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(Compilations of the Multiple Choice Questions)
For

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Economy

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Inflation

1. Which one of the following statements is incorrect with respect to Inflation?

A. Deflation is considered good for the economy as it brings comfort to the consumers.

B. If the price of one good has gone up, it is not considered as inflation.

C. price index does not show the exact price rise or fall of a single good.

D. None of the above

Answer: A

Explanation

- Two terms are used to show a fall in general level of prices —disinflation and deflation.
- But these terms have very specific meanings in terms of price fall—while disinflation is considered good for the economy (as it brings comfort to the consumers), deflation is not considered good (as it invites the risks of slowdown and even recession in the economy).
- The rate of inflation is measured on the basis of price indices which are of two kinds—Wholesale Price Index (WPI) and Consumer Price Index (CPI).
- A price index is a measure of the average level of prices, which means that it does not show the exact price rise or fall of a single good.
- The rate of inflation is the rate of change of general price level which is measured as follows:
  - ✓Rate of inflation (year x) = Price level (year x) –Price level (year x-1)/ Price level (year x-1) × 100

2. Consider the following statements:

1. **Bottleneck Inflation takes place when the supply falls drastically and the demand remains at the same level.**
2. **The shortfall in total spending of the government over the national income creates inflationary gaps in the economy.**
3. **Inflation Spiral is a situation often deliberately brought by the government to reduce unemployment and increase demand by going for higher levels of economic growth.**

Which of the above statements is/are correct?

A. 1 and 3 only

B. 1 only

C. 2 and 3 only

D. 2 only

Answer: B

Explanation

- Bottleneck Inflation: This inflation takes place when the supply falls drastically and the demand remains at the same level.
  - ✓ Such situations arise due to supply-side hurdles, hazards or mismanagement which is also known as 'structural inflation'.
- The shortfall in total spending of the government (i.e., fiscal surplus) over the national income creates deflationary gaps in the economy.
  - ✓ This is a situation of producing more than the demand and the economy usually heads for a general slowdown in the level of demand. This is also known as the output gap.
- Reflation is a situation often deliberately brought by the government to reduce unemployment and increase demand by going for higher levels of economic growth.
- Governments go for higher public expenditures, tax cuts, interest rate cuts, etc. Fiscal deficit rises, extra money is generally printed at higher level of growth, wages increase and there is almost no improvement in unemployment.

3. India commenced inflation targeting 'formally' in February 2015 when an agreement between the GoI and the RBI was signed related to it—the Agreement on Monetary Policy Framework. Consider the following statements with respect to the same.

1. Inflation targeting is a strategy of specifying an inflation rate as a goal and adjusting monetary policy to achieve that rate.

2. As per the agreement, every six months, the RBI has to publish a document explaining the source of inflation.

3. The Centre has decided to retain the inflation target of 6%, with a tolerance band of +/- 2 percentage points for the Monetary Policy Committee of the Reserve Bank of India for 2021-26.

Which of the above statements are correct?

A. 1 and 2 only

B. 2 and 3 only

C. 1 and 3 only

D. 1, 2 and 3

Answer: A

Explanation

- The announcement of an official target range for inflation is known as inflation targeting.

- It is done by the Central Bank in an economy as a part of their monetary policy to realise the objective of a stable rate of inflation (the Government of India asked the RBI to perform this function in the early 1970s).
- India commenced inflation targeting 'formally' in February 2015 when an agreement between the GoI and the RBI was signed related to it—the Agreement on Monetary Policy Framework.
- The agreement provides the aim of inflation targeting in this way—it is essential to have a modern monetary framework to meet the challenge of an increasingly complex economy.
- The RBI will aim to bring CPI-C Inflation below 6 per cent by January 2016. The target for financial year 2016–17 and all subsequent years shall be 4 per cent with a band of +/– 2 per cent (it means the 'healthy range of inflation' to be 2–6 per cent).
- The Centre has decided to retain the inflation target of 4%, with a tolerance band of +/- 2 percentage points for the Monetary Policy Committee of the Reserve Bank of India for the coming five years.

4. Which of the following is/are the effects of inflation on an economy?

1. Investment in the economy is boosted by the inflation in the short term.

2. Lenders suffer and borrowers benefit out of inflation.

3. Consumption expenditure fall with rise in Inflation.

4. Export segment of the economy benefits due to inflation.

Select the correct code.

A. 1, 2 and 3 only

B. 2 and 3 only

C. 2, 3 and 4 only

D. 1, 2, 3 and 4

Answer: D

Explanation

- There are multi-dimensional effects of inflation on an economy both at the micro and macro levels.
  - ✓ Creditors and Debtors: Debtors: Inflation redistributes wealth from creditors to debtors, i.e., lenders suffer and borrowers benefit out of inflation. The opposite effect takes place when inflation falls (i.e., deflation).
- Investment in the economy is boosted by the inflation (in the short-run) because of two reasons:
  - ✓ Higher inflation indicates higher demand and suggests entrepreneurs to expand their production level, and
  - ✓ Higher the inflation, lower the cost of loan
- Consumption as well as investment both of the expenditures rise as inflation rises. Increased prices make our consumption levels fall as goods and services we buy get costlier.

- We see a tendency among the people to cut their consumption levels aimed at neutralising the impact of price rise — making consumption expenditure fall.
- Exact opposite happens once prices head downward. On the other hand inflations make 'investment' expenditure increase as a result of decreased cost of money/finance (inflation brings benefit to borrower—known as 'inflation premium').
- With inflation, exportable items of an economy gain competitive prices in the world market.
- Due to this, the volume of export increases (keep in mind that the value of export decreases here) and thus export income increases in the economy.
- It means export segment of the economy benefits due to inflation.
- Importing partners of the economy exert pressure for a stable exchange rate as their imports start increasing and exports start decreasing (see the next point).

5. Consider the following pairs:

Term :: Meaning

1. **Boom :: Strong upward fluctuation in the economic activities**
2. **Growth Recession :: Economy tries to come out of the low production phase to survive.**
3. **Skewflation :: An episodic price rise pertaining to one or a small group of commodities.**

Which of the above pairs is/are correct?

A. 1 and 2 only

B. 1 only

C. 2 and 3 only

D. 1, 2 and 3

Answer: B

Explanation

- Economists usually distinguish between inflation and a relative price increase.
- 'Inflation' refers to a sustained, across-the-board price increase, whereas 'a relative price increase' is a reference to an episodic price rise pertaining to one or a small group of commodities.
- This leaves a third phenomenon, namely one in which there is a price rise of one or a small group of commodities over a sustained period of time, without a traditional designation.
- 'Skewflation' is a relatively new term to describe this third category of price rise.
- Growth Recession is an expression coined by economists to describe an economy that is growing at such a slow pace that more jobs are being lost than are being added.
- The lack of job creation makes it 'feel' as if the economy is in a recession, even though the economy is still advancing.