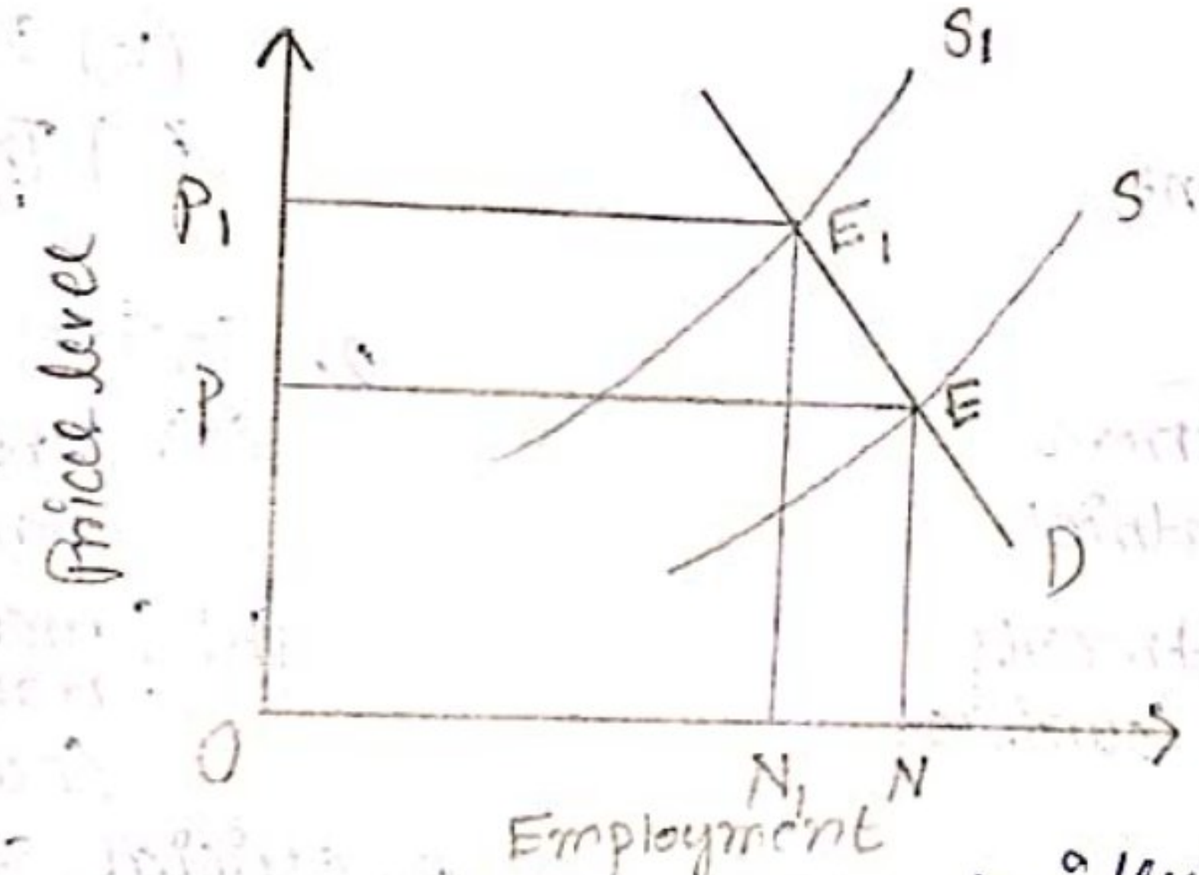
(3) What is Stagflation?

Ans: The word "stagflation" is the combination of stag plus flation, taking 'stag' from stagnation and 'flation' from inflation. Thus it is a paradoxical situation where the economy experiences stagnation on unemployment along with a high rate of inflation. It is, therefore, also called "inflationary recession". One of the principal causes of stagflation has been restriction in the aggregate supply. When aggregate supply is reduced, there is a fall in output and employment and the price level rises.

Another cause of restriction in aggregate supply is the increase in indirect taxes by central, state and local governments. When indirect taxes are increased, they raise costs and prices and reduce output and employment.



The phenomenon of stagflation is illustrated, where employment is measured on the horizontal axis and the price level on the vertical axis. The initial equilibrium is at E. Where the demand curve 'D' intersects the supply curve 'S' and the price level is 'OP' and the employment level is 'ON'. When the aggregate supply is reduced the supply curve 'S' shifts to the left as 'S1'. The new equilibrium is at 'E1' where 'S1' intersects the 'D' curve. Now the price level rises from 'OP' to 'OP1' and the level of employment from 'ON' to 'ON1'.

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