CHAPTER FOURTEEN

DETERMINANTS OF EMPLOYMENT AND INCOME

1. EQUILIBRIUM LEVEL OF NATIONAL INCOME

A stable level of national income where fluctuations do not arise is known as equilibrium level of national income. National income can be in equilibrium above or below the level of full employment where the economy faces inflationary or deflationary situations. It is necessary to eliminate these evils from the economy. We have two approaches to discuss the equilibrium level of national income which are as follows:

1. AGGREGATE SUPPLY – AGGREGATE DEMAND APPROACH

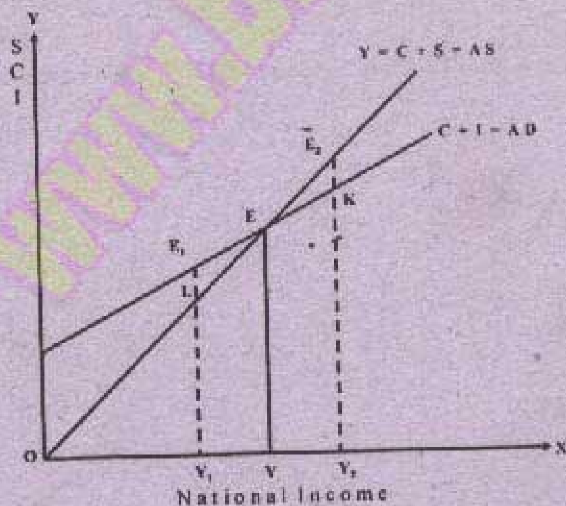
National income of a country at market price is known as aggregate supply. People spend a part of their incomes on consumer goods while the other part is saved, so aggregate supply can be shown as: **Y = C + S**

Total expenditure on consumer and investment goods by private individuals and government during a given year is called aggregate supply which can be shown as: **Y = C + I**

Equilibrium level of national income is determined at a point where aggregate demand becomes equal to aggregate supply i.e.

$$C + S = C + I$$
$$AS = AD$$

If at any time disequilibrium appears, some forces act and react automatically and the equilibrium position of the national income restores. We can explain this phenomenon with the help of the following diagram:



This diagram shows that C+S is income line or aggregate supply. Any point on this line shows

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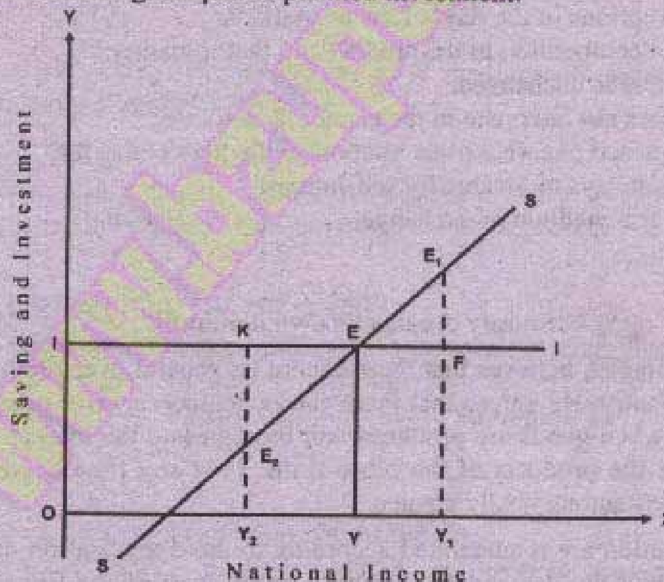
that total income is equal to total expenditure. Aggregate demand curve C + I intersects the aggregate supply curve C + S at point E where aggregate supply and aggregate demand are equal and the equilibrium level of national income is OY.

If we assume that the level of national income is OY_2 instead of OY, aggregate supply and aggregate demand are not equal at this level of income. Aggregate supply i.e. income is E_2Y_2 and aggregate demand i.e. total expenditure is KY_2. There is saving equal to E_2K. This shows that people do not spend all of their incomes, so all the goods produced in an economy will not be sold. There will be over production in the economy. Prices will become low, profits will go down, and entrepreneurs reduce investment. Employment level, income of the people fall and national income falls to its original equilibrium position where total income and total expenditures are equal.

If we assume that the level of national income is OY_1 instead of OY, aggregate supply and aggregate demand are not equal at this level of income. Aggregate supply i.e. income is LY_1 and aggregate demand i.e. total expenditure is E_1Y_1. Expenditure is greater than income by LE_1. This shows that at this level of income people spend more than their incomes. This situation is always favorable for investment. Investment increases due to rise in prices. Employment level and production increase and the level of national income starts moving towards its original equilibrium level where total income and total expenditures are equal.

2. SAVING – INVESTMENT APPROACH

According to this approach, in the short-run, equilibrium of national income is determined at a point where planned saving is equal to planned investment.



