Example of socio-Economic impact assessment

INFLATION AND ECONOMIC POLICIES

INFLATION AND UNEMPLOYMENT

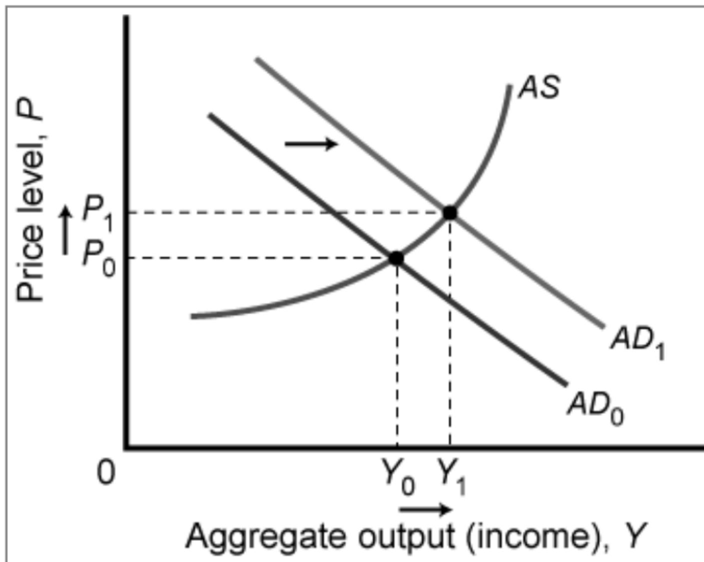
Inflation is another important indicator of the economy. Inflation is the continuing rise in the overall price level of an economy. Inflation, in large part, guides government policy. Long-term inflation can be a major problem. Inflation is almost always existent, the price level is constantly rising, but in a sustained economy, the inflation rate is stable. There are multiple indices for measuring inflation and none are completely up-to-date and accurate, they give an accurate enough picture of inflation. These indices allow us to adjust our production numbers. (Say we produce 1 trillion monetary units worth of stuff the first year and produce 1.5 trillion the next, since the price level has risen and our production really hasn't, we may only have really produced 1.2 trillion relative to the first year.) It is important to distinguish between the real figures and nominal figures.

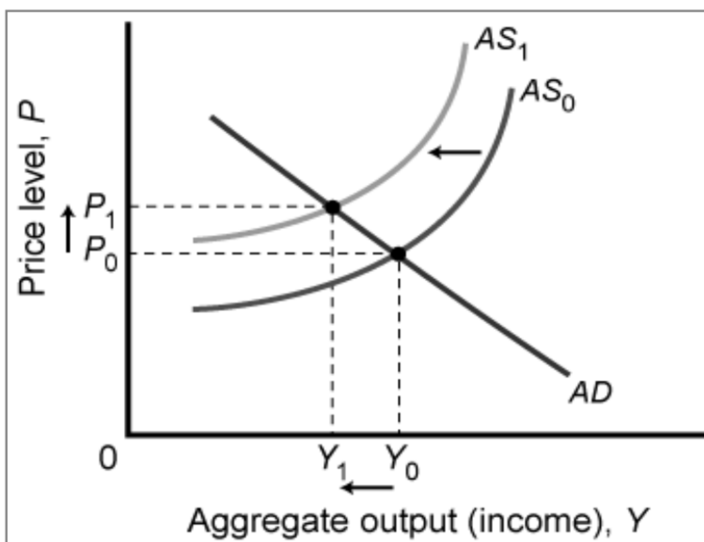
Inflation is the rise in price level and people set the prices, so the inflation is caused by people thinking that raising prices will get them more of the output. There are two types of inflation.

- ***Demand-pull inflation*** is inflation initiated by an increase in aggregate demand.
- ***Cost-push,*** or ***supply-side, inflation*** is inflation caused by an increase in costs.

1. DEMAND-PULL INFLATION

Demand-pull inflation is caused by great demand and a scarcity of supply. When there is scarcity, based on the laws of supply and demand, prices go up. People are willing to pay more for a needed product or needed labor. Thus, prices go up and workers' wages go up; people are willing to charge more for everything. Demand-pull inflationary markets are at full employment.



