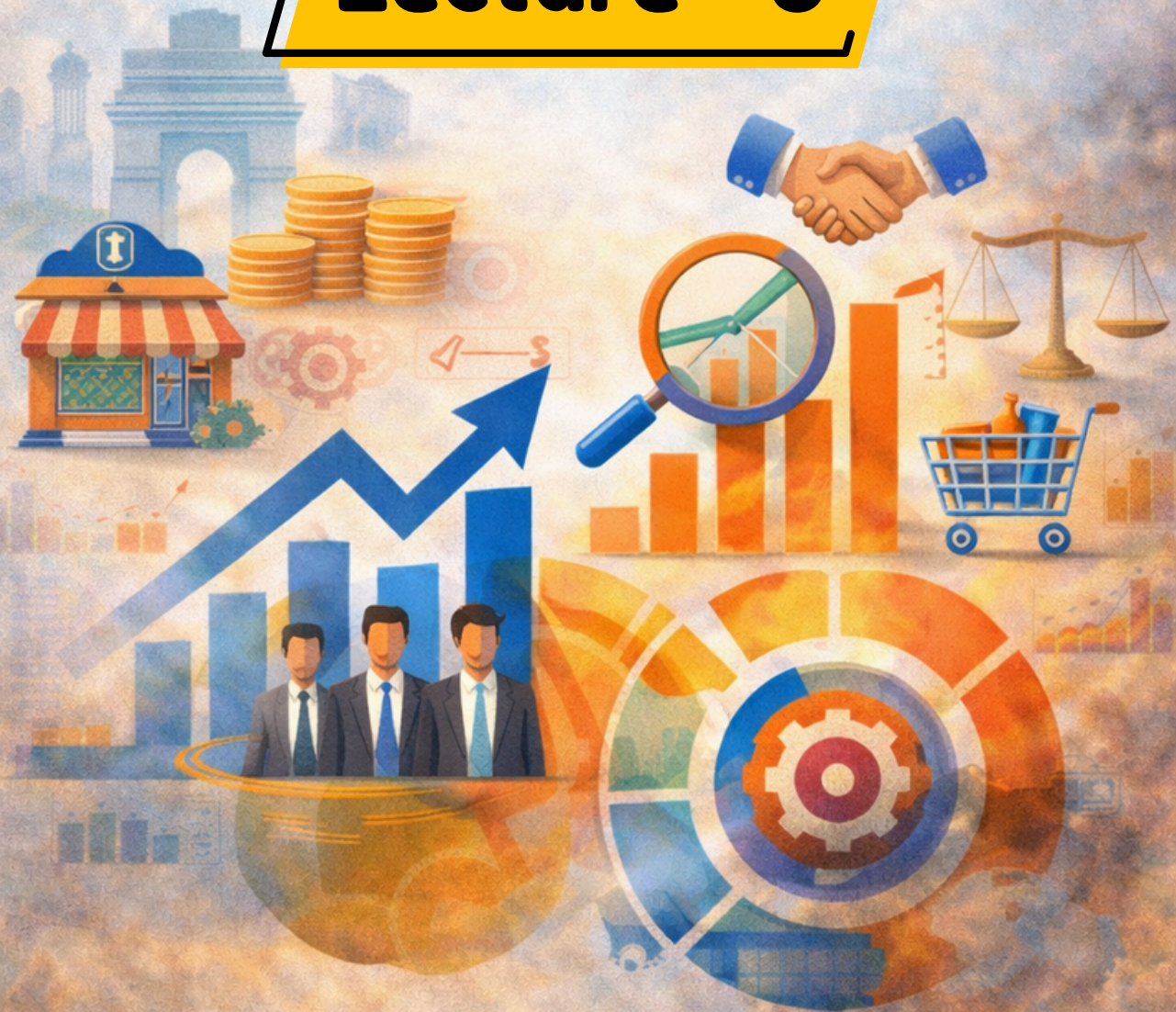
PARMAR SSC

INFLATION AND UNEMPLOYMENT

Lecture - 3



BY PARMAR SIR

FUNDAMENTALS OF INFLATION

Definition

- Inflation is a sustained increase in the general price level of goods and services in an economy over a period of time.
- **Purchasing Power:** As prices rise, the purchasing power of money decreases (i.e., each unit of currency buys fewer goods than before).
- **Value of Money**: Inflation erodes the real value of money.

