Money and Banking

Section 3

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DURING THIS SECTION WE WILL DISCUSS THE FOLLOWING MAIN POINTS:

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3.2 INFLATION-DEFINITION AND MEANING

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3.3 DEFLATION-DEFINITION AND MEANING 3.3.1 CAUSES OF DEFLATION

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3.4 STAGFLATION -DEFINITION AND MEANING

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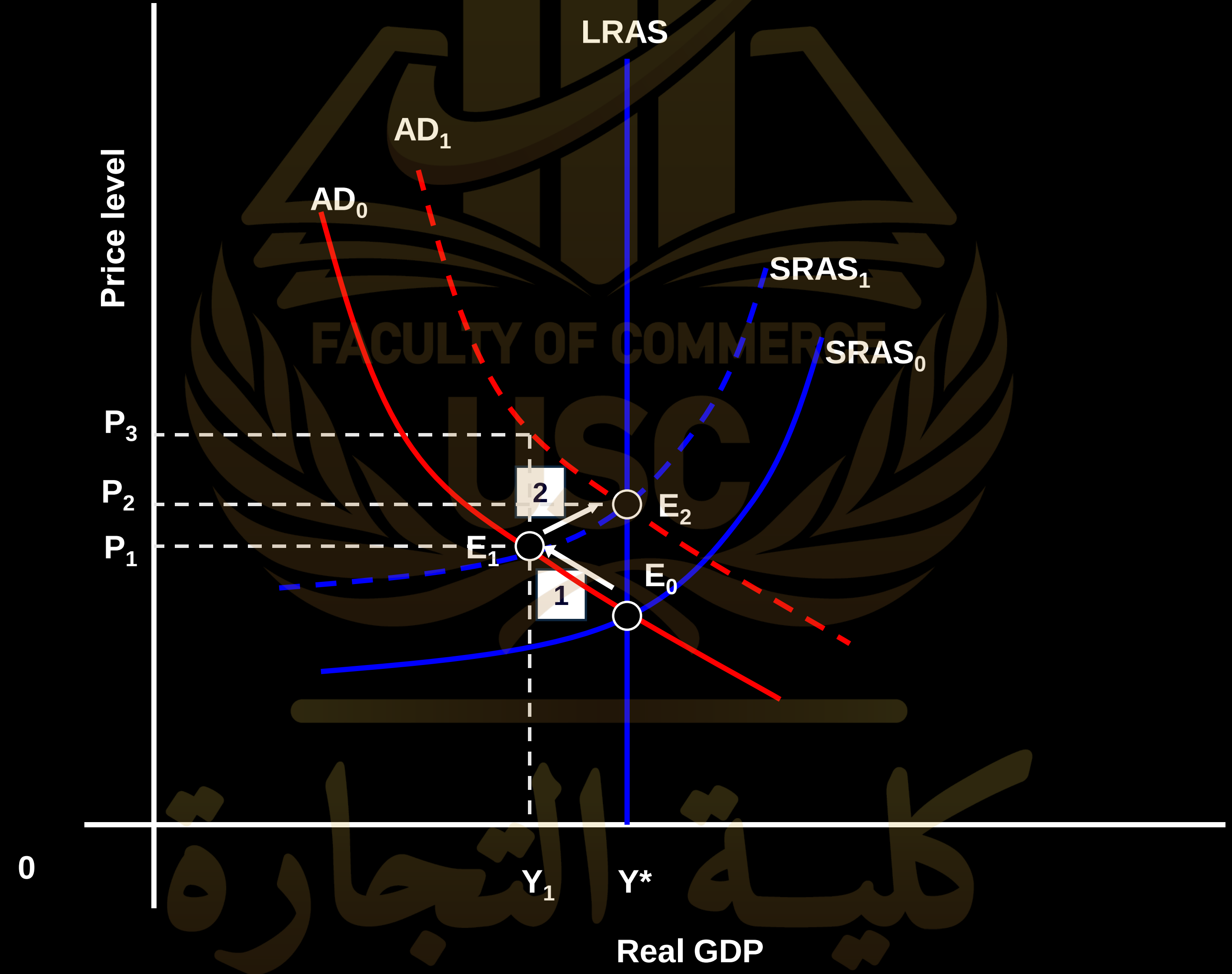
CHAPTER 3

Economic Fluctuations And Their Impact On Economic Growth Structure

INFLATION

IS THE PROCESS OF PERSISTENT INCREASE IN THE PRICE LEVEL.

