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Economics

Q. In the late 1990s a growing number of economists argued that world policymakers were focusing too much on fighting inflation. The economists also argued that the technical level of potential output had risen. Show their argument using the AS/AD model. Ans. During the 1970s and the 1980s inflation had risen to relatively higher levels as compared to the earlier decades. The tightening of the monetary policy was one of the action that lead to the fall inflation rate after remaining high for two continuous decades.

But economists in the past have argued that there has been too muchstresson fighting inflation during 1990s. The prime reasons for this argument is the fact that both fiscal and monetary side, i. e. both the instruments which managed the demand side of the economy where used for curbing inflation at a time when there was a technical boom in the economy in the form of enhancing productivity. This lead to the potential output of the economy to increase and therefore had a favourable impact on efforts to curb inflation.

This enhancement of productivity (which was primarily due to decline in prices of computers) during the 1990s especially the later half is the chief factor that lead to the shift of the aggregate supply curve of the economy as shown in the figure. The Aggregate supply curve shifts from AS0 to AS1. This shift is because of the technical progress during the concerned period. The technical progress caused the economy to produce a higher level of produce from the same amount of inputs because of productivity enhancement which caused the prices in the economy to cool off automatically.

This is visible in the graph where the aggregate price in the economy falls from P0 to P1. Therefore, the argument made by the economist during this period of unneeded stress being given on fighting inflation is valid from the macroeconomic point by looking at the aggregate demand and supply curve. The shift of the aggregate supply due to technical progress backs up the argument stating the fall in economy real prices in aggregate sense due shift of the supply curve.