IMPACT ON BORROWERS AND LENDERS

- **Example:** If you borrow ₹10,000 today and repay it after a year during high inflation, the ₹10,000 you return cannot buy the same amount of goods it could when you borrowed it. Effectively, the value of the debt has shrunk.
- **Debtors (Borrowers):** Benefit. They repay loans with money that has less purchasing power than when they borrowed it.
- **Creditors (Lenders):** Lose. The money returned to them buys less than it would have at the time of lending.
  - **Remedy:** Lenders must charge a Real Interest Rate to protect against this loss.
  - **Formula:** ***Real Interest Rate = Nominal Interest Rate - Inflation***

FISHER'S QUANTITY THEORY OF MONEY

- Irving Fisher gave the Money Illusion concept.
- Fisher's Quantity Theory explains the relationship between money supply, velocity of money, price level, and transaction.

MV = PT
M = Money Supply
V = Velocity of Money
P = Price Level
T = Transaction

The equation suggests that an increase in the money supply (M) leads to an increase in the price level (P), assuming that the velocity of money (V) and the level of transactions (T) are constant.

The theory also implies that changes in the money supply have a significant direct impact on inflation, as an increase in the money supply leads to an increase in the price level, which in turn reduces the purchasing power of consumers.

TYPES OF INFLATION

1. **Creeping Inflation (3-4%):** Mild and considered healthy for economic growth (analogous to "salt" in food—necessary in moderation).
2. **Walking Inflation (4-10%):** A warning signal to the government to control prices.
3. **Running Inflation (10-20%):** High inflation that requires strong monetary intervention.
4. **Galloping Inflation (20-100%):** Very high inflation; currency value drops rapidly.
5. **Hyper Inflation (>100%):** Prices skyrocket uncontrollably (e.g., Venezuela, Zimbabwe). Currency becomes practically worthless.

Seigniorage (Inflation Tax)

- **Definition:** The profit earned by the government by printing currency.
- **Why it's a "Tax":** When the government prints more money to pay its bills, it causes inflation. This inflation reduces the value of the cash in your pocket. You didn't pay directly, but you lost value—hence, "Inflation Tax."

Q. Why doesn't the government print money to repay its loans?

Ans. The government can do this, called **deficit financing**, but excessive money printing increases inflation. If overused, it can lead to uncontrolled inflation, as seen in Venezuela.

CAUSES OF INFLATION

Demand Pull Inflation	Cost Push Inflation
It is caused by an increase in demand (demand side inflation)	It is caused by an increase in production costs (supply side inflation)
It can be caused by strong economic growth, increased government spending or increased exports	It can be caused by increased wages, raw material prices, or indirect taxes
It can be short-term	It can be long-term
"Too much money chasing too few goods", an expression that describes demand-pull inflation	Increase in cost of any factors of Production and Input Cost

Imported Inflation

- **Core Cause:** Global prices rising.
- **Meaning:** When a country imports essential goods (like Oil) and international prices go up, domestic prices also go up.

Example:

- India imports Crude Oil.
- If Crude Oil becomes expensive globally ⇒ Petrol/Diesel price rises in India ⇒ Transport cost rises ⇒ Vegetables/Milk prices rise.

MEASUREMENT OF INFLATION

Wholesale Price Index (WPI) and Consumer Price Index (CPI) is used to measure inflation.

Inflation Rate Formula:

- To find the percentage rate of inflation between two years:

$$Inflation Rate = \frac{(\text{Current Year Index} - \text{Previous Year Index})}{\text{Previous Year Index}} \times 100$$

Price Index Formula:

- To find the index value for a current year:

$$Price Index = \frac{\text{Cost of Market Basket in Current Year}}{\text{Cost of Market Basket in Base Year}} \times 100$$

Wholesale Price Index (WPI)

WPI measures the average change in the prices of goods at the wholesale level (before they reach the final consumer).