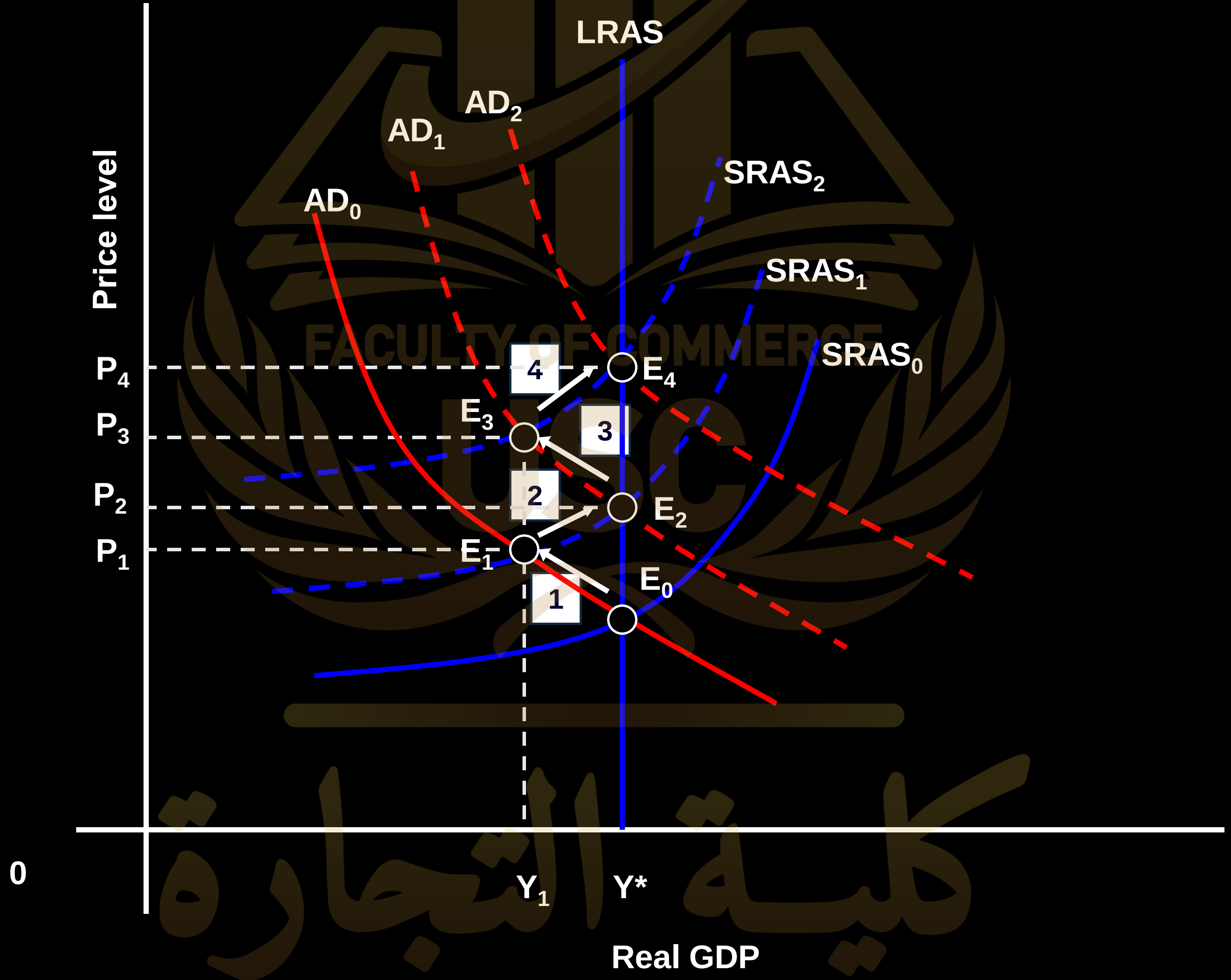
A Single Supply Shock



A Single Supply Shock

- The final effect of a single supply shock depends on whether or not it is accommodated by monetary expansion.
- A supply shock causes the SRAS curve to shift leftward from $SRAS_0$ to $SRAS_1$, as shown by arrow 1.
- Short-run equilibrium is established at E_1.
- If there is no monetary accommodation, the unemployment would exert a downward pressure on wage costs, causing the SRAS curve to shift slowly back to the right to $SRAS_0$.
- Prices would fall, and output would rise, until the original equilibrium was restored at E_0.
- If there is monetary accommodation, the AD curve shifts from AD to AD, as shown by arrow 2.
- This re-establishes full-employment equilibrium at E_2, but with a higher price level, P_2.

