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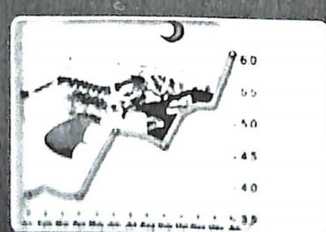

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INDEX

Inflation and Unemployment

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- **Introduction:**

Inflation and unemployment economic problems both impact the common man life. High Productivity (Real GDP), price stability and low unemployment are the most desirable macroeconomic goals. In this regard in 1960, the concept of Phillips curve emerged, by A.W. Phillips who is the pioneer of the Phillips curve in UK. This curve suggests negative relationship between the rate of inflation and unemployment. There are two studies which provided explanations of the possible Phillips curve, relationship between the two variables in the short-run and the long run as; first one is, in short run, there is tradeoff between inflation and unemployment. Second, in the long run there is no significant tradeoff between inflation and unemployment. Therefore economists are in best interest to identify their relationship; there is a short run tradeoff between the rate of inflation and unemployment, (McConnell, 16th Ed). In this regard it has been also seen in many studies that there is short run tradeoff between Inflation and unemployment in different countries in different time periods.

- **Objectives:**

1. To study whether inflation causes unemployment.
2. To study the relation between inflation and unemployment
3. To study the cost of inflation and cost of unemployment on the society

- **Methodology:**

The study is based on secondary data collected from journals, articles, newspapers and books.

- **Inflation Rate:**

Inflation refers to a general rise in prices measured against a standard level of purchasing power. Previously the term was used to refer to an increase in the money supply, which is now referred to as expansionary monetary policy or monetary inflation. Inflation is measured by comparing two sets of goods at two points in time, and computing the increase in cost not reflected by an increase in quality. The most well known are the CPI which measures consumer prices, and the GDP deflator, which measures inflation in the whole of the domestic economy.

- **Unemployment Rate:**

The labor force is defined as the number of people employed plus the number unemployed but seeking work. The unemployment level is defined as the labor force minus the number of people currently employed. The unemployment rate is defined as the level of unemployment divided by the labor force.

- **Inflation and unemployment:**

Inflation and unemployment go hand in hand. For every country, maintaining a low unemployment rate is the main objective. It is usually believed that inflation and unemployment are inversely proportional. There are many economists, who hold the opinion that low rate of unemployment together with low inflation rate may be a source of concern. Both low inflation rate and low unemployment rate, may be hypothetical. In real practice, this rarely happens. If a particular country has full employment, it can be said to have minimum rate of unemployment. If a nation maintains a minimum rate of unemployment in a condition when inflation rate is stable, it is said to follow the natural rate of unemployment. In other words, the natural rate of unemployment is the minimum rate of unemployment, which can be sustained.

- **Does Inflation Cause Unemployment?**

There are a few different scenarios where inflation can cause unemployment. However, there is not a direct link. Often we will notice a trade off between inflation and unemployment – e.g. in a period of strong economic growth and falling unemployment, we see a rise in inflation.

Also it is important to bear in mind, (especially in the current climate) If the economy has deflation or very low inflation and the monetary authorities target a modest rate of inflation, then this may help boost growth and reduce unemployment.

Inflation can cause unemployment when:

1. The uncertainty of inflation leads to lower investment and lower economic growth in the long term.
2. Inflationary growth is unsustainable leading to a boom and bust economic cycle.
3. Inflation leads to decline in competitiveness and lower export demand, causing unemployment in the export sector (especially in a fixed exchange rate).

1. **Inflation creates uncertainty and lower investment**

One argument is that a period of high and volatile inflation discourages firms from investing. Because inflation is high, firms are less certain investment will be profitable. It is argued that countries with higher inflation rates tend to have lower investment and therefore lower economic growth. Therefore, if there are poor levels of investment this could lead to higher unemployment in the long term.

It is argued that countries with low inflation rates, such as Germany have enabled a long period of economic stability which helps to attain a long term low unemployment rate. Low inflation in a country like Germany also helps them to become more competitive within the Eurozone, which also helps create employment and reduce unemployment.

2. **Inflationary booms causes recessions**

If the economy overheats; if the rate of economic growth is faster than the long run trend rate – then we will tend to get demand pull inflation. Firms push up prices because demand is growing faster than supply. In the short term, this higher growth may lead to lower unemployment as firms take on more workers.

However, this rate of economic growth is unsustainable – e.g. consumers may get into debt to increase spending, but as the economy falters they cut back on spending leading to lower AD. Also, if inflation increases, Monetary authorities will tend to increase interest rates to reduce inflation. A sharp increase in interest rates can cause economic growth to fall, leading to recession and unemployment. Therefore an economic boom with high inflation is often followed by a recession.