This diagram shows that saving and investment curves intersect each other at point E. At this point equilibrium level of national income is OY. If we assume that the equilibrium level of national income is OY_1 instead of OY, savings are greater than investment at this level of income. At this level, FY_1 is investment while E_1Y_1 is saving i.e., saving is greater than investment by E_1F. This means that all the savings do not convert into investment. Employment, income, and prices will go down. Due to decreased incomes, saving potential will reduce and

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ultimately they will become equal to the level of investment at the original equilibrium level.
If we assume that the equilibrium level of national income is OY_2 instead of OY, savings are lesser than investment at this level of income. At this level, KY_2 is investment while E_2Y_2 is saving i.e., saving is lesser than investment by KE_2. This means that all the savings are being utilized for investment purpose. Employment, income, and prices will go up. Due to increased incomes, saving potential will increase and ultimately they will become equal to the level of investment at the original equilibrium level.

2. SAY'S LAW OF MARKETS

Classical economists are of the view that there is always full employment of labor and other resources in a capitalist economy. According to classicists, general over-production and general unemployment are of temporary nature. Capitalist economy always operates at full employment level. If unemployment exists in an economy for a longer period, it is due to the intervention of the government or of the firms having monopoly power.
According to the classical economists, market forces automatically allocate resources among various uses and determine the shares of factors of production and help the economy to operate at full employment level.

ASSUMPTIONS

Following are the assumptions of the Say's Law of Markets;

١) There is perfect competition in the product and factor market.
٢) Technology remains unchanged.
٣) Government does not intervene in the economic activities.
٤) Economy is a closed one. (No trade relations with other countries)
٥) Individuals are always motivated by self-interest.
٦) Money serves as a medium of exchange.

STATEMENT

"Supply creates its own demand"

J.B.Say, a French economist, believes that there cannot be general over-production and general unemployment in a country. He agrees that there can be temporary over-production. Statement of the law shows that when goods are produced and brought into the market for sale, it creates equivalent demand for the products of the other firms. If at any time goods are produced in excess, excess demand is automatically created.

If the factors of production are remunerated according to their physical productivity, there can be no misjudgment about the demand for products on the part of the firms. There cannot be deficiency in aggregate demand and hence there must not be general overproduction and unemployment.

SAVING AND INVESTMENT

According to J.B.Say, a part of the income is spent on consumer goods and the other part is

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saved. Savings are automatically spent on investment.

According to Dillard, "Since saving is just another form of spending, according to the classical theory, all income is spent, partly for consumption and partly for investment. There is no reason to expect a break in the flow of the income stream and therefore supply creates its own demand".

Aggregate saving and aggregate investment are also automatically maintained through the changes in the rate of interest. If at any time saving exceeds investment, rate of interest decreases and vice versa. The equality between saving and investment at full employment level is brought about by changes in rate of interest.

Many other economists agree with the view of J.B.Say about supply creates its own demand but they admit that in the short period there can be unemployment and frictional unemployment but in the long-run there is always a tendency of full employment.

CRITICISM

J.M.Keynes criticizes the classical theory of employment as follows:

1. **FULL EMPLOYMENT**

   J.M.Keynes criticizes that full employment is not possible. Normally economy operates at less than full employment level.

2. **SAVING – INVESTMENT EQUALITY**

   J.M.Keynes is of the view that it is not the rate of interest but income which is the equilibrating force between saving and investment.

3. **MONEY**

   According to classical theory, money serves as a medium of exchange while Keynes recognizes the influence of money on income, outcome, and employment.

4. **GOVERNMENT INTERVENTION**

   J.M.Keynes criticizes that economy cannot be in equilibrium automatically. He is of the view that government intervention is necessary to save the economy from depression and inflation.

5. **AUTOMATIC CREATION OF DEMAND**

   J.M.Keynes is of the view that when employment increases, income increases but there is no guarantee that saved part of income will be spent on investment. There appears a deficiency of demand which causes unemployment. So supply does not create its own demand.

6. **WAGE CUT**

   According to classical theory, unemployment disappears if the workers accept a reduction in their real wages. J.M.Keynes is of the view that unemployment exists even if the workers accept lower wages due to the deficiency in aggregate demand.

3. KEYNESIAN THEORY OF INCOME DETERMINATION

Classical economists believed that in ordinary circumstances economy operates at full employment level. J.M.Keynes is of the view that equilibrium of the economy at full employment level is not necessary. If any country wishes to improve the level of employment, it has to change the volume of investment in the economy.
According to J.M.Keynes, "The level of employment in a country is a function of national income. The higher the level of national income, the higher is the volume of employment and smaller the level of national income, the smaller is the volume of employment".

DETERMINATION OF NATIONAL INCOME

ASSUMPTIONS

Following are the assumptions for the Keynesian model of income determination:

- There is no government interference.
- Propensity to consume remains constant.
- There is no change in population for a short period.
- Employment is a function of income.
- Economy is a closed one.
- This is relevant for the short run.
- There is no change in distribution of wealth.
- There is no change in the stock of capital.