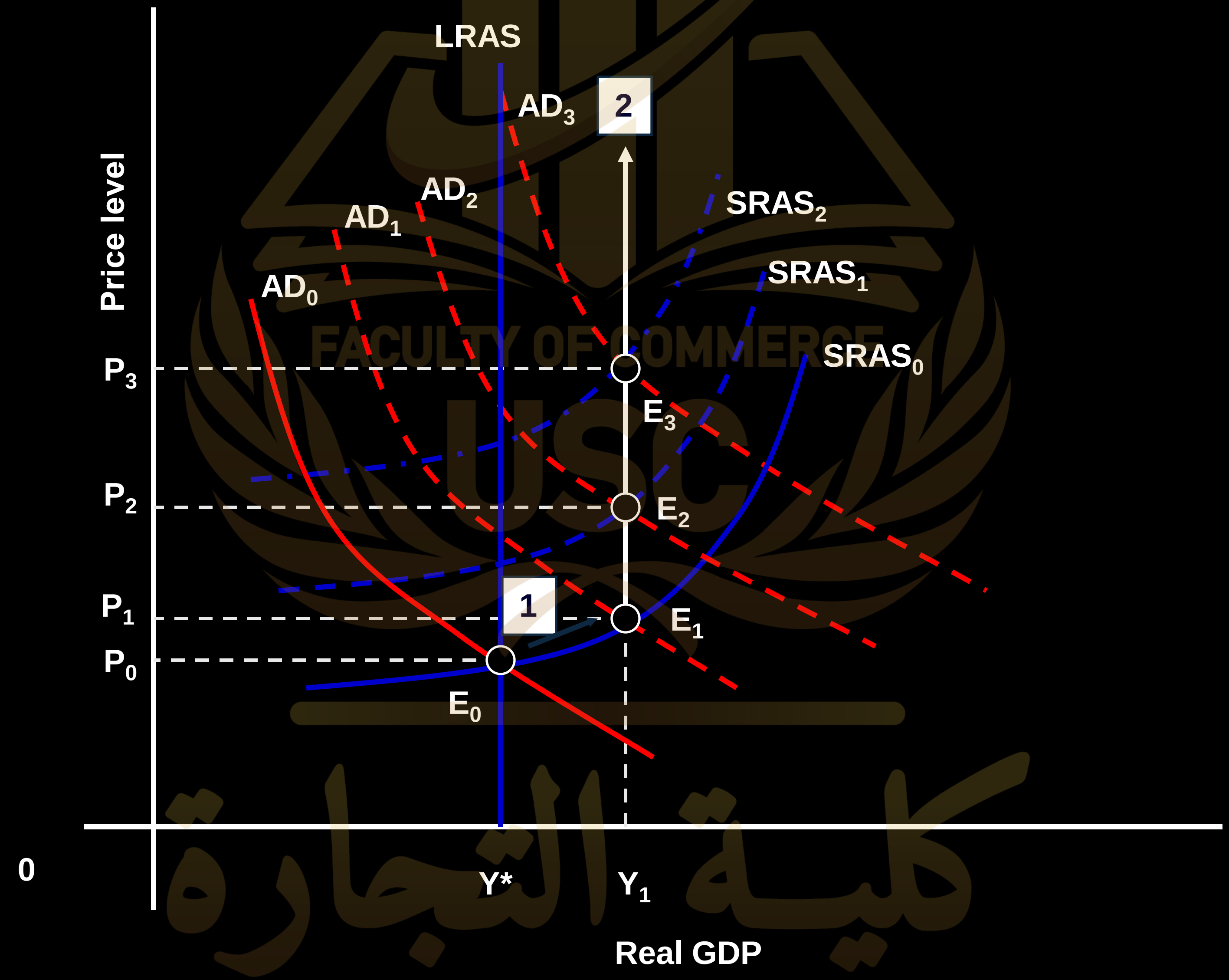
Monetary Accommodation of a Repeated Supply Shock



Monetary Accommodation of a Repeated Supply Shock

- Monetary accommodation of a repeated supply shock causes a continuous inflation in the absence of excess demand.
- The initial equilibrium is at E_0. A supply shock then takes equilibrium to E_1. This is stagflation phase of rising prices and falling output; it is indicated by arrow 1.
- If the monetary authorities then accommodate the supply shock, the AD curve shifts to AD_1 taking equilibrium to E_2. This is the expansionary phase of rising prices and rising output (arrow 2).
- A second supply shock takes equilibrium to E_3 (arrow 3) and a second round of monetary expansion takes it to E_4 (arrow 4).
- As long as the supply shock and monetary accommodation continue, the inflation continues.