Key Characteristics:

- **Focus:** Tracks prices of goods traded between corporations (bulk trading).
- **Services:** NOT included in WPI. It only tracks goods.
- **Publishing Body:** Office of Economic Adviser (OEA), under the Ministry of Commerce and Industry.
- **Base Year:** 2011-2012 (Upcoming - 2022-23).
- **Frequency:** Published monthly.

$$WPI = 100 \times \frac{\text{Cost of a fixed basket of goods in the current year}}{\text{Cost of fixed basket of goods in base year}}$$

Consumer Price Index (CPI)

CPI measures the average change in prices of goods and services at the retail/consumer level. It reflects the cost of living for the common man.

Key Characteristics:

- **Focus:** What the final consumer pays.
- **Services**: INCLUDED (e.g., education, medical care, transport).
- **Publishing Body**: National Statistical Office (NSO), under the Ministry of Statistics and Programme Implementation (MoSPI).
- **Base Year**: 2012 (Upcoming - 2024)
- **Used By**: RBI uses CPI (Combined) for inflation targeting and formulating monetary policy.

$$CPI = 100 \times \frac{\text{Cost of a fixed basket of goods and services in the current year}}{\text{Cost of a fixed basket of goods services in base year}}$$

Weightage Distribution in WPI:

The WPI basket is divided into three major groups. The weightage determines how much impact a price change in that category has on the overall index.

- **Manufactured goods (64.2%)**
- **Primary articles (22.6%)**
- **Fuel and power (13.5%)**

Weightage Distribution in CPI:

Unlike WPI, the CPI basket prioritizes food items, reflecting household spending habits.

- **Food and Beverages (45.8) -highest**
- **Housing (10%)**
- **Fuel and power (6.8%)**



Four types of CPI

The CPI is calculated for different segments of the population because their consumption baskets differ.

CPI Type	Target Group	Published By	Base Year
CPI - IW	Industrial Workers	Labour Bureau (Min of Labour)	2016
CPI - AL	Agricultural Labourers	Labour Bureau (Min of Labour)	1986-87 (2019)
CPI - RL	Rural Labourers	Labour Bureau (Min of Labour)	1986-87 (2019)
CPI (Combined)	Rural + Urban (General)	NSO (MOSPI)	2012 (2024)

PRODUCER PRICE INDEX

- **Definition:** Measures the average change in selling prices received by domestic producers for their output.
- **Perspective**: Unlike CPI (buyer's perspective), PPI looks at inflation from the seller's perspective.
- **Significance**: It captures price changes at the "factory gate" before taxes and distribution costs are added. It is considered a leading indicator because cost increases here are usually passed on to consumers later.
- **Stages Tracked:** Raw materials, intermediate goods, and finished products.

CORE INFLATION VS. HEADLINE INFLATION

- Inflation figures are often reported in two ways to distinguish between general trends and volatile short-term changes.

A. Headline Inflation

- **Definition:** This is the raw inflation figure reported based on the Consumer Price Index (CPI).
- **Scope:** It includes all commodities in the basket, including food and energy.
- **Significance**: This is the rate that affects the common consumer's daily life and is the "headline" news figure.

B. Core Inflation

- **Definition**: Core inflation is a measure of inflation that excludes volatile items like Food and Energy (Fuel).
- **Formula:**

Core Inflation = Headline Inflation - Volatile Inflation (Food + Fuel)

INDEX OF INDUSTRIAL PRODUCTION (IIP)

- While CPI/WPI measures prices, the IIP measures volume or growth in production.
- **Definition**: It is a statistical indicator that measures the growth of industrial production in a country over a specific period.
- **Publishing Body**: National Statistical Organisation (NSO) under the Ministry of Statistics and Programme Implementation (MoSPI).
- **Base Year**: 2011-2012. (Upcoming 2022-23)
- **Significance**: It helps gauge the health of the industrial sector (Manufacturing, Mining, Electricity).