AGGREGATE DEMAND AND AGGREGATE SUPPLY

The level of both income and employment is determined by the equality of aggregate demand and aggregate supply. Aggregate demand in a two sector economy consists of the aggregate consumption and aggregate investment expenditures. The aggregate demand equation is;

$$Y = C + I$$

Aggregate supply is identically equal to national income of a country. The equation of aggregate supply is;

$$Y = C + S$$

EQUILIBRIUM INCOME AND OUTPUT

According to J.M.Keynes, the level of national income and employment is determined at a point where the aggregate demand function intersects the aggregate supply function.
We can explain this phenomenon with the help of following figure:

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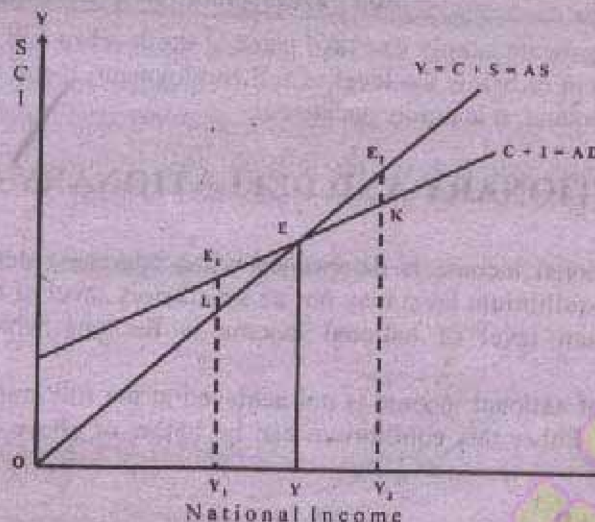


In this diagram aggregate demand and aggregate supply curves intersect each other at point E. Here E is the point of effective demand. OY is the level of national income.

DISEQUILIBRIUM

The disequilibrium can arise by two ways:

1. **AGGREGATE SUPPLY EXCEEDING AGGREGATE DEMAND (AS > AD)**
   If we assume that the level of national income is OY_2 instead of OY, aggregate supply and aggregate demand are not equal at this level of income. Aggregate supply i.e. income is E_2Y_2 and aggregate demand i.e. total expenditure is KY_2. There is saving equal to E_2K. This shows that people do not spend all of their incomes, so all the goods produced in an economy will not be sold. There will be over production in the economy. Prices will become low, profits will go down, and entrepreneurs reduce investment. Employment level, income of the people fall and national income falls to its original equilibrium position where total income and total expenditures are equal.

2. **AGGREGATE DEMAND EXCEEDING AGGREGATE SUPPLY(AD > AS)**
   If we assume that the level of national income is OY_1 instead of OY, aggregate supply and aggregate demand are not equal at this level of income. Aggregate supply i.e. income is LY_1 and aggregate demand i.e. total expenditure is E_1Y_1. Expenditure is greater than income by E_1L. This shows that at this level of income people spend more than their incomes. This situation is always favorable for investment. Investment increases due to rise in prices. Employment level and production increase and the level of national income starts moving towards its original equilibrium level where total income and total expenditures are equal.

EQUILIBRIUM AND FULL EMPLOYMENT

J.M.Keynes argues that equilibrium level of income as determines by equality of aggregate demand and aggregate supply does not mean full employment output. The equilibrium between

aggregate demand and aggregate supply can take place at the level of full employment, above the level of full employment or below the level of full employment. If full employment level is at the point of effective demand, it is purely accidental.

4. INFLATIONARY AND DEFLATIONARY GAPS

Equilibrium level of national income is determined when aggregate demand and aggregate supply are equal. Every equilibrium level may not be satisfactory level of national income. The most desirable equilibrium level of national income is the one which achieves at full employment level.

If the equilibrium level of national income is not achieved at the full employment level, there can be two possibilities. Either this equilibrium can be below or above the full employment level.

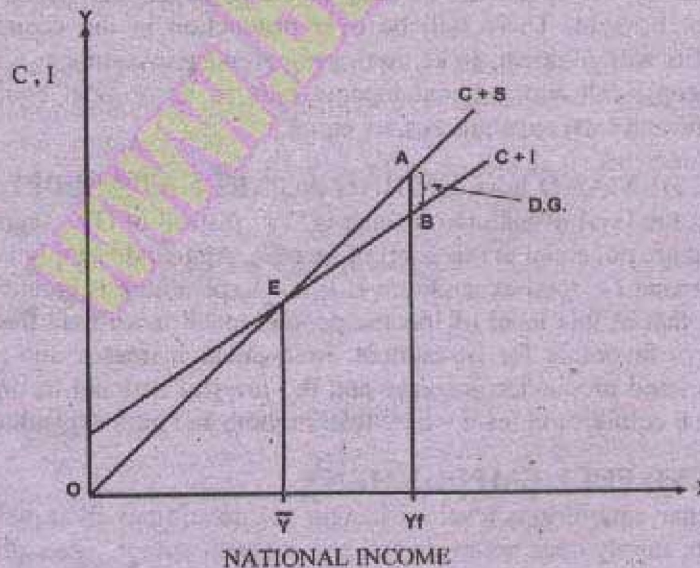
DEFLATIONARY GAP

If the equilibrium level of national income is below the full employment level, then it means further opportunities for investment exist and economy can be lifted to the level of full employment.