A Validated Demand-shock Inflation



A Validated Demand-shock Inflation

- Monetary validation will cause the AD curve to shift, offsetting the leftward shift in the SRAS curve and maintaining an inflationary gap in spite of the ever-rising price level.
- An initial demand shifts equilibrium from E_0 to E_1 (along the path indicated by arrow 1), taking GDP to Y_1 and the price level to P_1. The resulting inflationary gap then causes the SRAS curve to shift to the left.
- This time, however, the money supply increases, shifting the AD curve to the right. By the time the aggregate supply curve has reached $SRAS_1$, the aggregate demand curve has reached AD_2, taking equilibrium to E_2. GDP remains constant at Y_1, while the price level rises to P_2.

A Validated Demand-shock Inflation

- The persistent inflationary gap continues to push the SRAS curve to the left, while the continued monetary validation continues to push the AD curve to the right. By the time the aggregate supply reaches $SRAS_2$, the aggregate demand curve has reached AD_3. The price level has risen still further to P_3, but the inflationary gap remains unchanged at Y_1-Y*.
- As long as this monetary validation continues, the economy moves along the vertical path of arrow 2.

The effect of inflationary shocks

Initial shock	Initial effects	Alternative possibilities	Final effects
Demand shock (*AD* curve shifts rightward)	*P* rises *Y* rises above *Y** (inflationary gap) *SRAS* curve starts to shift upwards	Isolated shock Not validated →	Case 1 *P* rises further *Y* falls back to *Y**
		Sustained shock Validated →	Case 2 *P* rises continuously *Y* remains above *Y**
Supply shock (*SRAS* curve shifts leftward)	*P* rises *Y* falls below *Y** (recessionary gap)	Isolated shock → Not accommodated →	Case 3 *P* falls *Y* returns to *Y**
		Isolated shock → Accommodated →	Case 4 *P* rises further *Y* returns to *Y**
		Repeated shock Accommodated →	Case 5 *P* continues to rise *Y* remains at, or below *Y**

common measures of inflation

1- Consumer Price Indexes (CPIs) which measure the price of a selected basket of goods by a "typical consumer"

2- Product Price Indexes (PPIs) measure the price received by a producer

3- Wholesale Price Indexes measure the change in the price of a selected basket of goods at wholesale prior to sales taxes. Used in India.

4- Commodity Price Indexes measure the change in price of a selection of commodities. In the case of the gold standard the sole commodity used was gold.

5- GDP deflator It is based on the ratio of the total amount of money spent on GDP to the inflation-corrected measure of GDP constant-price or "real" GDP. It is the broadest measure of inflation.

TYPES OF INFLATIONS

- 1- BASED ON THE DEGREE OF GOVERNMENT CONTROL

Open Inflation: which no steps are taken to control rising prices.

Suppressed Inflation: which rising prices are checked by administrative measures like price control.

2- BASED ON POLITICAL CONDITIONS

- **WAR TIME INFLATION:** IN ORDER TO MEET WAR EXPENSES GOVERNMENT INCREASES THE SUPPLY OF MONEY.

- **POST-WAR INFLATION:** TENDENCY OF INFLATION PERSISTS EVEN AFTER THE WAR DUE TO GOVERNMENT SPENDING ON THE REPAIR AND RECONSTRUCTION OF DAMAGE PROPERTY AND INCREASING MONEY SUPPLY THAN THE PRODUCTION OF GOODS AND SERVICES.

- **PEACE TIME INFLATION:** UNDER-DEVELOPED COUNTRIES NEED LARGE RESOURCES FOR ECONOMIC PLANNING AND DEVELOPMENT PROGRAMS.