The Eight Core Industries

- Within the IIP, there are Eight Core Industries that are considered the backbone of the economy.
- **Weightage**: These eight industries collectively account for approximately 40.27% of the total weight of items included in the IIP.
- **Implication**: If these industries perform well, the overall industrial growth is likely to be positive.

List of 8 Core Industries:(Arranged from Highest to Lowest Weightage)

1. Refinery Products (Highest weightage - heavily dependent on imported crude oil).
2. Electricity.
3. Steel.
4. Coal.
5. Crude Oil.
6. Natural Gas.
7. Cement.
8. Fertilizers.

TYPES, INDICATORS, AND DYNAMICS OF INFLATION

1. Disinflation

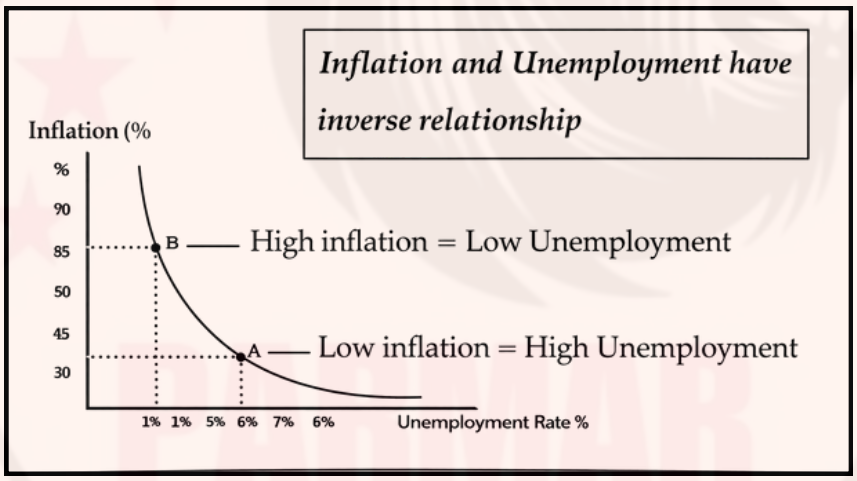
- **Definition**: Disinflation is a decrease in the rate of inflation. Prices are still rising, but at a slower pace than before.
- **Mechanism**: It is measured by the change in the inflation rate from one year to the next.
- **Example**:
  - Year 1 Inflation: 10%
  - Year 2 Inflation: 8%
  - Year 3 Inflation: 5%
- **Observation**: Prices are still increasing (positive inflation), but the speed of the increase is slowing down.
- **Cause**: Often caused by a slowdown in the money supply through tighter monetary policy.

2. Deflation

- **Definition:** Deflation is a general decrease in the price of goods and services. It is effectively "negative inflation."
- **Impact:** During deflation, the purchasing power of money increases (you can buy more with the same amount of cash).
- **Why is it bad?** — While lower prices sound good, deflation indicates a shrinking economy.
- **Cause:** Reduced money supply, reduced investment, or lower production.
- **Cycle:** If prices are falling, consumers delay purchases (waiting for cheaper prices), which lowers demand further, leading to lower production and job losses.

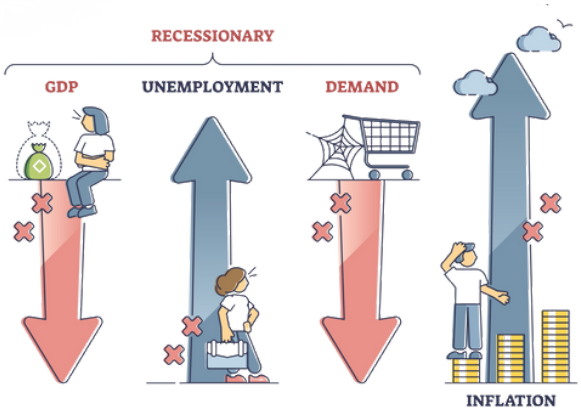
Phillips Curve

It is a graph that shows the relationship between unemployment and inflation in an economy.