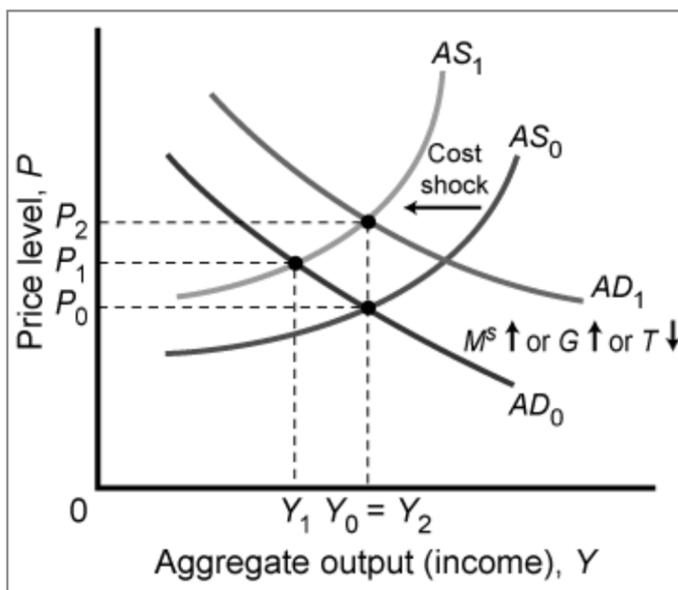


Demand pull factors

- monetary factors
- Increase in government spending, given tax revenue
- Cut in tax rate without change in government expenditure
- Upward shift in investment function
- Downward shift in saving function
- Upward shift in export function
- Downward shift in import function

2. COST-PUSH INFLATION

The second type is **cost-push inflation**. Unlike in demand-pull inflationary economies, cost-push economies may not have surplus demand. However, certain groups have the ability to force their own prices up, therefore forcing those who buy their products to raise their own prices. Both of these forces combine to form inflationary pressures on an economy. One is often supplemented by the other. People also raise their prices to keep up with the inflation they project will occur. However, the inflation is unexpected sometimes and people struggle to catch up by setting their prices higher.



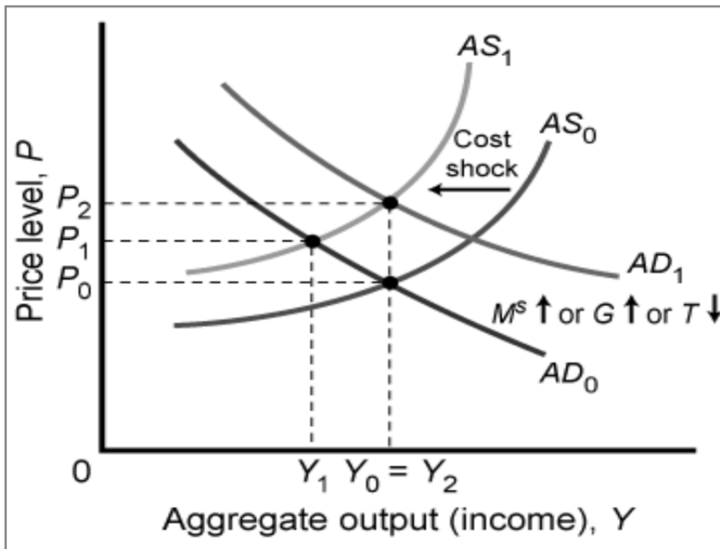
Inflation has the effect of moving wealth from those who don't raise their prices to those who do. If workers increase their demands for payment, they get more money, so they can pay for the increased prices of the companies. However, if someone could not raise their prices, they lose wealth. Inflation can make it hard for people to judge prices, as it's hard for them to constantly readjust themselves to shifting price levels. When inflation goes out of control and expectations of inflation rise, inflation can potentially wreck an economy.