This can be done by utilizing the savings available in a country. So long as the full employment savings are not utilized, there exists deflationary gap. The size of the gap is measured by the deficiency between the savings at full employment level and actual investment.

- At Full employment level AS > AD
- $Y_F > \overline{Y}$

EXPLANATION WITH THE HELP OF DIAGRAM



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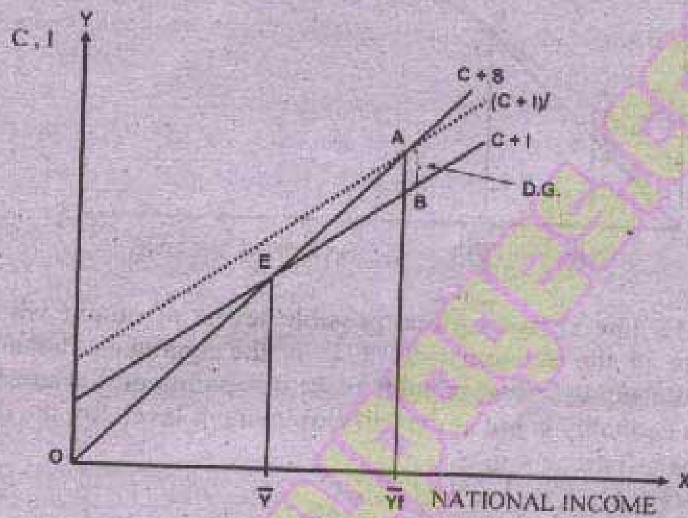
Aggregate supply C+S line shows various possible levels of output which the business sector might produce in the economy. 'C + I' is the aggregate demand curve which intersects the aggregate supply curve at point E. At this point equilibrium level of national income exists but the economy is not at the full employment level. So, the distance between 'A' and 'B' shows the deflationary gap.

FILLING THE DEFLATIONARY GAP



To fill the deflationary gap, AD should be increased at full employment level. Due to the increase in consumption or investment, the aggregate demand curve shifts Upward to (C + I)'. This new aggregate demand curve intersects the aggregate supply curve at point A. At this point, the new equilibrium of national income prevails at full employment level.

INFLATIONARY GAP

If full employment savings fall short of scheduled investment at full employment, there is said to be an inflationary gap.

Inflationary gap exists when due to excess spending, the level of income rises above the level of full employment. The amount by which the aggregate demand exceeds the full employment level of income is known as the Inflationary Gap.

- At Full employment level AD > AS
- $\bar{Y} > Y_F$

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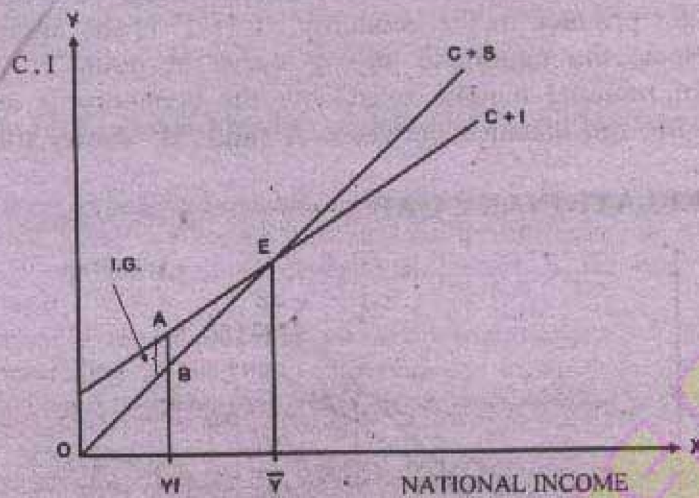
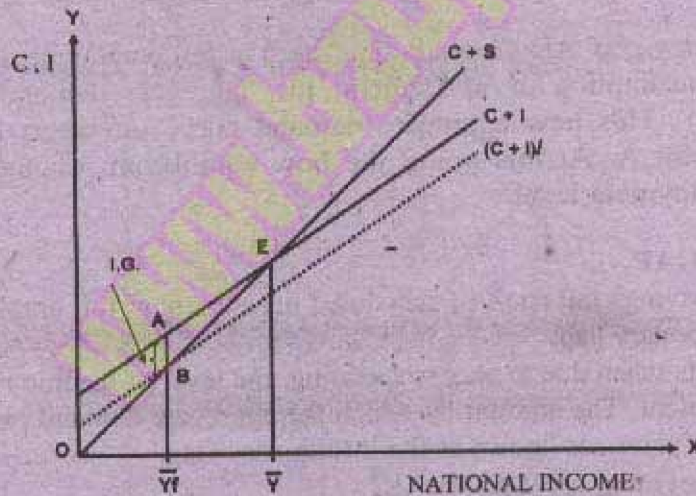
EXPLANATION WITH THE HELP OF DIAGRAM



Aggregate supply C+S line shows various possible levels of output which the business sector might produce in the economy. 'C + I' is the aggregate demand curve which intersects the aggregate supply curve at point E. At this point equilibrium level of national income exists but the economy is not at the full employment level. So, the distance between 'A' and 'B' shows the inflationary gap.