3- BASED ON RATE OF INFLATION

- **CREEPING INFLATION:** REFERS TO THAT INFLATION WHEREIN PRICES RISE VERY SLOWLY.
- **WALKING INFLATION:** REFERS TO THAT INFLATION WHEREIN PRICES RISE QUICKLY.
- **RUNNING INFLATION:** WHEN THERE IS A RAPID INCREASE IN PRICES IN DIFFERS PERIOD
- **HYPER INFLATION:** IT REFERS TO A SITUATION WHEN PRICES RISE AT AN UNEXPECTED RATE.

4- BASED ON SCOPE

- **SECTORAL INFLATION:** WHEN INFLATION AFFECTS ONLY A PARTICULAR PART OF THE COUNTRY OR COVERS ONLY ONE OR TWO GOODS.
- **COMPREHENSIVE INFLATION:** WHEN INFLATION AFFECTS ON ALL PARTS OF THE COUNTRY.

5- BASED ON PROCESS

- **WAGE INDUCED INFLATION:** INCREASING WAGES RESULTS INTO HIGHER COST OF PRODUCTION AND INCREASED PRICES.
- **PROFIT INDUCED INFLATION:** IN DEVELOPED COUNTRIES LIKE AMERICA, BIG COMPANIES ADD A GIVEN PERCENTAGE OF PROFIT TO THE COSTS. SO, GOODS PRICES RISE VERY HIGH.
- **DEFICIT INDUCED INFLATION:** SUCH INFLATION IS THE OUTCOME OF DEFICIT FINANCING BY THE GOVERNMENT.
- **STAGFLATION:** INVOLVES INFLATIONARY RISE IN PRICES AND WAGES WITH A DECREASE IN PRODUCTION AND INCREASE IN UNEMPLOYMENT DUE TO FALL IN AGGREGATE DEMAND.

CAUSES OF INFLATIONS

Demand side

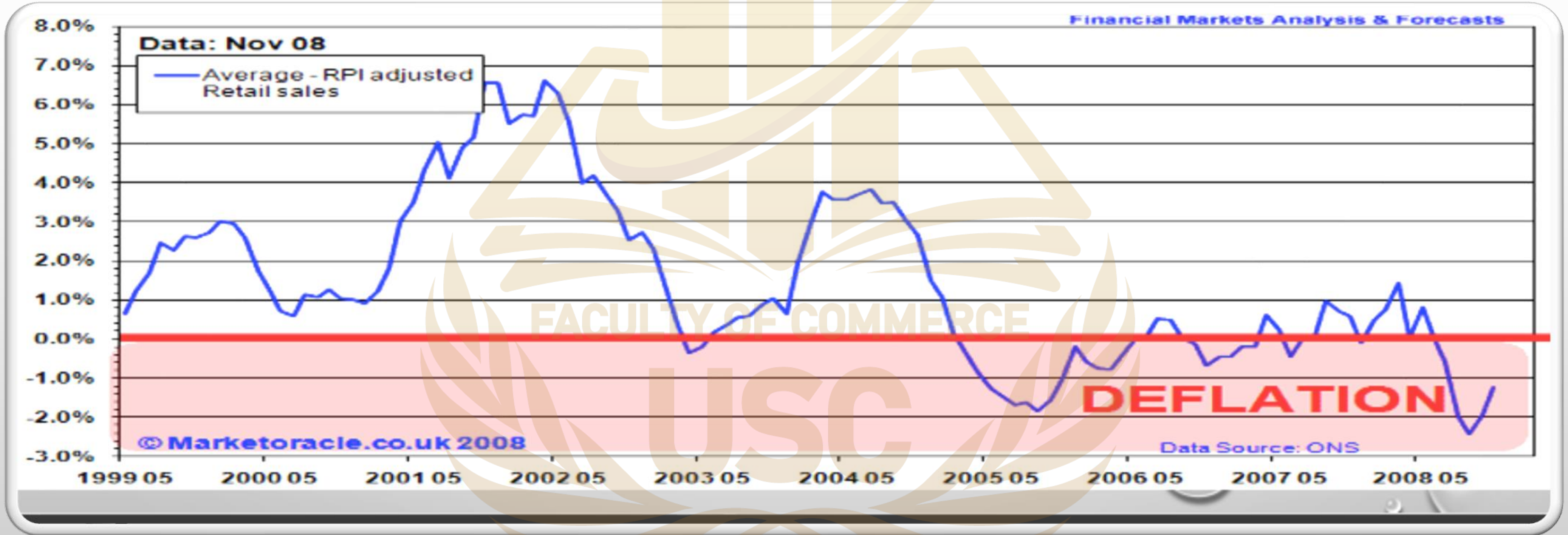
1. Increase in Public Expenditure
2. Deficit Financing
3. Cheap Monetary Policy

Supply side

1. Less Production .
2. Artificial Scarcity
3. Taxation Policy of the Government

IMPACT OF INFLATION ON ECONOMIC GROWTH

- (1) EFFECT ON DEBTORS AND CREDITORS
- (2) EFFECT ON INVESTORS
- (3) EFFECT ON FIXED SALARIED CLASS



DEFLATION

A SITUATION WHERE PRICES OF ESSENTIAL GOODS AND SERVICES DECLINE OVER TIME.