Cost Push factors

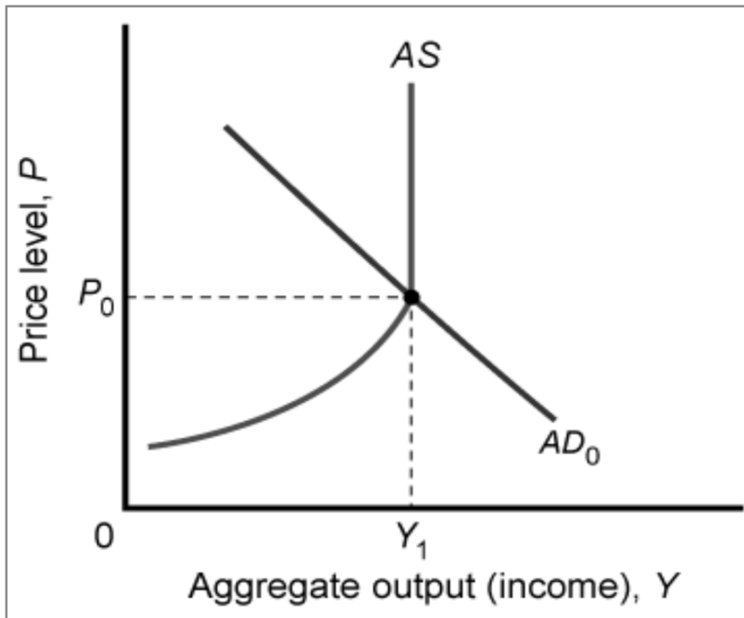
- wage push

- Profit push
- Supply shock

Stagflation occurs when output is falling at the same time that prices are rising.



- One possible cause of stagflation is an increase in costs.



Hyperinflation is inflation of 100% or more. Large inflation causes people to spend their money quickly and not save it for future investment (because that money wouldn't be able to buy much soon). This kind of severe inflation can destroy confidence in the economy in general.

Inflation and unemployment are interrelated to each other. When a country encourages rapid growth and unemployment goes down, this could trigger massive inflation as a result of excess demand and cost-pull

as explained above. But if a country wants to cut down on inflation, the cost is often the increase in unemployment and lack of growth.

Impact of Inflation:

- Distribution of income and wealth
- The rich get richer and poor get poorer
- Loss to fixed income earners
- Gains to profit earners
- Gains to the debtors
- Loss to the creditor
- Loss to wage earners
- Government
- Economic growth
- Employment

KEYNESIAN VIEW OF INFLATION

As opposed to the Classics, who view inflation as a problem of ever-increasing money supply, Keynesians concentrate on the institutional problems of people increasing their price levels. Keynesians argue that firms raise wages to keep their workers happy. Firms then have to pay for that and keep making a profit by subsequently raising the prices. This causes an increase in both wages and prices and demands an increase of money supply to keep the economy running. So, the government then issues more and more money to keep up with inflation. This differs from the classical model. Classics view changing money supply as affecting inflation while Keynesians view inflation as the cause of changing money supply.

- The key to the classical view of inflation was the Quantity Theory of Money .
- This theory revolved around the Fisher Equation of Exchange :

  MV = PT

  where:

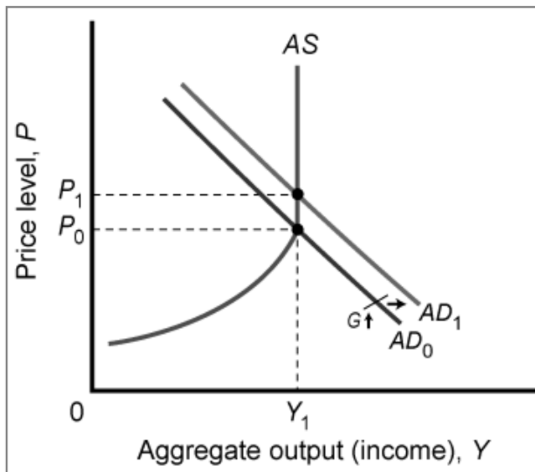
    - M is the amount of money in circulation
    - V is the velocity of circulation of that money
    - P is the average price level and
    - T is the number of transactions taking place
- He argued that increases in the money supply would not inevitably lead to increases in inflation.
- Increasing M may instead lead to a decrease in V.
- In other words the average speed of circulation of money would fall.
- Alternatively, the increase in M may lead to an increased in T (number of transactions), because as we have seen Keynes disputes the assumption that the economy will find its own equilibrium.
- It may be in a position where there is insufficient demand for full-employment equilibrium, and in that case increasing the money supply will fund extra demand and move the economy closer to full employment.
- Keynesians tend to argue that inflation is more likely to be cost-push inflation or demand-pull inflation.