3. Stagflation

- **Definition:** Stagflation is a paradoxical situation characterized by high inflation and low economic growth (stagnation).
- **Equation:** Stagflation = Stagnation + Inflation.
- **Key Feature:** It leads to high unemployment as a direct consequence.
- **Cause:** When the Production of goods and services in an economy slows down or declines.
- **Why it is unique:** It defies the Phillips Curve (which suggests that high inflation usually comes with low unemployment). In stagflation, the economy is stagnant (not producing/growing), yet prices are still rising.



4. Shrinkflation

- **Definition:** Shrinkflation occurs when companies reduce the size or quantity of a product while keeping the retail price exactly the same.
- **Purpose:** It is a "stealth" tactic to hide rising production costs without scaring off customers with a visible price hike.
- **Example:**
  - **Chips Bags:** Bags containing more air than chips.
  - **Beverages:** Pepsi reducing bottle size from 320ml to 250ml.
- **Conclusion:** You pay the same amount for less value.

5. Bottleneck Inflation (Structural Inflation)

- **Definition:** This occurs when supply cannot keep up with demand due to sudden "choke points" in the supply chain, such as labor shortages, raw material scarcity, or shipping delays.
- **Cause:** It is triggered by labor shortages, raw material scarcity, or shipping delays that prevent goods from reaching the market efficiently.
- **Analogy:** Think of it as an economic traffic jam. Even if everyone is ready to spend, a "narrow road" in logistics forces the whole system to a costly crawl.
- **Result:** Prices spike because the limited supply simply cannot satisfy the high consumer appetite.
- **Conclusion:** The system slows down, and you pay more due to inefficiency and scarcity.

6. Skewflation

- **Definition:** It occurs when there is a sharp price increase in one or two specific sectors (like food or energy) while prices in other areas remain stable or even decrease.
- **Cause:** This often happens due to sudden supply shocks in specific industries.
- **Context:** The overall inflation average might look misleadingly low, but consumers feel the pinch in daily essentials.
- **Conclusion:** The price rise is not uniform across the whole economy but is concentrated in a few essential goods.

7. Reflation

- **Definition:** A deliberate fiscal or monetary policy used by governments to stimulate the economy and increase output after a period of recession or deflation.
- **Goal:** To "re-inflate" price levels and boost demand by increasing the money supply or reducing taxes.
- **Method:** This is typically done by lowering interest rates or increasing government spending to encourage spending.
- **Challenge:** The main challenge is to stop it at the right time before it turns into excessive, uncontrolled inflation.

8. Inflationary Gap

- **Definition:** This occurs when the total demand (Aggregate Demand) in an economy exceeds its maximum capacity to produce (Aggregate Supply) at the level of full employment.
- **Cause:** It represents "excess" spending that cannot be matched by more goods, signaling that the economy is "overheating".
- **Result:** Since factories and labor are already at their limit, this extra demand doesn't create more growth; it simply pushes prices higher.
- **Solution:** Governments typically close this gap by raising taxes or cutting spending to "cool down" the market.

9. Inflation Target

- **Definition:** A monetary policy where a central bank sets a specific percentage as its primary goal for the annual inflation rate.
- **Mechanism**: The bank adjusts interest rates (like the Repo Rate) to keep price increases within a "comfort zone" to ensure economic stability.
- **In India:** The RBI's target is 4% with a tolerance band of +/- 2% (meaning it should stay between 2% and 6%).
- **Benefit:** This strategy creates transparency and predictability, helping businesses and consumers plan their finances.

GREAT DEPRESSION VS. GREAT RECESSION

- **A Great Depression (1929 to 1939):** A severe global economic downturn characterized by high rates of unemployment, poverty, and drastic reductions in industrial production and trade.
- **Great Recession (Late 2007 to mid-2009):** A period of market decline in economies around the world triggered by the US sub-prime crisis and widespread banking failures.

UNEMPLOYMENT

- **Definition**: Unemployment refers to a situation where a person actively searches for work but is unable to find employment.
- In India, unemployment data is collected by the National Sample Survey Office (NSSO). The NSSO uses three distinct approaches to measure the employment status of individuals:

1. **Usual Status Approach:** Estimates employment based on a reference period of 365 days (one year).
2. **Current Weekly Status (CWS):** Estimates employment based on a reference period of one week.
3. **Current Daily Status (CDS):** Estimates employment based on the activity status on each day of the reference week.