FILLING THE INFLATIONARY GAP



To fill the Inflationary gap, AD should be decreased at full employment level. Due to the decrease in consumption or investment, the aggregate demand curve shifts downward to (C + I)'. This new aggregate demand curve intersects the aggregate supply curve at point A. At this point, the new equilibrium of national income prevails at full employment level.

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5. INFLATION

"A situation where the general price level persistently moves upward in a country is called inflation".

"Inflation is defined as a sustained increase in the general level of prices for goods and services".

In the words of Coulborn, "Too much money chasing too few goods"

In the words of Keynes, "True inflation begins when the elasticity of supply of output in response to increase in money supply has fallen to zero or when output is unresponsive to changes in money supply".

TYPES OF INFLATION

There are many types of inflation. Some of these are as follows;

1. CURRENCY INFLATION

If general price level is continuously increasing due to increase in the amount of currency, it is called currency inflation.

2. CREDIT INFLATION

If inflation occurs due to increase in bank loans, it is called credit inflation.

3. CREEPING INFLATION

If a sustained increase in prices of goods and services is less than 3% per annum, it is called creeping inflation.

4. HYPER INFLATION

If general price level increases 20% or more per month in a country, it is called Hyperinflation.

Hyperinflation is unusually rapid inflation. In extreme cases, this can lead to the breakdown of a nation's monetary system. One of the most notable examples of hyperinflation occurred in Germany in 1923, when prices rose 2,500% in one month. It is also called Galloping Inflation.

5. OPEN INFLATION

Open Inflation is the result of uninterrupted operation of the market mechanism. There are no checks or controls on the distribution of commodities by the government. Increase in demand and shortage of supply persist which tend to lead open inflation. Unchecked open inflation leads to hyperinflation.

6. SUPPRESSED INFLATION

When government imposes physical and monetary controls to check open inflation, it is known as suppressed or repressed inflation.

Market mechanism is not allowed to function normally by the use of licensing, price controls and rationing in order to suppress extensive rise in prices. So long as such controls exist, the present demand is postponed and there is diversion of demand from controlled to uncontrolled commodities. But as soon as these controls are removed, there is open

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inflation.

Suppressed inflation adversely affects the economy. When the distribution of commodities is controlled, the prices of uncontrolled commodities rise very high. Suppressed inflation reduces the incentives to work because people do not get the commodities they want to have. Controlled distribution of goods also leads to mal-allocation of resources. This results in diversion of productive resources from essential to non-essential industries. Suppressed inflation leads to black marketing, corruption, and hoarding *etc.*

7. STRUCTURAL INFLATION

According to Prof. Charles, inflation occurs when the structure of internal demand of a country changes, while the aggregate demand of a country does not change. When demand for commodities in different sectors increase in accompanied with rise in prices and wages and there are other sectors where demands for commodities decline but prices and wages do not go downward, the overall trend of prices tend to rise in an economy.

EFFECTS OF INFLATION

Inflation affects different people differently. This is because of the fall in the value of money. When prices rise or the value of money falls, some groups of the society gain, some lose, and some stand in between.

There are two economic groups in every society, the fixed income group and the flexible income group. People from the first income group lose and those belonging to the second group gain.

The reason is that the price movements in case of different goods, services, assets *etc.* are not uniform. When there is inflation, most of the prices rise but the rate of increase of individual prices differs much. Prices of some goods and services rise fast, of others slow and of still others remain unchanged.

1. DEBTORS AND CREDITORS

During periods of rising prices, debtors gain and creditors lose. The value of money falls when prices rise. Though debtors return the same amount of money but they pay less in terms of goods and services. This is because the value of money is less than when they borrowed money. So the burden of debt is reduced and debtors gain.

On the other hand, creditors lose. Although they get back the same amount of money which they lent, they receive less in real terms, because the value of money falls.

2. SALARIED PERSONS

Salaried persons such as clerks, teachers, and other white collar persons lose when there is inflation. The reason is that their salaries are slow to adjust when prices are rising.

3. WAGE EARNERS

Wage earners may gain or lose depending upon the speed with which their wages adjust to rising prices. If their unions are strong, they may get their wages linked to the cost of living index. In this way they may be able to protect themselves from the bad effects of inflation. But there is often time lag between raising wages by employers and the rise in prices. So the workers lose because by the time, wages are raised, the cost of living index may have increased further. But where the unions have entered into contractual wage for a fixed

period, the workers lose when prices continue to rise during the period of contract. On the whole, the wage earners are in the same position as the white collar persons.

4. FIXED INCOME GROUP

Pensioners, recipients of interest and rent belong to fixed income group. Pensioners get fixed pensions, interest and rent an earner get fixed payments, and same is the case with holders of fixed interest bearing securities, debentures and deposits. All such persons lose because they receive fixed payments, while the value of money continues to fall with rising prices.