EXPECTATIONS AND INFLATION

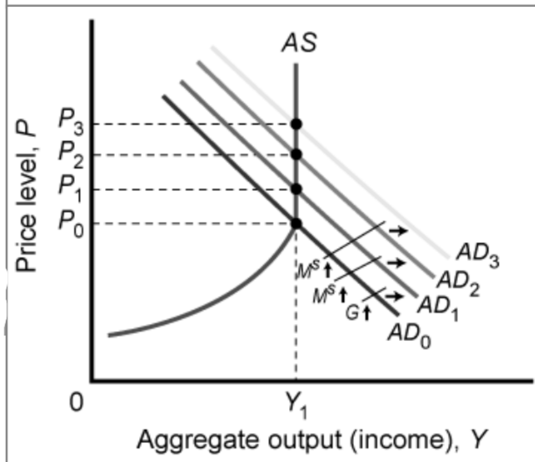
If every firm expects every other firm to raise prices by 10%, every firm will raise prices by about 10%. This is how expectations can get "built into the system."

- In terms of the *AD*/*AS* diagram, an increase in inflationary expectations shifts the *AS* curve to the left.

Money and Inflation:



An increase in *G* with the money supply constant shifts the *AD* curve from *AD*0 to *AD*1. This leads to an increase in the interest rate and crowding out of planned investment



If the Fed tries to prevent crowding, it will increase the money supply and the *AD* curve will shift farther and farther to the right. The result is a sustained inflation, possibly hyperinflation.

Costs of Inflation: Almost everyone thinks inflation is evil, but it isn't necessarily so. Inflation affects different people in different ways. It also depends on whether inflation is anticipated or unanticipated. If the

inflation rate corresponds to what the majority of people are expecting (anticipated inflation), then we can compensate and the cost isn't high. For example, banks can vary their interest rates and workers can negotiate contracts that include automatic wage hikes as the price level goes up. Problems arise when there is unanticipated inflation:

- Creditors lose and debtors gain if the lender does not anticipate inflation correctly. For those who borrow, this is similar to getting an interest-free loan.
- Uncertainty about what will happen next makes corporations and consumers less likely to spend. This hurts economic output in the long run.
- People living off a fixed-income, such as retirees, see a decline in their purchasing power and, consequently, their standard of living.
- The entire economy must absorb reprising costs ("menu costs") as price lists, labels, menus and more have to be updated.
- If the inflation rate is greater than that of other countries, domestic products become less competitive.

People like to complain about prices going up, but they often ignore the fact that wages should be rising as well. The question shouldn't be whether inflation is rising, but whether it's rising at a quicker pace than your wages. Finally, inflation is a sign that an economy is growing. In some situations, little inflation (or even deflation) can be just as bad as high inflation. The lack of inflation may be an indication that the economy is weakening.

How Is It Measured?

Measuring inflation is a difficult problem for government statisticians. To do this, a number of goods that are representative of the economy are put together into what is referred to as a "market basket." The cost of this basket is then compared over time. This results in a price index, which is the cost of the market basket today as a percentage of the cost of that identical basket in the starting year.

There are two main price indexes that measure inflation:

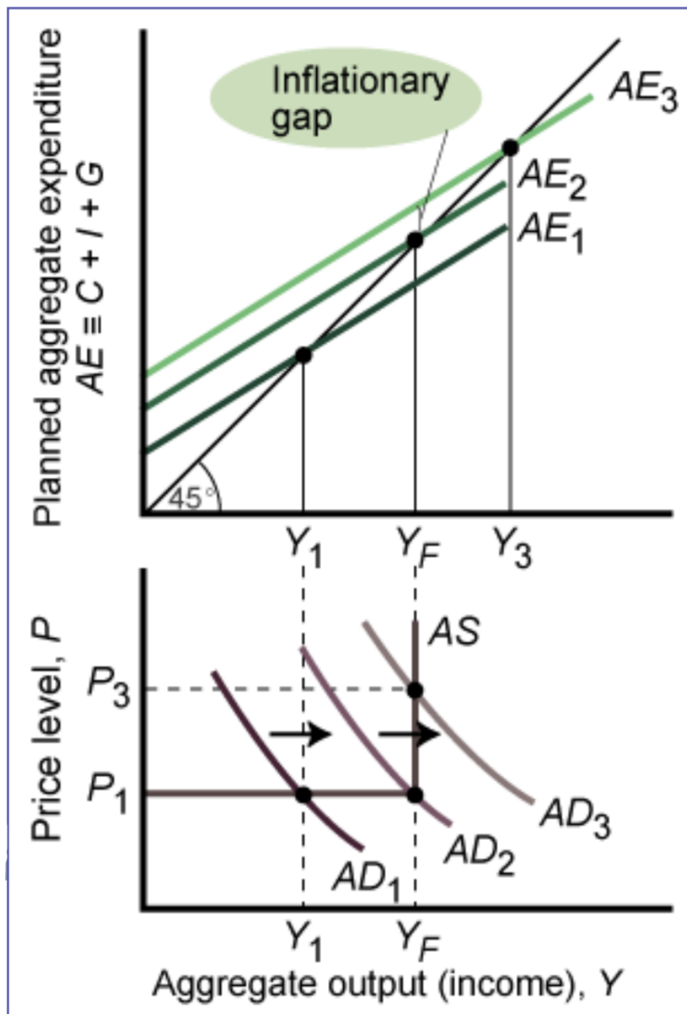
- **Consumer Price Index** (CPI) - A measure of price changes in consumer goods and services such as gasoline, food, clothing and automobiles. The CPI measures price change from the perspective of the purchaser.
- **Producer Price Indexes** (PPI) - A family of indexes that measure the average change over time in selling prices by domestic producers of goods and services. PPIs measure price change from the perspective of the seller.