Types of Unemployment

1. Structural Unemployment

- **Definition:** Occurs when there is a mismatch between the skills possessed by the workforce and the skills required for the available jobs.
- **Cause:** Often driven by technological advancements (e.g., AI or advanced machinery) replacing manual labor or requiring new technical skills.
- **Key Feature:** The jobs exist, but the workers lack the specific qualifications to fill them.

2. Educated Unemployment

- **Definition:** A situation where people with academic degrees (graduates/post-graduates) are unable to find suitable employment.
- **Prevalence:** Primarily seen in urban parts of India.
- **Example:** An engineering graduate unable to find a job because they lack practical, industry-relevant skills.

3. Frictional Unemployment

- **Definition:** A short-term type of unemployment that occurs when a person is in the process of moving from one job to another.
- **Also Known As:** Search Unemployment or Voluntary Unemployment.
- **Example:** An employee resigning from a current job to search for a better opportunity or prepare for competitive exams (like CGL).

4. Disguised Unemployment

- **Definition:** A situation where more people are working than actually needed for a task.
- **Key Concept:** The Marginal Productivity of the extra workers is Zero. Removing them would not affect the total output.
- **Example:** A family of five working on a small farm that only requires three people. The extra two appear employed but are effectively unemployed.
- **Prevalence:** Most common in the rural agricultural sector.

5. Cyclical / Economic Unemployment

- **Definition:** Unemployment caused by economic fluctuations or business cycles (booms and recessions).
- **Mechanism:** During a recession (like the Great Recession or COVID-19), demand falls, leading to layoffs. When the economy revives, employment opportunities return.
- **Prevalence:** Mostly seen in capitalist/urban sectors.

Seasonal Unemployment

- **Definition:** Unemployment that occurs during specific times or seasons of the year.
- **Example:**
  - **Agriculture:** Farmers are unemployed during the non-sowing/harvesting seasons.
  - **Festive Sellers**: Sellers of fireworks (Diwali) or colors (Holi) who only have work during festival seasons.

6. Classical Unemployment

- **Definition:** Also known as Real Wage Unemployment. It occurs when real wages for a job are set too high (above the market clearing level), leading to more job seekers than available job openings.
- **Example:** When unions or minimum wage laws force wages higher than what companies can afford to pay, companies hire fewer workers.

7. Natural Unemployment

- **Definition:** The lowest level of unemployment that a healthy economy can sustain without causing inflation.
- **Concept:** Even in a booming economy, there will always be some level of unemployment (like frictional or structural) because people are constantly switching jobs or skills are updating. It is considered "natural".

MARGINAL WORKER VS. MAIN WORKER

Marginal Worker	Main Worker
Marginal worker is someone who is employed for less than 6 months or 183 days	Main worker is someone who is employed for more than 6 months or 183 days
E.g. Landless agricultural laborers and people who work in low-wage industries	E.g. Construction workers, seasonal employees, independent contractors



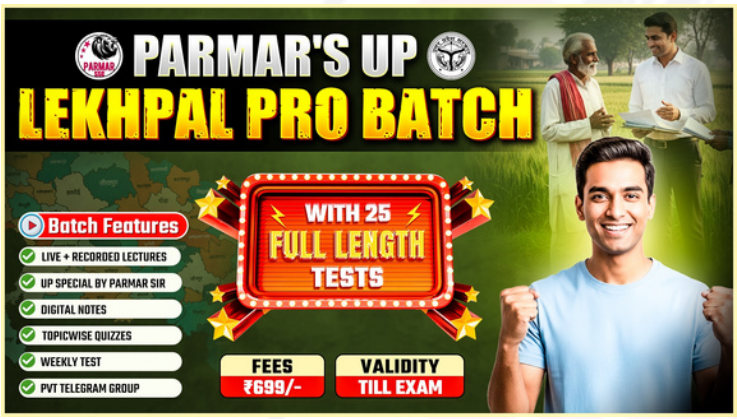


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