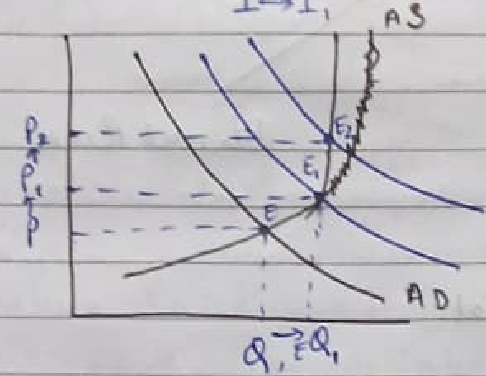
MPN is the change in output results from employing an added unit of labour

Monetary Policy - Output and Inflation

IS curve shows equilibrium in goods market and LM curve in money market so when money supply increases LM curve shifts downward.
Rate will decrease and income increase and AD will increase so does the price

Once AS is constant further increase in AD will result only in price increase





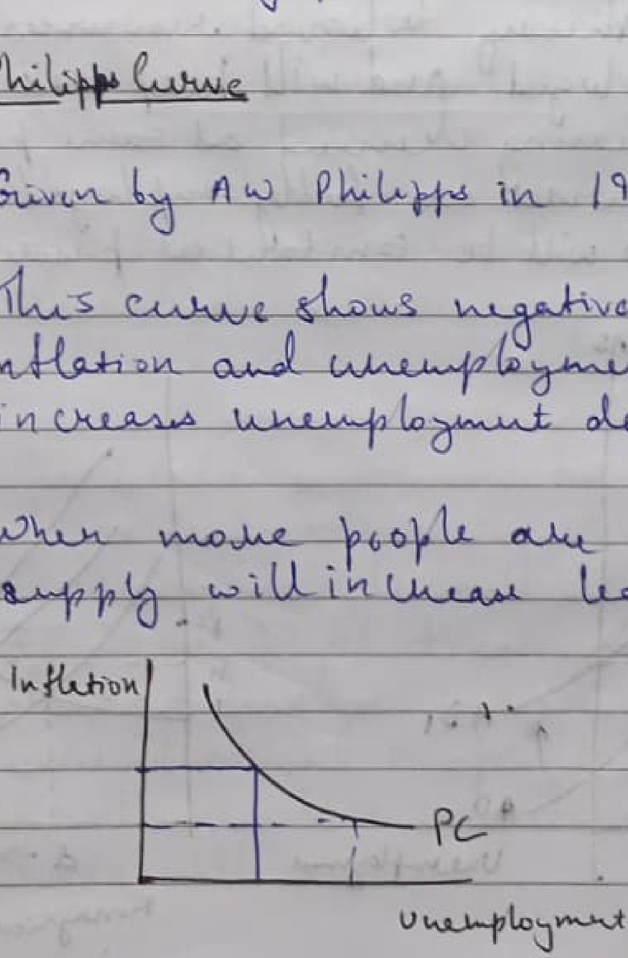
According to the Famous monetarist Milton Friedman inflation is always and everywhere a monetary phenomenon.

<u>Philipps Curve</u>

Given by AW Philipps in 1958.

This curve shows negative relation between inflation and unemployment i.e. when inflation increases unemployment decreases.

When more people are employed money supply will increase leading to inflation.



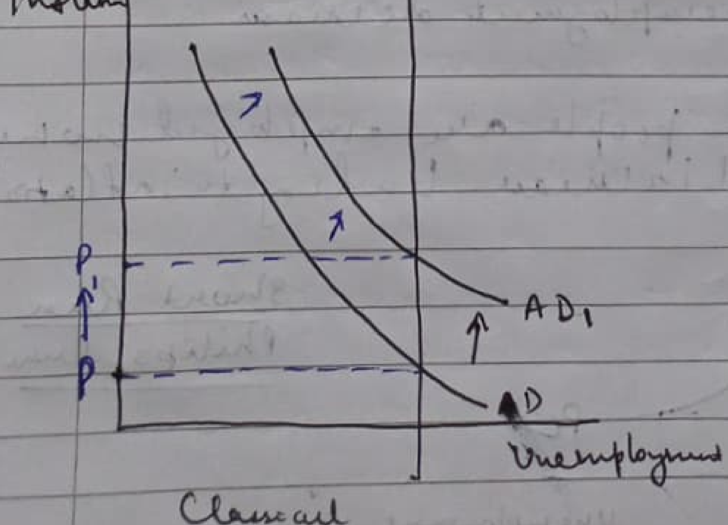
Short-Run Philips Curve

This theory failed in 1970's as US faced stagflation i.e. stagnant growth with inflation (high unemployment + high inflation)