5. EQUITY HOLDERS

The persons, who hold the shares and stocks of companies which do not carry a fixed rate of interest, gain during inflation because when prices are rising, business activities expand which increases profits of companies. So dividends increase at a faster rate than prices.

6. BUSINESSMEN

Businessmen of all types such as producers, traders, and real estate holders gain during periods of rising prices.

When prices are rising, the value of producers' inventories rise in the same proportion. So the producers make more profit by selling their stocked commodities. Same is the case with traders in the short-run. Producers' profits move in another way. Cost of production does not rise to the extent of the rise in the prices of goods. This is because prices of raw material and other inputs and wages do not rise immediately to the level of price rise. The holders of the real estate also profit during inflation because the prices of landed property increase much faster than the general price level.

7. AGRICULTURISTS

Agriculturists are of three types; landlords, peasant proprietors, and landless agricultural workers.

- Landlords lose during rising prices because they get fixed rents.
- Peasant proprietors who own and cultivate their farms, gain. Prices of farm products increase more than the cost of production.
- Landless agricultural workers are losers because their wages are not raised by the farm owners because trade unionism is absent among them.

8. PRODUCTION

When prices start rising, production is encouraged. Producers earn windfall profits. They invest more in anticipation of higher profits in the future. This tends to increase employment, production and income. But this is only possible up to the full employment level. Further increase in investment beyond this level leads to severe inflationary pressures within the economy because prices rise more than the production as the resources are fully employed. So inflation adversely affects production after the level of full employment.

9. DISTRIBUTION OF INCOME

Inflation tends to increase inequalities in the distribution of wealth. The poor and the middle class suffer because their wages and salaries are more or less fixed but the prices of

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commodities continue to rise. They become more impoverished.

On the other hand, businessmen, industrialists, traders and others with flexible incomes gain during rising prices. The latter category of persons becomes rich at the cost of the former category of the persons. There is unjustified transfer of wealth from the poor to the rich.

10. GOVERNMENT

Inflation affects the government in various ways. It helps the government in financing activities through inflationary finance. As the money income of the people rises, government collects that in the form of taxes on incomes and commodities. So the revenues of the government increase during inflation.

The real burden of the public debt increases during inflation. But the government expenses also increase with rising costs of public projects and increase in the administrative expenses as prices and wages rise.

11. BALANCE OF PAYMENTS

Inflation affects adversely the balance of payments of a country when prices rise more rapidly in a home country than in foreign countries. Products become costly compared to foreign products. This tends to increase imports and reduce exports, thereby making the balance of payments unfavorable for the country.

12. SOCIAL EFFECTS

Inflation is harmful socially. By widening the gulf between the rich and the poor, rising prices create discontentment among the masses. Pressed by the cost of living, workers resort to strikes which lead to loss in production, lured by profit, people resort to hoarding, black marketing, adulteration, manufacture of sub-standard commodities, speculation *etc.* Corruption spreads in every walk of life. All this reduces the efficiency of the economy. Rising prices also encourages agitations and protests by political parties against the government.

CAUSES OF INFLATION

Following are the major causes of inflation:

1. GENERAL RISE OF DEMAND FOR GOODS

General rise in demand for goods causes the rise in prices. Usually this inflationary trend is a result of non-productive expenditure of the government. People find more money incomes but there is no proportional increase in the production of goods. Therefore, prices tend to rise. This general price rise is termed as **'Demand-Pull Inflation'**. High growth rate of population can also cause the demand-pull inflation.

2. RISE IN COSTS

Sometimes the cost of production increases due to the short supply of raw materials their high prices. The banks may raise the interest rate or money wage may rise due to the pressure of the trade unions. Due to these reasons cost of production increases and entrepreneurs supply goods at higher prices. This is **'Cost-Push Inflation'**.

3. DEFICIT FINANCING

Deficit financing is to print currency notes to meet the budget deficit. This additional money is not duly backed up by necessary legal reserves. This money when pumped into the system creates demand for more goods which are not readily available. The logical outcome is the price rise i.e., inflation.

4. **DEFICIT IN BALANCE OF PAYMENTS**

A country faces deficit in its balance of payments when its international payments are greater than its international receipts. The value of its currency falls in the foreign markets and it has to pay more for imports. Costly imports, especially when these are raw materials, are bound to create inflationary trends in the economy.

REMEDIES FOR INFLATION

There are many harmful effects of inflation. The worst hit section of the society is that which is unable to save itself from the damages caused by inflation. This section consists of factory workers, other low paid laborers, pensioners, and government employees. In order to exercise social justice, effective measures are needed to control inflation. These measures are classified into the following three categories.

A) DIRECT MEASURES

When inflation is demand-pull by nature, following measures should be adopted to control the increasing demand for goods and services.

1. **PERSUASION**

The government may appeal to the people to do voluntary savings. This appeal may bear fruit if the citizens have economic and social consciousness and are fired with love for the country. If they decide to save more and spend less, the excessive demand is cut off and inflation can be brought under control.

2. **DEFFERED PAY SCHEME**

If the people do not volunteer to save more, the government can decide upon compulsory savings. J.M.Keynes advised the governments of U.K. and Western European countries to implement deferred Pay Scheme on industrial workers in order to control the inflation in these countries after World War – II.