INFLATION GAP

An **inflationary gap** is the amount by which the real Gross domestic product exceeds potential GDP. The real GDP is also known as GDP "adjusted for inflation", "constant prices" GDP because it measures the aggregate output in a country's income accounts in a given year, expressed in base-year prices. On the other hand, the potential GDP is the quantity of real GDP when a country's economy is at full-employment.

When an initial increase in aggregate demand produces inflation (so called demand-pull inflation) and real GDP increase, the price level and real GDP

are determined at the point where the new aggregate demand and the short-run aggregate supply meet. This point is known as **above full-employment equilibrium**, since the short-run aggregate supply is above the long-term aggregate supply, i.e. above the aggregate supply at full employment.



The gap created between real GDP and potential GDP is the consequence of inflation and that is why it is called the inflationary gap.

Obviously, this situation cannot last forever, because there is a shortage of labour. The shortage of labour produces the rise of wage rates, which makes the short-run aggregate supply decrease, until it reaches the full-employment level. The short-run aggregate supply decrease makes an upward pressure on the price level, consequently causing inflation. The once created gap between real GDP and potential GDP was the sign of forthcoming inflation and that is why it is called the inflationary gap.

Deflationary Gap:

Economic term describing the situation when Gross Domestic Product is below its full-employment level. In theory, such a situation would lead to the existence of unemployed resources, which should lead to falling prices (deflation) for those resources as the unemployed ones compete in the market.

- The output of the economy cannot exceed the maximum output of *YF*.
- The difference between planned aggregate expenditure and aggregate output at full capacity is sometimes referred to as an *inflationary gap*.

DEFLATIONARY POLICIES

- ► Deflationary policies to dampen down the level of economic activity might include:

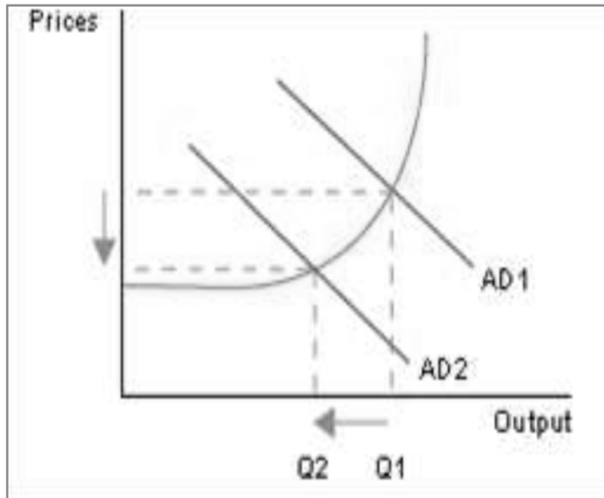
  = Reducing the level of government expenditure

  = Increasing taxation (either direct or indirect) to discourage spending

  = Increasing interest rates to discourage saving

  = Reducing money supply growth

- ► The first two policies would be considered contractionary fiscal policies,
- ► The second two are contractionary monetary policies.
- ► The impact of them should be to reduce aggregate demand and therefore the level of output.
- ► The diagram below shows this:



- The initial level of aggregate demand was inflationary – prices were increasing rapidly.
- However, the deflationary policies have reduced demand to AD2 and thus reduced the level of inflation.