DEFLATION CAN DUE TO

- The fall in supply of money
- The rise in supply of other goods and services
- The increase in demand for money
- the fall in supply of other goods and services

CAUSES OF DEFLATION

- **GROWTH DEFLATION:** ARISES DUE TO INCREASE IN EFFICIENCY AND PRODUCTIVITY.

- **2. CASH-BUILDING DEFLATION:** WHEN THE DEMAND FOR MONEY INCREASE.

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- **3. BANK CREDIT DEFLATION:** THE CENTRAL BANK CAN LIMIT THE POWER OF COMMERCIAL BANKS TO CREATE MONEY BY MAINTAINING HIGH CASH RESERVE RATIO, THEN MONEY SUPPLY WILL DECLINE, AND THE PURCHASING POWER WILL DECREASE CAUSES DEFLATION(RECESSION).

- **4. CONFISCATORY DEFLATION:** IT WAS A FORCED DEFLATION IMPOSED UPON PEOPLE BY EXERCISING POLITICAL POWER.

IMPACT OF DEFLATION ON ECONOMIC GROWTH

1. Impact On Production:

Deflation is a situation of falling prices.

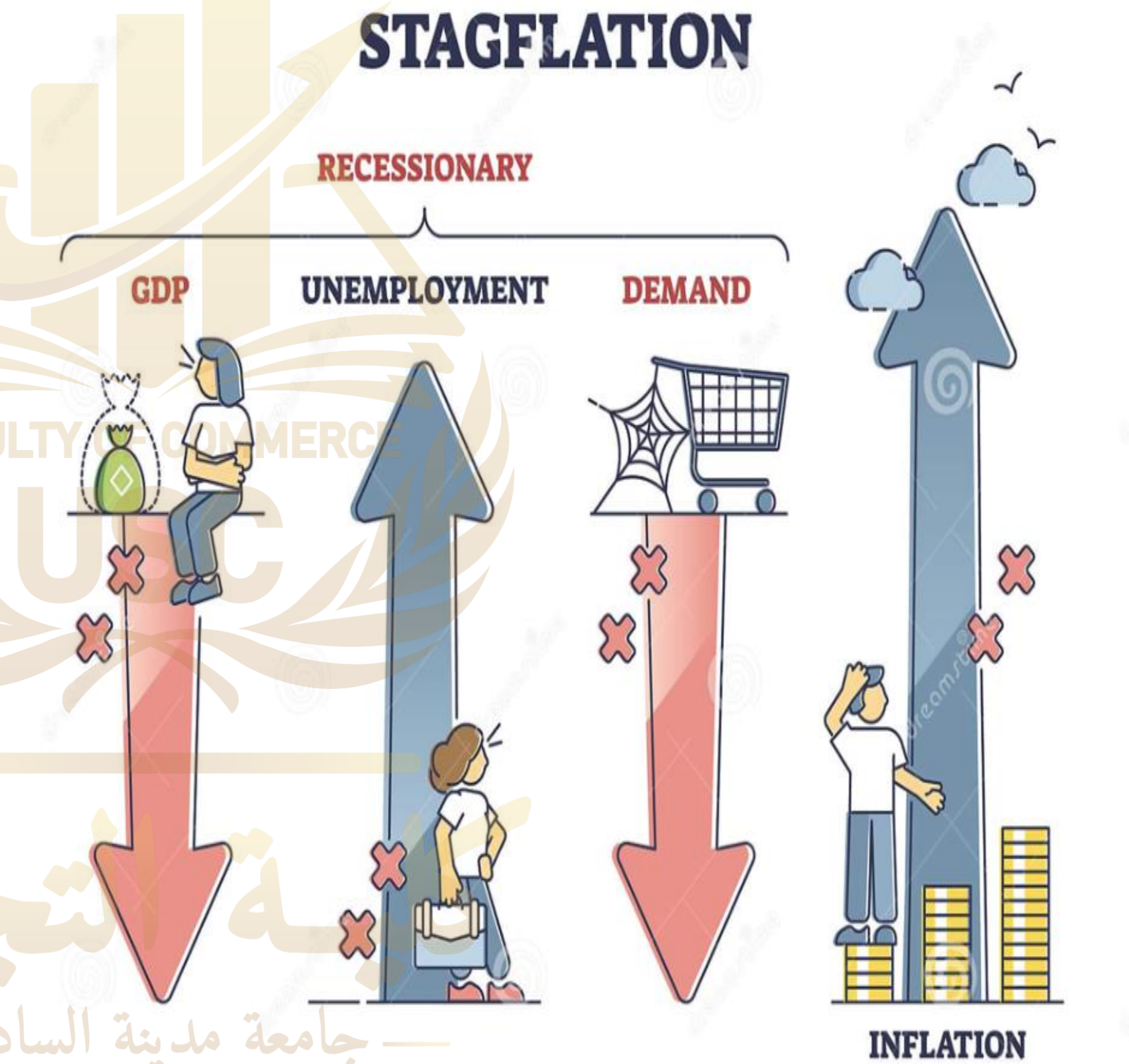
2. Impact of Debt Payers:

