Chapter 1
Introduction

Inflation and Unemployment are the two important variables in macro economics. Management of these two variables are received the maximum attention of those who are entrusted with the responsibility of managing their respective economies of the world. Reasons for the priority and urgency to control inflation and unemployment can be appreciated only after knowing their causes and consequences for the society. Although inflation always means a rise in prices or decline in the purchasing power of currency. But on the basis of rate of price rise, inflation can be termed as "hyperinflation", runaway "inflation", and "galloping inflation" referring to very high rate of inflation and as "creeping inflation" denoting a slow but continuous rise in the general price level. There can be several causes of inflation "Demand Pull" inflation is a result of excessive total spending over available supply of goods and services in the economy. "Structural inflation" is similar to the demand pull inflation, but it can occur even when total demand and total supply are in balance. The structural inflation occurs due to the existence of excess due to the existence of excess demand and increasing cost pressures in certain industries even when total demand is not more than the total supply. Food sector gives another example of structural inflation. Even when there is low demand of food in the economy, food shortage can occur if unfavorable whether conditions cause the supply of foods to fall short of demand and prices tend to rise. This resembles with the demand pull inflation but since total the money demand is not more than money supply, the economy as a whole does not experience a demand pull inflation; other types inflation such as "cost-push", "wage push", and "profit push" inflation are collectively referred to as "administered-price" inflation.

There are several effects of inflation. It has adverse impact on income distribution. A price rise tends to benefit some individuals and harm others. While for some income earners, income rises more rapidly than prices during inflation, for many people just the opposite is true. Those who have fixed incomes are seriously affected as the real income decline during periods of inflation.

Inflation also has effect on lending and savings. Inflation benefits the borrowers at the expense of the lenders and savers. The saving rate and hence investment rate is affected adversely. Inflation, in a country, has also adverse effects on foreign trade. The competitiveness of a country may be seriously affected.

Regarding unemployment, economists general classify unemployment into three types according to the causal factors, namely, frictional unemployment, cyclical unemployment and structural unemployment. Sometimes seasonal and disguised unemployments are also mentioned. The structural unemployment refers to the persons who are between the jobs. A certain amount of frictional unemployment is desirable to provide freedom and mobility to workers. However, the size of frictional unemployment can be a topic of debate and discussion. Cyclical unemployment results from business recessions and depressions when total spending in the economy is below the full employment productive capacity of the economy. In such a situation, the economy has same natural resources, manpower and productive equipment as before the cyclical unemployment occurred but the problem is that economy does not produce because the goods and services being produced are not being purchased. The people were not buying because they either had lost their jobs or feared the loss of their jobs. Structural unemployment arises due to a mismatch between job seekers and job openings. It refers to a situation when both the jobs and job seekers exist but something prevents the filling up the vacancies.

Normally, structural unemployment results from either a geographic or skill mismatch. A geographical mismatch occurs when the jobs do not move to the unemployed workers, and unemployed workers do not move to the jobs. A skill mismatch occurs when there are both job vacancies and unemployed job seekers in the same geographical area, but the job seekers are not qualified to fill the vacancies. India, IT sector is facing the problem of structural unemployment, where not more than 25 percent IT engineers are said to be employable due to lack of proper skills matching the job requirement. Similar situation is prevailing in education, where well qualified faculty recruitment is not met. Seasonal fluctuations in employment also occurs in a member of industries such as Agricultural workers, construction workers, employees of tourist resorts are often not fully employed throughout the year due to peak and lean seasons from view point of employment. Unemployment has both economic and social implications for a country like India. Occurrence of unemployment results in the loss of output, loss in revenue of the government and in consequence disastrous effect on developmental works. The social cost of unemployment can not be measured in money terms, but it involves an intolerable amount of human suffering. Unemployment means loss of self-respect, poverty and frustration. It can even lead to social unrest in the country. There are other types of unemployment also in developing countries like India. These are underemployment and disguised unemployment. Disguised unemployment refers to zero or very low productivity level and is most prevalent in Indian agriculture sector. The presence of this type of unemployment makes functioning of labour market inefficient.

Having discussed the causes and consequences of inflation and unemployment, obviously, it would be extremely desirable to reduce or eliminate altogether, if possible, the menace of inflation and unemployment.This requires, however, the knowledge of relationship between unemployment and inflation. This relationship is exhibited by “Phillips curve” named after its originator, Australian economist AW Phillips. According to Phillips curve, there is a trade-off between inflation and unemployment. Thus, policy makers face a serious dilemma. Efforts to reduce unemployment usually result in increased inflation, while efforts to decrease inflation usually bring about an increase in the unemployment rate. Ever since, the contribution made by AW Phillips, a number of studies have been done to know the nature of relationship empirically between inflation and unemployment in the context of different countries, so that suitable policies can be formulated. The findings are not conclusive and different studies have come out with different evidences. Another important part of the debate the Phillips curve involves a disagreement among the investigators about whether unemployment causes inflation or inflation causes unemployment.

Statement of Problem

The phenomenon of high inflation and unemployment is generally bad and should be avoided if possible. There is considerable disagreement over which of the two is more harmful. Since, a certain amount of inflation and unemployment is unavoidable and since efforts to reduce one, usually result in an increase in the other. Growing volume of literature on the theoretical foundation of the celebrated Phillips curve has clearly established that the trade-off between inflation and unemployment is essentially a short run phenomenon. Expectation augmented Phillips curve ensures that unemployment would remain at its natural rate irrespective of the rate of inflation in the long run. This is also shown that the expectation formation about inflation makes the short run Phillips curve an unstable curve. The result of the previous study on the India examined the Phillips curve has same shape as the aggregate supply curve. As the policy measures to contain inflations and unemployment differ with difference in the shape of Phillips curve, the determination of the shape of Phillips curve becomes very important. The present work is a modest attempt towards that end. Another issue that deserves investigation is regarding causation between inflation rate and unemployment rate.

Objectives of the study

1. To estimate the Expectation Augmenting Phillips curve and interpret the results.
2. To avoid spurious regression, the series of observations on the relevant variables are tested for their unit roots or stationarity.
3. To conduct Granger Causality Test for different pairs of variables.

Limitation and significance of the study

The major limitation of this study is non availability of data on unemployment. No source provides comprehensive, regular and reliable data. Census of India collects data on labour force with a gap of 10 years. Similarly National Sample Survey Organisation(NSSO) conducts survey after five years. The number of unemployed registered with employment exchanges is also highly unreliable. Moreover, definition of unemployment adopted by these sources is also not uniform. The significance of the study lies in the fact that knowledge of the nature or relationship between inflation and unemployment can enable the policy makers to formulate policies to minimize the harmful consequences of inflation and unemployment for the society.

Chapterisation Scheme

The entire subject matter of the present dissertation has been organized in the following five chapters:

Chapter-1 Introduction .

Chapter-2 Survey of Literature.

Chapter-3 Analytical Framework.

Chapter-4 Techniques of Analysis and Interpretation of Results.

Chapter-5 Conclusion.