UNIT II

- Inflation – Meaning
- Types of inflation
- Causes for inflation
- Inflationary gap
- Anti-inflationary measures
- Business cycle : Types
- Phases of business cycle

INFLATION

- Inflation refers to the continuous increase in the general price level over a period of time.
- Inflation refers to the increase in the absolute prices and not relative prices.

Types and Causes of inflation

- When the aggregate demand increases due to increase in money supply by increase in government expenditure is termed as demand pull inflation.
- When inflation arises because of an increase in wages, profits or fall in aggregate supply is called as cost push inflation.

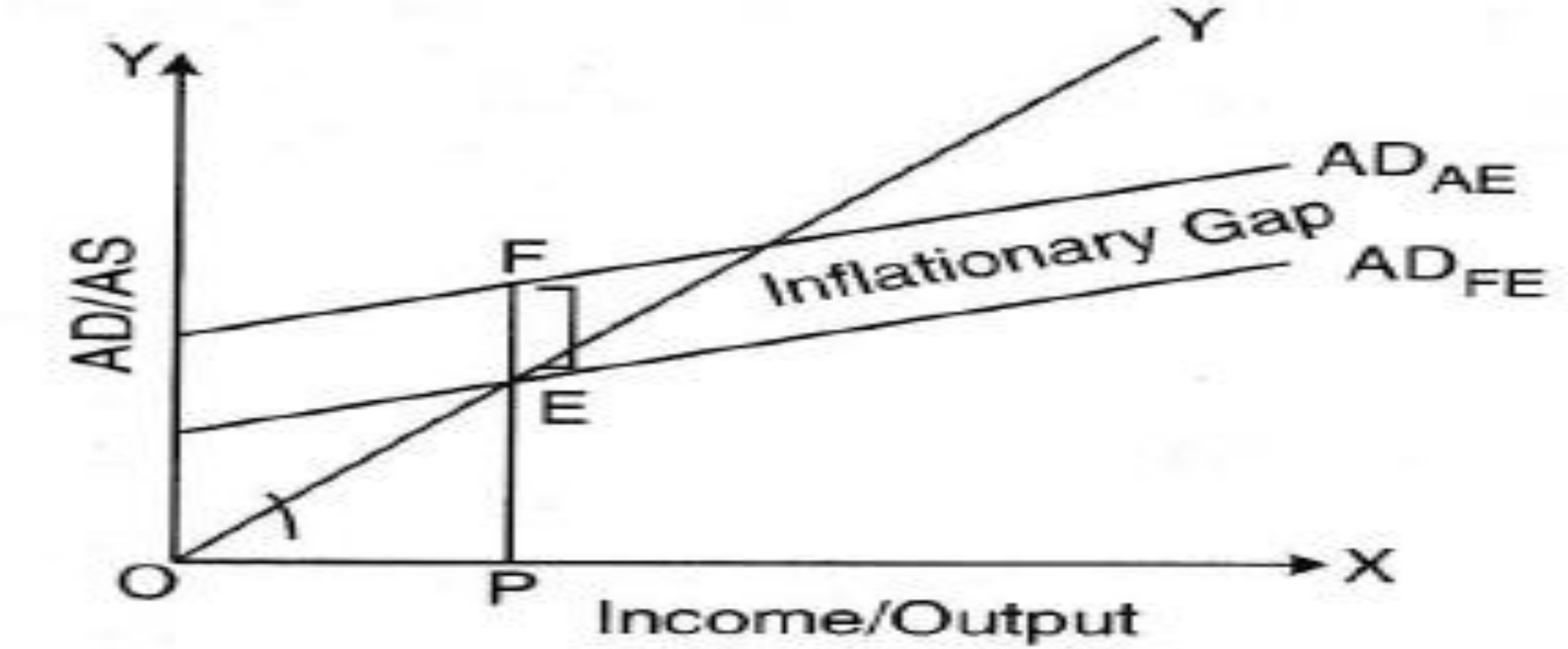
Factors that cause inflation

- Expansion in government expenditure.
- Tax laws; Reduction in taxes
- Expansion in the monetary policy
- Reduction in the interest rates
- Excessive growth in the supply of money and hyperinflation

Inflationary gap - Meaning

Inflationary gap arises when the aggregate demand exceed the full employment level of aggregate supply. This is a situation where, there is an increase in demand without increase in production and employment.

Inflationary gap



Source: https://www.sarthaks.com

In the above graph FE is inflationary gap; AD is aggregate demand: AS is aggregate supply; ADAE is aggregate demand above full employment level; ADFE is aggregate demand at full employment level.

Inflationary gap

Inflationary gap can be narrowed by increasing the amount of savings in an economy so that there is reduction in aggregate demand. The gap might get reduced when there is increase in taxes and fall in government expenditure. The government can also use monetary policy as an instrument to control the money supply and reduce the inflationary gap.