According to this scheme, a part of the workers' wages was credited to their saving accounts. These savings were declared frozen during the period of inflation. However the workers were allowed to withdraw and spend their savings when inflationary pressure was over and recession was likely to set in. This scheme proved a perfect success.

3. **CONTROL ON PRICES**

The government may declare control on the prices of essential consumable articles such as wheat flour, pulses, rice, ghee, sugar, cloth, petrol, and kerosene oil *etc.* This policy has proved an effective force to check the price spirals in Pakistan.

B) MONETARY MEASURES

Inflation is a state wherein supply of money exceeds the supply of goods. Supply of money is to be reduced to control the inflation. Central bank of a country can adopt the following monetary

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measures in this connection.

1. **SALE OF GOVERNMENT SECURITIES**

   The central bank acts as an agent of the state. In order to reduce money supply and to restrain the inflationary trend, it starts selling government securities to scheduled banks and to the general public. Since these securities are sold for cash money, therefore a huge amount of cash is sucked off the circulation. The money supply is reduced and demand pressure is somewhat relieved.

2. **RAISING BANK RATE**

   In order to control inflation, the central bank raises the bank rate, commercial banks follow the suits and they too raise the interest rate so that they can maintain their profit ratio. The bank loans become costly for the firms and they demand less advances.

3. **RAISING RESERVE RATIO**

   Scheduled banks are legally bound to deposit a described percentage of their deposits as legal reserves with the central bank. This percentage is termed as reserve ratio.

   At the time of inflation, central bank raises the reserve ratio so that the lending power of the commercial banks may reduce. This reduces the volume of credit money as well as the intensity of inflation.

C) FISCAL MEASURES

The measures adopted by the government to tackle an economic situation through changes in the magnitude of public income and public expenditures. Fiscal measures can succeed only if these are in line with monetary measures of the central bank.

1. **RAISING TAXES**

   Government raises direct taxes to eliminate extra demand for goods and services. Higher income tax means lower disposable personal incomes and reduced demand for consumable items. Direct taxes reduce aggregate demand as well as prices and the rate of inflation. Government may also raise indirect taxes on the articles of comfort and luxuries.

2. **SURPLUS BUDGET**

   The government declares surplus budget wherein the government extracts more money in the form of taxes from circulation but pumps less money into circulation through its expenditure. Total money supply is reduced and prices are stabilized.

6. DEFLATION

"A state of economy in which the quantity of money in circulation falls short of the quantity of goods and services is known as deflation".

A general decline in prices, often caused by a reduction in the supply of money or credit is called deflation. Deflation can be caused also by a decrease in government, personal or investment spending. The opposite of inflation, deflation has the side effect of increased unemployment since there is a lower level of demand in the economy, which can lead to an economic depression.

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CAUSES OF DEFLATION

Following are the reasons of deflation:

1. EXCESSIVE SAVINGS

If the people start saving beyond the desirable level, the consumption expenditure falls extraordinarily. Production of the firms is not sold out and the prices start declining.

2. UNEMPLOYMENT

Unemployment is the result as well as a cause of deflation. Jobless workers are deprived of incomes. They become unable to pay the prices of good, so they cannot demand goods. Aggregate demand falls. Contraction of production and trade gains further reduces the employment. In fact unemployment multiplies during deflation.

3. SURPLUS BUDGET

Government prepares surplus budget in order to cure inflation. If the authorities overestimate the intensity of inflation and prescribe surplus budget of undue high potency, it is a case of killing a patient with the help of doctors. In this situation, surplus budget becomes the cause of deflation.

4. CONTRACTION OF CREDIT MONEY

High interest rate may reduce the demand for bank loans. Due to fall in demand for loans, overall circulation of money shrinks and prices tend to fall. This is the situation of deflation.

5. FALL IN DEMAND FOR EXPORTS

In some countries, the exports are a large part of national produce. The demand for exports may fall due to many reasons. The fall in demand for exports means that goods remain in the country creating excess supply and fall in prices. So there is deflation.

EFFECTS OF DEFLATION

The twin problems, inflation and deflation, are contagious by nature and spread out from one industry to the other and from one economy to the other. Effects of deflation are as follows:

1. FALL IN PRODUCTION

Firms produce and sell for profits but during deflation, prices of products fall, profit margins are narrowed, and some of the businesses may bear losses. Firms reduce their production.

2. UNEMPLOYMENT

Production and employment are the two sides of the same coin. During deflation, there is a general contraction of production and the firms lay off some or many of their workers depending upon the intensity of deflation. Demand for other inputs also falls. Deflation and unemployment are inseparable companions.

3. FALL IN THE PACE OF ECONOMIC DEVELOPMENT

Economic development is a process during which national product of a country continues to rise year after year and per capita income increases steadily. But during deflation the national product tends to fall although population keeps growing. During the periods of

deflation, per capita income declines. Pace of economic development is affected.