MEASURES TO CONTROL INFLATION

Monetary Measures

- Bank rate policy
- Variable reserve ratio
- Open market operation
- Statutory liquidity ration
- Moral suasion
- Selective credit controls

Fiscal Measures

- Cut down in public expenditure
- Tax policy

Price and Wage Control

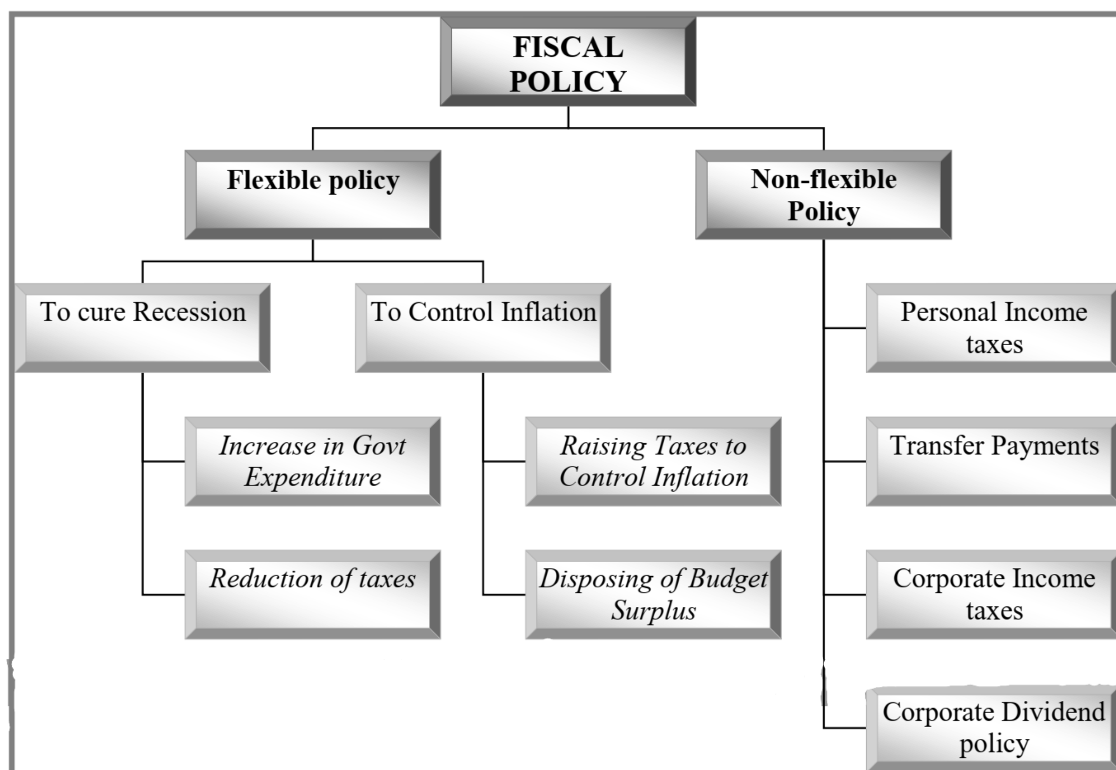
- Price control
- Wage control
- Indexation

FISCAL POLICY

Fiscal policy is one concept strongly advocated by Keynes. After all, Keynesian economists are those who support government regulation. Fiscal policy, then, is government regulation of its own spending and taxes to influence a country's economy. Fiscal policy works as government spending and taxes can provide an initial shock to the economy that triggers adjustments. Increasing taxes, for example, would cut down on people's disposable income and slow the economy in an effort control it. On the other hand, lowering taxes can give people more money to spend and thus provide a boon to the economy. Increasing government spending, too, can give suppliers an incentive to increase production and thus increase income.

There are two types of fiscal policy, depending on what the goal is. Expansionary fiscal policy means an increase in overall spending in the economy is represented by an upward shift of the expenditures graph. On the other hand, contractionary fiscal policy is represented by a downward shift of the consumption graph. Using mathematical and graphical analysis, it's possible to predict the affects of government fiscal policy. As the graph of expenditures shifts up and down, we can find the point of intersection with the production graph to find the new equilibrium income.

Fiscal Policy Can Be Divided In Two Types



I) DISCRETIONARY (flexible) FISCAL POLICY FOR STABILISATION

Fiscal policy is an important instrument to stabilises the economy, that is, to overcome recession and control inflation in the economy. By discretionary policy we mean deliberate change in the Government expenditure and taxes to influence the level of national output and prices. Fiscal policy generally aims at managing aggregate demand for goods and services. To cure recession expansionary fiscal policy and to control inflation contractionary fiscal policy is adopted.