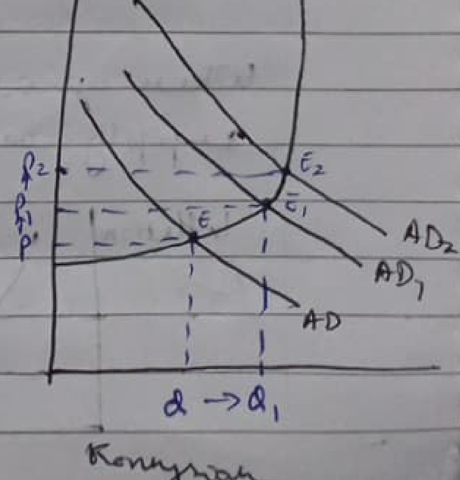
Philipps Curve

- Long-Run
  - NAIRU
  - Natural Rate
- Short Run

Classical theory believed resources were fully employed so with increase in demand, prices will increas but in Kenngsian theory believed resources are underemployed and will keep on increasing with increasing demand at same price till resources are fully employed after which AS will be constant at price will rise.



Classical



Kennysian

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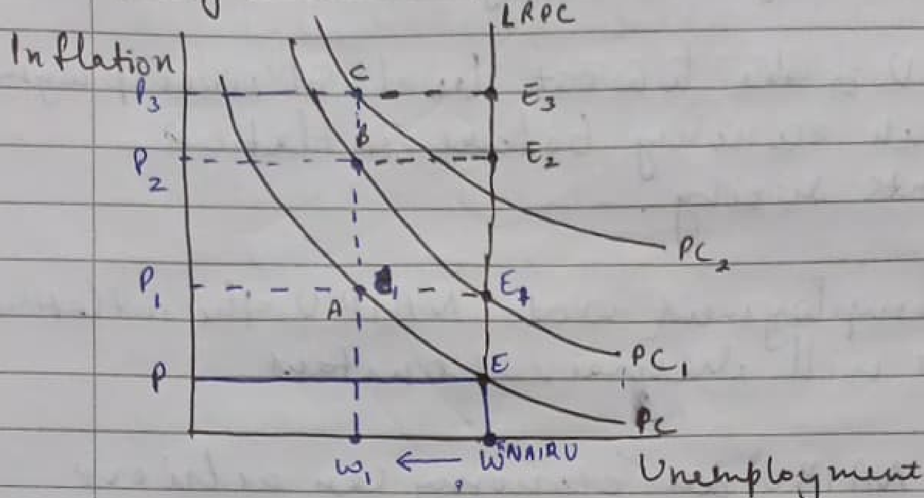
Long Run Philips Curve



When Price is at P and unemployment at w govt. use expansionary fiscal policy to reduce unemployment which reduces from w to w_1 but increases Prices from P to P_1, which results in ask for higher wages at pt. A which causes layoff and reaches equilibrium at increased Price at P_1 at E_1, now again govt. uses this method and cycle repeats itself giving a straight line PC in long run. Which means there is no tradeoff b/w inflation and unemployment in long run.

The LRPC was intoro by Milton Friedman, if we keep increasing the inflation rate in order to decrease unemployment rate at some pt of time the workers will demand higher wages which companies cannot afford to pay to all its workers it will result in layoff hence unemployment rate will increase.

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Non-Accelarating Inflationary Rate of Unemployment (NAIRU)

NAIRU is the lowest level of unemployment in an economy before inflation starts rising.

If unemployment is at NAIRU the inflation rate will remain constant.

At NAIRU an economy can achieve sustainable rate of employment and price stability

NAIRU is also called Natural Rate of Unemployment.

Even at full level of employment (under classical theory) some unemployment is present.
Suppose someone doesnot like his job so he left yet it will be considered employed this is called frictional unemployment.
Structural Unemployment is when a work previously done require new skills to be complete otherwise that person will be unemployed.

So, natural rate of unemployment is combination of structural and frictional unemployment.

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Full employment is an illusion there is always natural rate of unemployment persist in the economy which is the combination of frictional and structural.

If unemployment rate is reduced below NAIRU the inflation increases at an exponential rate.

Mercantalists (believed that a powerful economy is one which has gold and silver and exports instead of imports any)
↓
Classical (free market, no govt intervention and market at full employment)
↓
Keynesian (full employment is rare)
↓
Monetarist (focused on monetary phenomenon for the reasoning of inflation)
↓
New Classical