Due to fall in prices, the value of money in real terms appreciates and making debts in money more costly.

STAGFLATION

refers to economic condition where economic growth is very slow, and prices are rising.

It's a combination of stagnation(Recession or deflation) and inflation.



IMPACT OF STAGFLATION ON ECONOMIC GROWTH

- The stability of the real value of the domestic currency.
- Increasing Savings and investments

Q1: In the Keynesian liquidity preference framework, a rise in the price level causes the demand for money to __________ and the demand curve to shift to the __________, everything else held constant.

A increase; left

B increase; right

C decrease; left

D decrease; right

Answer: B

Q2: Which of the following is the feature of money?

A General acceptability

B Homogeneous unit

C Liquid asset

D All of these

Answer: D

Q3: Which of the following concepts is the opposite of inflation?

A stagflation

B Deflation

C Recession

D None of the above

Answer: B

Q4: A government resorts to __________ to reduce inflation.

A Cuts in government spending

B Increase in government expenditure

C Reduction in repo rate

D None of the above

Answer: A

Q5: When the price levels of goods and services are falling continuously, this phenomenon is called ___________.

A stagflation

B Deflation

C Inflation

D None of the above

Answer: B

Q6: Inflation is measured by ________

A smith’s index

B sale price index

C Consumer price index

D None of the above

Answer: C

Q7: The combination of stagnation and inflation is known as ______.

A Demand-pull inflation

B Cost-push inflation

C Stagflation

D None of the above

Answer: C

Q8: Purchasing power of money falls when:

A Price level rises.

B Income falls.

C Price level falls.

D Money supply falls.

Answer: A

Q9: ……. Represents a measure of inflation.

A Consumer Price Indexes (CPIs)

B Product Price Indexes (PPIs)

C Wholesale Price Indexes

D All the above

Answer: D

Q10: Represents The Causes Of Inflations

A Increase in Public Expenditure

B Deficit Financing

C Less Production

D All the above

Answer: D

Q11: A situation where prices of essential goods and servic decline over time.

A Inflation

B Deflation

C Stagflation

D None of the above

Answer: B

Q12: Represents The Causes Of Deflations

A Growth Deflation

B Bank Credit Deflation

C Cash-Building Deflation

D All the above

Answer: D

Q13: Refers to economic condition where economic growth is very slow, and prices are rising.

A Inflation

B Deflation

C Stagflation

D None of the above

Answer: C

Q14: is a financial institution and a financial intermediary that accepts deposits and channels those deposits into lending activities.

A Financial markets.

B Banks.

C Companies.

D Intermediators.

Answer: B

Q15: ……………. is a public institution that manages a state's currency, money supply, and interest rates.

A Saving bank.

B Commercial bank.

C Central bank.

D Consumer bank.

Answer: C

Q16 Which of the following is the feature of money?

A General acceptability

B Homogeneous unit

C Liquid asset

D All of these

Answer: D

Q17 Which of the following is an effect of inflation?

A Erosion in purchasing power.

B Homogeneous unit

C Liquid asset

D All of these

Answer: D

THANK YOU FOR YOUR ATTENTION