A) Fiscal Policy to cure recession:

The recession occurs when aggregate demand decreases due to fall in private investment. Private investment may fall when businessmen

become highly pessimistic about making profits in future, resulting in decline in marginal efficiency of investment. A fall in private investment expenditure, aggregate demand curve shifts down creating a deflationary or recessionary gap.

There 2 fiscal methods to get the economy out of recession.

- **Increase in Government Expenditure.**
- **Reduction of taxes.**

i) Increase in Government Expenditure to Cure Recession:

This is the important tool to cure depression. Government may increases expenditure by starting public works, such as buildings roads, dams, ports telecommunication links, irrigation works electrification of new areas etc. Government buys various types of goods and materials and employs workers. The effect of this increase in expenditure is both direct and indirect. The direct effect is the increase in incomes of those who sell materials and supply labour for these projects. The output of these public works also goes up together with the increase in incomes, and for those who get more income they spend further on consumer goods depending on their marginal propensity to consumer. This creates the multiplier. As during the period of recession there exists excess capacity in the consumer good industries, the increase in demand for them bring about expansion in their output which further generates employment and incomes for the unemployed workers and so the new income are spent and serpent further and the process of multiplier goes on working till it exhausts itself.

ii) Reduction in Taxes to Overcome Recession: The reduction in taxes increases the disposable income of the society and causes the increase in consumption spending by the people.

B) Fiscal Policy to Control inflation:

When due to large increases in consumption demand by the households or investment expenditure by the entrepreneurs, or biggest budget deficit caused by too large an increase in Government Expenditure, aggregate demand increases beyond what the economy can potentially produce by fully employing its given resources, it gives rise to the situation of excess demand which results in inflationary pressures in the economy.

This inflationary situation can also arise if too large an increase in money supply in the economy occurs. In these circumstances inflationary gap occurs which tend to bring about rise in prices. If to check the emergence of successful steps exceeds demands or close the inflationary gap are not taken, the economy will experience a period a period of inflation or rising prices. For the last few decades, both the developed and developing countries of the world have faced problems of demand-pull inflation. Both have faced an alternative way of looking at inflation is to view it from the angles of business cycles.

After recovery from recession, when during upswing an economy finds itself in conditions of boom and become overheated prices start rising rapidly. Under such circumstances anti cyclical fiscal policy calls for reduction in aggregate demand. Thus fiscal policy measures to control inflation are

1) **Reducing Government expenditure and;**
2) **Increasing tax**

II) NON_DISCRETIONARY FISCAL POLICY: AUTOMATIC STABILIZERS

There is an alternative to use of discretionary fiscal policy, which generally involves the problem of, large in recognizing the problem of recession or inflation and large of the taking appropriate action to tackle the problem.

In this Non-discretionary fiscal policy, the tax structure and expenditure are so designed that taxes and government spending vary automatically inappropriate direction with the changes in National Income. That is, these taxes and expenditure pattern without any special deliberate action by the government and parliament automatically raise aggregate demand in times of recession and reduce aggregate demand in times of boom and inflation and there by help in insuring economic stability. These fiscal measures are therefore called automatic stabilizers or built-in stabilizers.

Policies to reduce a balance of Payments Deficit

1. Devaluation.

This involves lowering the value of the currency against others.

- If there is a devaluation in the currency the price of importing French goods increases and therefore the quantity demanded falls.
- Exports will be cheaper in price for the French and will increase the quantity of exports
- Therefore we would expect a devaluation to lead to an improvement in the current account. However it does depend upon the elasticity of demand for exports and imports.

2. Deflation

If govt reduces AD by raising interest rates or increasing taxes then people will have less money to spend so they reduce consumption of imports.

· The UK has a high mpm therefore a reduction in AD improves the current account significantly

· Deflationary policies will also put pressure on manufacturers to reduce costs and this will lead to more competitive exports and so exports will increase

· The success of this policy depends on the elasticity of demand for imports

· However this policy will conflict with other macroeconomic objectives With lower AD, growth is likely to fall causing higher unemployment

3. Supply Side Policies

These can improve the competitiveness of the economy and exporters, but this will take time to have effect

4. Protectionism

Increased tariffs of quotas will reduce imports and improve the current acc However :

1) Protectionism leads to retaliation so exports will decrease
2) Domestic industries may become uncompetitive, because there is no incentive.

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