Basic information on the price stability economics essay

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Price stability, next to economic growth, full employment and an internal as well as external balance, represents one of the five objectives of economic policy. As part of the division of labor among economic policymakers, the responsibility of achieving and maintaining price stability has been entrusted to the central banks. Article 105 of the Treaty of Rome stipulates that maintaining price stability is the primary objective of the Eurosystem.

The objective of price stability refers to the general level of prices in the economy and implies avoiding both a substantial increase in the price level (inflation) and a permanent decline in the price level (deflation). Price stability has such high priority within economic policy because as part of the financial framework for a country's economic activity it ensures stable and predictable conditions which, in turn, have a positive impact on economic activity and the employment rate. By contrast, a continued increase in the price level entails a series of unfavorable effects on private households and businesses and consequently on the economic and social cohesion of a society.

A Detailed Explanation of the Benefits of Price Stability

In detail, there are six reasons why price stability has a positive impact on economic activity:

First, price stability makes it easier for people to recognize changes in the relative prices of various goods and services, since such changes are not obscured by fluctuations in the overall price level. As a result, businesses and consumers do not misinterpret general price changes and are able to make better informed consumption and investment decisions. This then allows the market to allocate resources more efficiently. By helping the

market to steer resources to where they can be used most productively, price stability increases the productive potential of the economy and thus the welfare of households.

Second, if creditors can be sure that prices will remain stable in the future, they will not demand an inflation risk premium to compensate them for the risks associated with holding nominal assets over the longer term. Lower risk premiums on real interest rates render monetary policy more credible and thus increase the efficiency with which capital markets allocate resources and make investing more attractive. This in turn fosters economic growth.

Third, credibly maintaining price stability also keeps individuals and businesses from diverting resources from productive uses in order to hedge against inflation. A high-inflation environment, for example, provides an incentive to stockpile real goods since they retain their value better in such circumstances than money or certain financial assets. However, stockpiling goods is not an efficient investment decision and therefore impairs economic welfare.

Fourth, tax and welfare systems can create perverse incentives which distort economic behavior. In most cases, these distortions are exacerbated by inflation, as progressive, nominal income-oriented fiscal systems lead to higher average taxation over time when the price and income levels increase. Price stability eliminates the costs of this so-called bracket creep phenomenon.

Fifth, inflation acts as a tax on cash inventory. This reduces household demand for cash and consequently generates higher transaction costs (such as more frequent bank visits).

Sixth, maintaining price stability prevents the considerable and arbitrary redistribution of wealth and income that arises in inflationary as well as deflationary environments, where price trends change in unpredictable ways (e. g. redistribution effects from creditors to debtors with unforeseen inflation). Typically, the weakest groups of society suffer the most from inflation, as they have only limited possibilities for hedging against it. An environment of stable prices thus helps maintain social cohesion and stability. As several examples in the twentieth century have demonstrated, high rates of inflation or deflation often create social and political instability.

All these arguments suggest that a central bank that maintains price stability substantially contributes to achieving broader economic goals, such as higher standards of living, high levels of economic activity and a greater number of jobs.

Effects of Inflation

Inflation is not considered bad so long as it creates additional employment to the factors of production. It becomes bad the moment it goes out of control. Inflation may be compared to a robber. It deprives the victim of some possession with the difference that robber is visible, inflation is invisible. The robber's victim may be one or a few at a time. But the victim of inflation is the whole nation. The robber may be dragged to a court of law but inflation

is legal. Inflation disrupts the economy and paves the way for social and economic upheavals, besides being highly demoralizing.

The entrepreneur faced with the demand for higher wages and trying to keep up with such a demand, a retired person trying to manage his living on a fixed pension, a person with fixed income meeting his needs of household expenditure by borrowing from banks and other financial organizations, and the housewife struggling hard to serve food in a period of rising prices are aware of the effects of inflation with out being told about it.

Effects of inflation on distribution: Inflation has the effect of redistributing income because prices of all factors do not in the same proportion. Entrepreneurs stand to gain more than wage earners or fixed income groups. Speculators, hoarders, black marketeers and smugglers gain on account of windfall profits. Change in the value of money also result in the redistribution of wealth, partly because during inflation there is no uniform rise in prices and partly because debts are expressed in terms of money. Inflation is a kind of hidden tad, highly harmful to the poorer sections of society. Thus, poor become poorer.