3. **Optimal rate of inflation**

   If an economy has a very low rate of underlying 'core inflation' e.g. 1%, then this is a sign that the economy is growing too slowly. This level of inflation means there is spare capacity and there is an output gap. Therefore, with slow growth, unemployment is likely to be higher. In this case, pursuing expansionary monetary policy which involves a higher inflation rate could help to boost economic growth and lead to lower unemployment.

   Problem of inflation in Indian economy is that, Inflation erodes the value of money that constrains people and firm to minimize their holding of cash. When price rises, sellers must use resources to change nominal prices. Then society's output of goods and services is reduced by devoting resources to these activities.

   Problem of unemployment in India is that, Loss of output is the major problem of unemployment because the unemployed labor force does not add to the productivity. And they do not pay taxes, even tax—payers of the society also bear some of the output cost of the unemployed.

- **Inflation imposes several costs on Society**

1. **Inflationary growth is unsustainable**. High inflation is often a sign the economy is overheating (demand growing faster than supply). This kind of boom is often followed by a bust (recession) Targeting a low rate of inflation helps to keep economic growth sustainable. Therefore, low inflation can help avoid recession and prevent a sudden rise in unemployment.
2. **Inflation discourages investment**. High and volatile rates of inflation can discourage firms from taking long-term investment decisions. This is because of the uncertainty and confusion around future revenues and profits. Therefore, it is argued countries with higher inflation rates tend to have lower growth rates over time. In the post war period, it was often argued Japan and Germany had better growth rates because of their low inflation.
3. **Decline in international competitiveness**. High inflation is likely to make your goods and services less competitive leading to a fall in exports and current account deficit. Often this high inflation will be offset by a fall in the exchange rate to restore competitiveness. But, in the case of countries in the Euro, they can't devalue, so inflation and higher wage costs have been very damaging to their economy.
4. **Inflation can erode savings**. If inflation is higher than interest rates, then inflation can wipe away people's savings. Inflation reduces the value of money, so people who rely on income from savings see a reduction in their living standards. This is

often a problem for pensioners who rely on savings. Therefore inflation can cause a redistribution of income in society from old to young and from savers to borrowers.

5. **Legacy of Inflation**. If people suffer from inflation, (e.g. lose savings, become worse off) then it will impact their future decisions. For example, people may be reluctant to buy government bonds because they fear the government will effectively default through inflation. People will be more reluctant to save, leaving less room for investment.

- **Economic Costs of Unemployment**

Inflation definitely has economic costs, however arguably the costs of unemployment are far greater. Some of the costs of unemployment:

1. **Much lower income**. The unemployed have to rely on unemployment benefits and they will see a drastic fall in income. Unemployment is one of the biggest causes of home repossessions (when you fail to keep up with mortgage payments) Losing your home is one of most traumatic events.
2. **Psychological costs**. Unemployment is one of the biggest causes of stress. Without work, people feel a lack of purpose and low self-esteem. This can precipitate health and psychological problems.
3. **Social Problems**. Unemployment can create a feeling of alienation from society. When you have a high unemployment rate amongst a particular group (region, ethnicity, age). feelings of social exclusion can be exacerbated. High unemployment rates are certainly one factor behind riots in cities in Spain, France and UK. It is not to excuse rioting, but if you have high unemployment and poor economic prospects it can only increase the risk of crime and vandalism.
4. **Higher Government Borrowing**. A rise in unemployment leads to lower tax revenue (less income tax) and higher government spending on benefits. This may require lower spending elsewhere in economy.
5. **Negative Spiral**. Higher unemployment will lead to lower spending in the economy leading to lower growth. The threat and fear of unemployment may be sufficient to reduce spending.

- **Which Has been the Biggest Cost To Society?**

It is usually assumed inflation makes savers worse off. But, in the post war period, this hasn't occurred, interest rates have been higher than inflation meaning most savers don't lost out. They still get an interest rate higher than inflation. Even now with base rates at 0.5% and CPI close to 5%, there are still saving accounts with a respectable interest rate. Also the inflation is caused by temporary cost push factors and is likely to decline soon.

The economic and social costs of unemployment are far greater. However, it is not incompatible to have both low inflation and low unemployment. But, sometimes Central Banks (especially ECB) have made the mistake of focusing on reducing inflation at the expense of lower growth and higher unemployment.

Consequently, this paper suggests some policy options for the government as follows:

(1) Restructuring the economy through inward growth not along foreign borrowed ideology;

(2) Efficient modern technology to create more sustainable jobs and enhance the real wage of workers;

(3) Ensure macroeconomic management of price instability;

(4) Improving infrastructure particularly electricity which in turn may generate employment.

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