4. MORAL DEGRADATION

The most important effect of deflation is the spread of moral degradation in society. When millions of families lose their source of income, there comes a wave of crimes such as cheating, bribery, theft, decoities, and murders. It is quite logical to think that when there is deflation in an economy, the worst hit individuals say good-bye to moral values in order to survive.

REMEDIAL MEASURES

Deflation is a hard nut to crack, however, government may adopt several measures to remove this evil from the economy. Following are some major remedies for inflation.

1. PUBLIC WORKS

The most effective measure for deflation is that government should plan heavy expenditures on public works like building dams, roads, rail tracks, and canals. Millions of workers can be employed in these huge projects. On receiving wages, workers demand goods and services, so the prices take an upward turn. To provide for this newly created demand the businessmen raise the production level and more workers find jobs in the expansion of business.

2. TRANSFER PAYMENTS

The government may increase its expenditures on transfer payments especially on subsidies and unemployment allowances to get rid of deflation.

Whereas subsidies increase demand for product and supplement the profits, the unemployment allowance enables the laid off workers to spend and demand goods although they are not earning incomes. Transfer payments are a good instrument to raise demand and prices.

3. INCENTIVES FOR PRIVATE INVESTMENT

Firms stop further investment during deflation to avoid losses. The government may offer them incentives to nurse the sick business to health. These incentives may be in the form of subsidies, cheaper loan facilities, and waiver or reduction f profit taxes.

4. INCOME TAX CUTS

Income tax cut is a useful device to increase the disposable income of the households. When tax liability is reduced, the people are able to spend more. Demand for goods and services rises and prices stop falling.

5. DEFICIT BUDGET

Government can stabilize the economy by preparing deficit budgets. Such a budget involves lesser tax revenues and more state expenditure. The deficit is met through internal and external borrowings by the government and if necessary through deficit financing. Money in circulation increases and the fall in prices stop.

7. A NOTE ON STAGFLATION.

"A period of little or no growth in the economy is called stagflation".

Economic growth of less than 2-3% is considered stagnation. Sometimes, it is used to describe low trading volume or inactive trading in securities.

"It is the combination of high unemployment and economic stagnation with inflation".

This happened in industrialized countries during the 1970s, when a bad economy was combined with OPEC raising oil prices.

Stagflation is a word introduced in economics in the 1970s to describe a combination of a stagnant economy and severe inflation. Previously, these two conditions had not existed at the same time because lowered demand, brought about by a recession, usually produced lower, or at least stable, prices. Large U.S. government deficits and sharp rises in the costs of energy have been cited as the chief causes of stagflation in the 1970s.

"A condition of slow economic growth and relatively high unemployment - a time of stagnation - accompanied by a rise in prices, or inflation is known as stagflation".

Stagflation occurs when the economy isn't growing but prices are - not a good situation for a country to be in. This happened to a great extent during the 1970s, when world oil prices rose dramatically, fueling sharp inflation in developed countries. For these countries, including the U.S., the effects of inflation were considerably made worse because of this stagnation.

"An economic phenomenon of the late 1960s and 1970s characterized by sluggish economic growth and high inflation is considered as stagflation".

The word is a blend of *stagnation* and *inflation*.

Stagflation is a term used in macroeconomics to describe a period characteristic of high inflation combined with economic stagnation, unemployment, or economic recession.

Stagflation is thought to occur when there is an adverse shock (a sudden increase, say in the price of oil) in a country's aggregate supply curve. The effects of rising inflation and unemployment are especially hard to counteract for the central bank. The bank has one of two choices to make, each with negative outcomes.

- The bank can choose to pursue a loose money policy to stimulate the economy and create jobs by increasing the money supply i.e., by lowering interest rates and intensify the inflation problem further.
- Pursue a tight money policy i.e., by increasing interest rates to try and rein in inflation at the cost of perhaps increasing unemployment further.

In the 1960s it was thought that the Phillips Curve associated with Keynesian economics suggested that stagflation is impossible because high unemployment lowers demand for goods and services which lowers prices. This results in low or no inflation. However, in the 1970s and 1980s, when presented with actual stagflation, it was realized that the relationship between inflation and employment levels was not a constant, but could be shifted, and that the Phillips relationship was better seen through payroll surveys of employment rather than household surveys.

By contrast, quantity theories of inflation, such as monetarism, argue that inflation is due to the money supply rather than demand and predict that inflation can occur with high unemployment if the government increases the money supply in a period of rising prices.

Stagflation occurred in the economies of the United Kingdom in the 1960s and 1970s and the United States in the Nixon administration of the early 1970s as reported by various news and

financial sites. The difficulty in fitting its existence within a Keynesian framework led to a greater acceptance of monetarist theories in the 1970s and1980s. The pendulum has swung back in the other direction as monetarism had increasing difficulty predicting the demand for money and the long period of low inflation and high employment of the 1990s - a kind of reverse of stagflation.

As of 2004 and 2005, global stagflation may be making a comeback with the price of oil well over $50 a barrel, the US government slowly increasing interest rates, and employment rates stagnant. Monetarists and Keynesian economics continue to have difficulty explaining the phenomena.

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