Effects of inflation on wage earners: Wage earners generally suffer during inflation, despite the fact that they obtain a wage rise to counter the rise in the cost of living. However, wages do not rise as much as the rise in price of those commodities which the workers consume. Further, wages are allowed to rise much later than the rise in prices. Thus, there is a lag between the two, which works to the disadvantage of the worker. If the workers are organized, they may not suffer much during inflation but if they are

unorganized like the agricultural laborers they may suffer more as they may not find it easy to get their wages increased.

Effects of inflation on middle class and salaried persons: The hardest hit are the persons who receive fixed income, usually called the middle class. Persons who live on past savings, fixed interest or rent, pensions, salaries etc., suffer during periods or rising price as their incomes remain fixed. The middle class who by hard work take care of children's education, livelihood in the times of sickness and old age and accommodate day to day expenses find it difficult to survive the times of serious inflation.

Effects of inflation on public morale: inflation result in arbitrary redistribution of wealth favoring businessmen and debts, and hurting consumers, creditors, petty shop-keepers, small investors and fixed income earners. This lowers the public morale. The ethical standards and the public morale falls to miserably low levels during the period of hyper-inflation.

Effects of inflation on debtors and creditors: Debtors borrow from creditors to repay with interest at some future date. Changes in price level effect them differently at different time periods. During inflation when the prices rise and the real value of money goes down, the debtors pay back less in real terms than what they had borrowed and thus, to that extent they are gainers. On the other hand, the creditors get less in terms of goods and services than what they had lent and lose to that extent.

Effects of inflation on Farmers: The price of farm products go up faster than costs. Costs lag behind prices of product received by the farmers. It has been observed in India that inflationary tendencies during war and post-war

periods have helped farmers in paying off their old debts. Moreover, farmers are generally debtors and have to pay less in real terms, while the land revenue, taxes, etc., do not rise much. Thus farmers generally gain during the periods of inflation.

Effects of inflation on the entrepreneurs: When prices rise, producers, traders, speculators and entrepreneurs gain on account of windfall profits because prices rise at a faster rate than the cost of production. Besides, there is time-lag between the price rise and the increase in cost. Moreover producers gain because the prices of their stock go up due to inflation. Also they generally being borrowers of money for business purpose, stand to gain.

Effects of inflation on Investors: Different kinds of investors are affected differently by inflation. An investor may invest in bonds and debentures which yield a fixed rate of interest or in real estate or equities (shares) whose returns (dividends) rise and fall with profits earned by the companies concerned. When prices rise, the returns on equities go up on account of the rise in profits, while the bond and debenture holders gain nothing as their income remains fixed. By the same logic, holders will lose during depression, while the debenture and bond holders gain.

Effects of inflation on Government: In a mixed economy, the public sector is affected by fluctuations in price level. As prices rise, the Government has to spend more on goods and services, including raw materials, for carrying through their projects. Estimates are revised and taxes are raised during the period of inflation.

The most immediate effects of inflation are the decreased purchasing power of the dollar and its depreciation. Depreciation is especially hard on retired people with fixed incomes because their money buys a little less each month. Those not on fixed incomes are more able to cope because they can simply increase their fees. A second destablizling effect is that inflation can cause consumers and investors to changer their speeding habits. When inflation occurs, people tend to spend less meaning that factories have to lay off workers because of a decline in orders. A third destabilizing effect of inflation is that some people choose to speculate heavily in an attempt to take advantage of the higher price level. Because some of the purchases are high-risk investments, spending is diverted from the normal channels and some structural unemployment may take place. Finally, inflation alters the distribution of income. Lenders are generally hurt more than borrowers during long inflationary periods which means that loans made earlier are repaid later in inflated dollars. What is Inflation .

Inflation is a rise in the general price level and is reported in rates of change. Essentially what this means is that the value of your money is going down and it takes more money to buy things. Therefore a 4% inflation rate means that the price level for that given year has risen 4% from a certain measuring year (currently 1982 is used). The inflation rate is determined by finding the difference between price levels for the current year and previous given year. The answer is then divided by the given year and then multiplied by 100. To measure the price level, economists select a variety of goods and construct a price index such as the consumer price index (CPI). By using the CPI, which measures the price changes, the inflation rate can be calculated. This is done

by dividing the CPI by the beginning price level and then multiplying the result by 100.