Reasons for inflationary gap

Increase in aggregate demand may be due to the following factors:

- Reduction in taxation
- Increase in marginal propensity to consume
- Increase in government expenditure
- Decrease in interest rates followed by increase in investment
- Increase in the expected returns on investment followed by increase in investment
- Exchange rate changes and increase in the demand for exports

Business Cycles

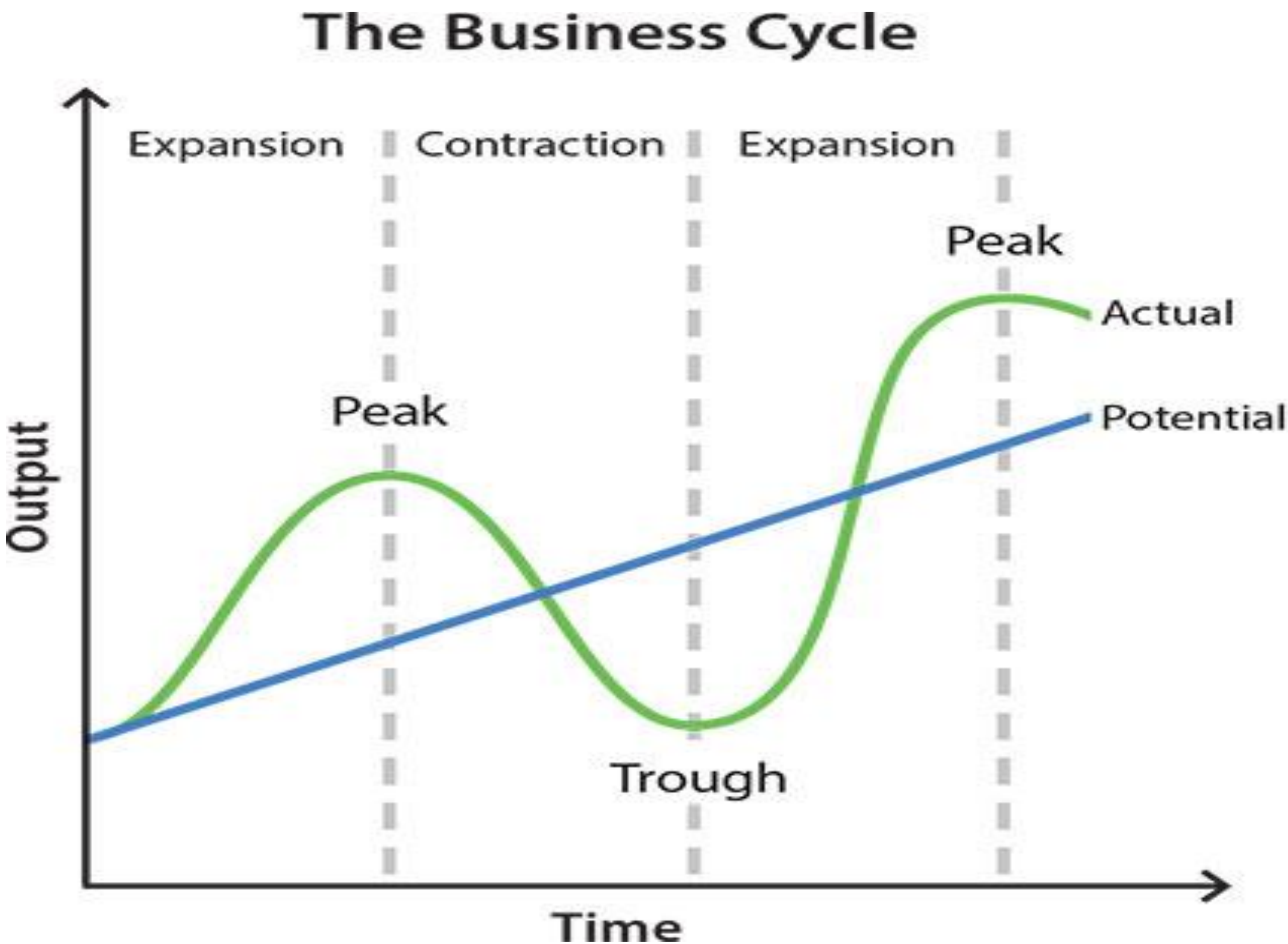
Business cycles are economic fluctuations that arise due to changes in aggregate demand and aggregate supply. Changes in the business cycles occur due to factors that operate outside the system. The effects of these factors can be favourable or harmful. These factors bring changes in the national output, income and employment.

Phases of business cycles

- Recession
- Depression
- Recovery
- Boom

Depression and Boom are the turning points of the curve. They are also termed as troughs and peaks respectively.

The diagram given below is taken from the website:
https://www.rba.gov.au/education/resources/explainers/recession.html



Recession

The period when there is a reduction in the economic activity leading to a fall in spending and demand is known as recession. During recession the GDP of the economy decreases and there is definite slowdown of development and growth in the macro economic variables. Some of the causes for recession may be high rate of interest; crash in the stock market; real estate crash; wage-price controls; slow down in the manufacturing sector; free

Market without government intervention; deflation and managerial inefficiency.

Depression:

Depression is severe than recession. There is persistent, sustained and long term slow down in the economy or economies. This lasts for a long period of time. During depression there is a fall in demand for goods and services. There is slow down of business and rise in unemployment.

Recovery

This is a phase of business cycle when the economy regains momentum of development and growth. This phase follows recession. The output and employment level in the economy improves.

Boom

There is a notable increase in the GDP growth of an economy. There is expansion of business, market, industry and economy as a whole.