Q 1. Analyze the role of fiscal and monetary policy in controlling inflation.

Answer: - Different measures are taken to control inflation in the country through reduction in the amount of total expenditure as it is not possible to increase production at the time of true inflation. The methods are to be used are as follows:

Fiscal Policy: -The policy regarding income and expenditure of the government and policy related to credit is called fiscal policy. The methods which are used for controlling inflation under fiscal policy are as follows: -

1. **Government Expenditure: -** Control of inflation can be made possible by reducing the amount of government expenditure. To reduce the government expenditure, unnecessary expenditure of government work may be stopped. If government expenditure of the country is reduced, the price level of the country tends to reduce.
2. **Tax: -** Government can reduce the amount of disposable income of the people by imposition of new tax or by increasing the rate of existing tax to reduce the amount of private expenditure. If the amount of private expenditure is reduced, the price level of the country tends to reduce.
3. **Public Debt: -** government can control inflation by taking loans from the public of the country. They can also do so by selling bonds or securities to the public. As a result, the amount of money at the hands of people is reduced. Those people who purchase these securities have to pay money to the government in exchange of securities. As a result, the total expenditure and price level of the country is reduced.
4. **Compulsory Savings: -** Government can control inflation by introducing compulsory saving schemes. One of the most important advantages of compulsory savings schemes is that it is possible to reduce the disposable income of the public by binding them to keep certain part of their income as deposit compulsorily. As a result, total expenditure of the public decreases leading to decrease in the price level of the country.

Monetary Policy: - It is applied by the monetary authority or the central bank of the country. During inflation, the central bank tries to reduce the total expenditure of the country by reducing the amount of money at the disposal of commercial banks for creating credit. The elements of monetary policy used by the central bank to control inflation are as follows: -

1.Bank Rate

2.Open Market Inflation

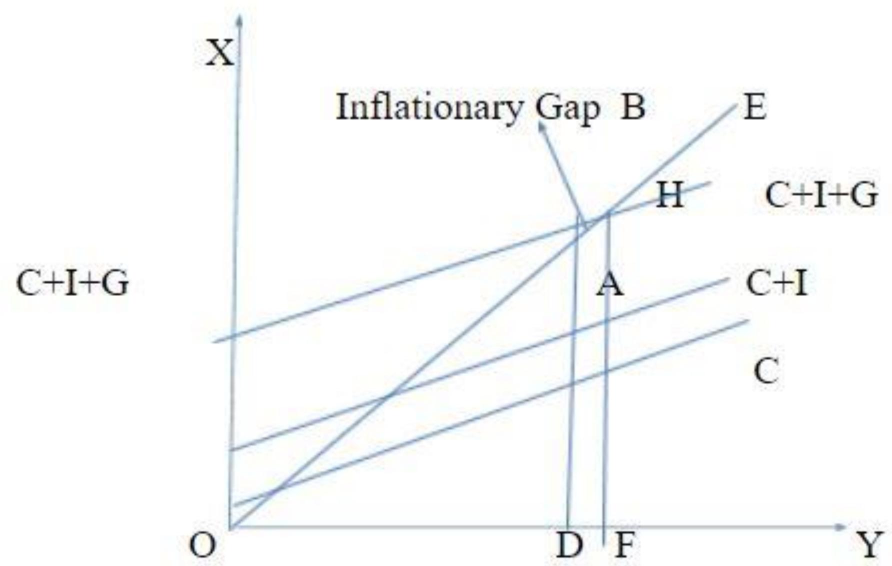
3.Variable Reserve Ratio (CRR/SLR definition, reduction in rate).

Q 2. What is an inflationary Gap? Explain the concept of inflationary gap with the help of the diagram.

Answer: - According to Professor Keynes- full employment level of income if the total demand for any commodity is greater than the total supply of commodity, then that excess demand for commodity is called inflationary gap.

To determine the total demand of the country three sectors of the economic system is considered. These three sectors are in the form of consumption expenditure, investment expenditure and government expenditure. Thus, total demand of the country is equal to C + I + G. So, it can be said that equilibrium level of income is determined were: - **Total Supply= Total Demand**

The concept of inflationary gap can be explained with the help of following diagram: -



In the above diagram we measure total income on the horizontal axis and C+I+G on the vertical axis. OE is the 45-degree line which is the total income line(Y) as well as the total supply curve of the commodity in the economy. From the above diagram it is seen that the C+I+G curve cuts the OE line at point H which is the equilibrium point. It is seen that the amount of total supply and the amount of total demand are equal to FH since equilibrium level of income is equal to OF. Here it is assumed that the maximum amount of income at full employment level of income is OD. This means that in society it is not possible to increase the total level of income more than the amount OD. Here OD is the full employment level of income because of which the total demand of the society that is C+I+G can be increased but supply remains constant. At this OD level of income, total demand of the society is DB where the total supply of the society is DA. So, here the amount of excess demand is (DB-DA) is equal to AB. This AB is called inflationary gap.

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