
GDP Deflator

GDP deflator is the ratio of GDP at current prices to GDP at constant prices.

$$\text{GDP Deflator} = \frac{\text{GDP at current Prices}}{\text{GDP at constant prices}}$$

The measure includes the entire economic activities including services. GDP deflator is available only annually with a long lag of over one year.

CAUSES OF INFLATION

- 1. Money Supply** -The prices rise whenever the supply of money increases faster than the supply of goods in an economy.
- 2. Defense Expenditure** increases the general price level without contributing anything to production.
- 3. Credit Facilities** Sometimes the commercial banks may grant loans easily leading to an increase in the supply of money and the demand for goods.
- 4. During war the supply of money increases without any increase in the supply of goods.**
- 5. Deficit Finance** results in an increase in the supply of money leading to inflation.
- 6. Hoarding** result in a reduction in the supply of goods in the market and an increase in the prices of goods.
- 7. Increase in Wages and Cost of Production.** If the producers pay a higher wage rate, they will raise the price of products. An increase in the cost of production will result in an increase in price level.
- 8. Natural Calamities** Natural calamities like failure of monsoon, floods etc reduces the supply of goods. But at the same time the supply of money increases, due to flood-relief operations.

EFFECTS OF INFLATION

- 1. Gain to debtors and loss to creditors.** Though the debtors return the same amount of money, the value of money is less than when they borrowed the money
- 2. Salaried Persons** like teachers, clerks etc lose during inflation. This is due to the fact that prices rise faster than the increase in salaries.
- 3. Wage earners** may gain or lose depending upon the speed with which their wages adjust to rising prices.
- 4.** People like pensioners, recipients of interest income etc lose when prices are rising.
- 5. Equity Holders** gain during inflation because of the rise in dividend payment and an increase in share prices.
- 6. Farmers gain** during inflation because prices of the farm products increase more than the cost of production.
- 7.** As the price level is increasing production is encouraged. The producers invest more in anticipation of higher profits. The level of employment, output and income increase up to the point of full employment.

7. Structural Unemployment Structural unemployment occurs when there is a mismatch between the supply of and demand for workers. Structural unemployment results due to the emergence of new products and techniques which requires new skills. At the same time other products become obsolete.

8. Underemployment workers employed are not able to utilize their technical skill fully in the productive process. Employment of persons having higher technical qualifications in ordinary jobs.

9. Technological Unemployment The displacement of labour by machinery and improved methods of production.

10. Natural Rate of Unemployment The rate of unemployment that prevails when output and employment are at the full employment level. It consists of frictional unemployment and structural unemployment. FU is the unemployment that exists as a result of individuals shifting between jobs and looking for new jobs. SU occurs when there is a mismatch between the supply of and demand for workers. It is the rate of unemployment consistent with a steady rate of inflation. Also known as the *warranted unemployment rate, the normal unemployment rate, the long run unemployment rate and the full employment unemployment rate*. The idea of natural rate of unemployment was developed by *Milton Friedman and Edmund Phelps*.

The Costs of Unemployment

The following are the principal costs of unemployment.

1. Output Cost Direct cost of unemployment is the loss of real goods and services. When unemployment rises, the reduction in the number of people working leads to a decline in the quantity of goods and services produced. As the unemployed may stop paying taxes and instead receive unemployment benefits, the society also bears some of the output cost of unemployment. The society is also adversely affected because of the reduction in food production, availability of medical care, education, the production of vehicles, movies and new houses.

2. Another cost is the *psychological cost* faced by unemployed workers and their families. Workers without steady employment for long periods lose job skills. Prolonged unemployment may also bring social and personal ills, anxiety, stress, depression, deterioration of physical and psychological health, drug abuse, alcoholism and suicide.

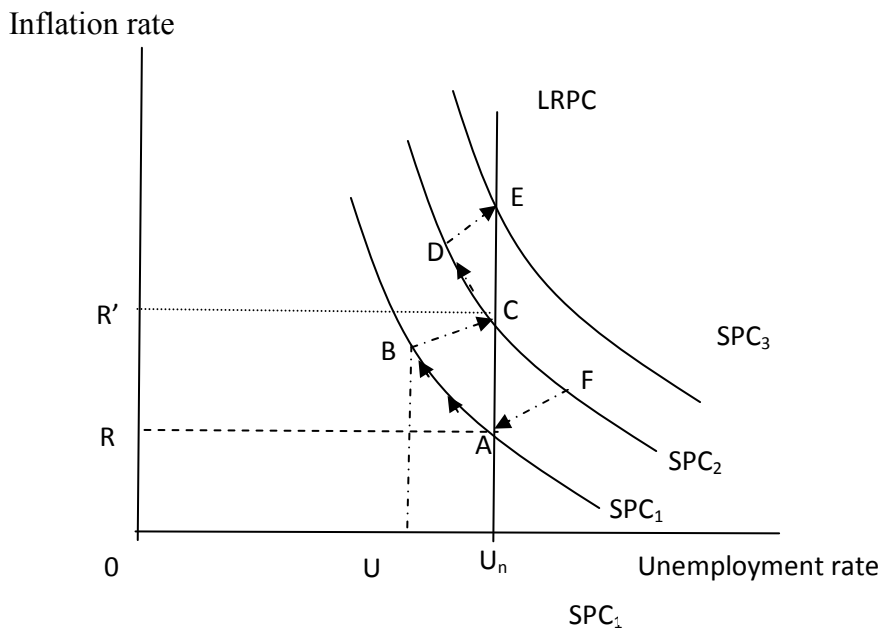
OKUN'S LAW

States the inverse relationship between real GDP and the unemployment rate. When real GDP rises, the unemployment rate falls and when the real GDP falls, the unemployment rate rises. This was studied for the first time by the American economist, *Arthur Okun*. Okun's law stated that the unemployment rate decreased by 1 percentage point for every 3 per cent increase in real GDP. Okun's law can be expressed as

$$\frac{Y^* - Y}{Y} = 3(u - u^*)$$

Y^* - potential output (full employment output)

Y - actual output



The curves SPC_1 , SPC_2 and SPC_3 , are the short-run Phillips curves at different levels of unemployment and inflation rates. Now, suppose that at some point of time the economy is at point A with unemployment rate of U_n and inflation rate of R and that these rates are consistent with the potential level of output. Now the policy makers consider U_n to be a high rate of unemployment and plan to reduce it by means of expansionary policies. As the economy is at the full employment, any expansionary policy will only push up the price. As the price level rises, the real wages go down.

As long as the workers are confused by the situation or do not realize the decline in the real wages, real wages continue to decline. As a result of fall in the real wages, employers increase their demand for labour. So employment increases and unemployment decreases. With rising prices and decreasing unemployment, the trade-off point A moves towards point B along the short-run Phillips curve SPC_1 .

This shows a decline in the unemployment rate from U_n to U . The inflation-unemployment combination at point B is not sustainable. Because workers eventually feel the decline in their real wages and begin to anticipate a further fall in their real income. Therefore, they begin to incorporate their 'expectations' into their demand for higher money wages matching with the expected price rise. They negotiate for a higher money wage rate at the time of the renewal of the labour contract.

As a result, real wages begin to rise. The rise in the real wage rate causes a decline in the demand for labour. Consequently, the labour market begins to move towards a higher equilibrium point C . The movement from point B to C indicates an increase in the rates of both inflation and unemployment. This indicates a shift in the Phillips curve from SPC_1 to SPC_2 . As a result, the rate of unemployment rises back to its natural level, U_n , the rate of inflation rises from R to R' . This is a situation of **stagflation** when both prices and unemployment increase simultaneously.