The short run for a restrictive monetary policy economics essay

Economics

\n[toc title="Table of Contents"]\n

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1. ECONOMICS \n \t
2. Question 1 \n \t
3. Question 2 \n \t
4. Question 3 \n \t
5. Question 4 \n \t
6. APPENDICES \n

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ECONOMICS

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Question 1

The economic rationale underlying the use of monetary policy as a macroeconomic stabilization is that the Central Bank can intervene with money supply and interest rates as it is essential tools stimulate the economy or cool down the economy. The stimulation effect is known as expansionary monetary policy it is implemented when the country's employment, national income and consumption spend remains subdued. The MPC can lower the repo rate and thus money supply to encourage fixed private capital formation and in turn production will increase simultaneously with employment and national income. On the contrary, when the economy is on the boom phase, the Central Bank can curb upward trend by introducing restrictive monetary policy hereby it deliberately increase the

repo rate to reduce credit fund and consumption spending and lowers the detrimental effects of demand pull inflation.

Question 2

The Central Bank decided to keep the repo rate unchanged at 5% per anum; the decision means that the prime interest rate for the bank lending remains unchanged at 8. 5%. This decision was mainly influenced by the depreciating rand to the dollar. The rand recorded a four year low to the dollar at R 9. 29 in March this year. On the other hand inflation continues to be a concern, fuelled by the weakening rand. The chain reaction states that when the rand become weak the South African exports elevates and thus, this instigates an upward pressure on the demand for local goods and local suppliers increase their prices. This phenomenon is known as demand pull inflation which occurs when there is an excessive increase in aggregate demand. Moreover, the oil price perpetually is escalating to greater heights. Oil is the mostly used resources in production since it is utilized to manufacture petrol and diesel amongst many things. This massive aggregation has a direct impact on local freight, hence production cost tends to ascend and supply is negatively impacted and aggregate supply contracts. The law of demand and supply states that the lower the supply, the higher the product cost. With that been said it is clear that prices of goods will be pushed up. This leads to cost-push inflation. The South African economy has been struck by vicious wage settlements. The minimum wage settlement in the agricultural sector is 52. 5 % according to data released by Andrew Levy Employment Publications. Also the wage settlements in the collective bargaining picked up from 6. 8% in the third quarter of 2012 to 8. 2% in the fourth quarter of

the same year. The significance of these results is that, wages form major part production cost and therefore companies are forced to allocate more resources to pay for the production of the goods and services. To continue to maintaining profit margins, the companies pass the cost hike to the consumers making the retail price tremendously high. These wage negotiations further worsens the effect of cost push inflation. Eskom has also decided to hike the cost of electricity, since electricity used across all sectors of the economy production costs will continue to be pushed up by this 8% tariff and thus inflation remain a major concern.

Question 3

The linkage from the monetary policy to the real sector can happen in two ways. Firstly the restrictive monetary policy. The central bank can increase the repo rate, this will discourage lending money and creation capacity of banks, thus the money supply will contract. This will in turn cause excess demand in the money market. Sales of money markets instruments will cause the prices to decrease and since there is an inverse relationship between prices and interest rate (TVM formulae), the interest rate will hike and the money market equilibrium will be at a point where real money supply intersects with money demand, thus interest rate will peak at that point. The higher interest rate will discourage real investment, because most people will choose to invest in the derivatives in the financial markets and optimise their portfolio returns. When capital formulation shrinks, the symbol which denotes fixed capital formulation will decrease aggregate expenditure given by the function (C+I+G+X-M). Accumulation stocks discourage production. When production decreases, real GDP will decline,

unemployment will increase and thus real income will inevitably decrease since real income is equal to aggregate expenditure. The level of economic activities will experience a downswing. On the bright side, however, a decrease in aggregate expenditure which is synonymous with a decrement in aggregate demand means that the aggregate demand will decrease and this creates a lower pressure on the demand for goods. Thus the demand pull inflation will minimize and the price level of goods will stabilise. That is the inflation is likely to be low. Furthermore, a decrease in general price level of goods will encourage exports and enable local firms to compete in a globally competitive market for exports. The increase in exports will have a positive contribution to the national income Y. Also, the current account balance denoted by (X-Z) will improve and thus Y= C+I+G+X-Z will also be in a better condition. However, the net effect of the restrictive monetary policy will ultimately result in lower national income. Since the effect of a decrease in capital formation will exceed that of the current account. This is known as the Keynesian transmission mechanism in the short run for restrictive monetary policy. On the contrary, we have the expansionary monetary policy with which the central bank aims at stimulating the economy. Initially the MPC would decrease the repo rate and this will obviously encourage money creation and lending capacity of commercial banks. The money supply will increase and this will cause a decrease in the money demand. Investors will choose to keep their money markets instrument and this will cause massive increase in the prices. When prices increase, the interest rate will decrease. A decrease in the interest rate will cause an increase in investment spending, and an increase in investment will

be felt in the real sector by the increase in fixed capital formation will have a positive effect in the national income Y. Since national income is equivalent to aggregate expenditure and aggregate demand, all three variables will lift. The demand in the economy will exceed the supply and thus pull prices of goods and service, creating a general and sustained increase in price level of goods (also known as inflation). The increase in the national income means that demand will increase thus firms will have to expand their supply. In order to achieve this, firms will have to hire more labour. Employment increase and consumer have more disposable income and consumers can now afford to buy more goods, locally and abroad. Goods imports will increase and the current account will deteriorate. This will have a minute negative impact on the local national income. In addition, inflation increase will make our exports more expensive for foreign buyers. Thus exports will further increase the current account deficit. Looking at the Keynesian transmission mechanism in conjunction with the South African economy at the moment, the following conclusion can be drawn: South African Reserve bank which acts as cornerstone for the South African economic stabilization has decided to leave the interest rate unchanged, so the equilibrium in the market will remain and the repo rate is still at 5% and the bank lending prime interest rate remains rigid at 8. 5%South African bond and equity inflows has been sustained for quite a long period of time, and this is expected to continue since the interest rate was not changed. Theoretically a 0% delta in the interest rate should leave capital formation unchanged. However, when we move to the real sector of this developing country, we see that the rising inflation and perpetual hikes in the petrol price steals

away the amount of disposable income that households possess and also, the marginal propensity to consume increases simultaneously with the rising price levels in the economy. This triggers a downward pressure on aggregate demand and thus domestic supply contracts. Statistics show that the economic growth (measure by the change in real GDP) will be a bit overcast with a little hit of sunshine expected later this year. It is however projected to fall under the 3. 5% potential output growth. The decrease in economic growth has a positive correlation with unemployment. Unemployment will decrease, thus lowering the real GDP. Wage settlements are also dragging down employment indirectly. The weakening of Rand is likely to encourage exports and reduce the current account deficit slightly.

Question 4

We strongly corroborate the recent decision taken by the MPC of not adjusting the interest rate. If the MPC opted for an expansionary monetary policy, that is, reduce the interest rate, consumption spending by household was going to increase and further creating demand pull inflation. Inflation was going to escape the 3 to 6% target interval, and with recent wage settlements cost push inflation was also going to take over. The inflation problem was also going to hinder exports growth. The weakening rand creates an opportunity for exporters in the country. However excessive inflation would pose a threat to this particular benefit. On the other hand capital inflation was going to decline. On the opposite end, a contractionary monetary policy intervention was going to further decrease the economic growth and employment was going to be scaled down tremendously. Therefore our ultimate inference is that the momentary policy made a sound

decision considering all the mutations in the developments and inflationary distress.

APPENDICES

See graphs attached to support question 4