Governments role in managing an inflationary economy

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Government’s Role In Managing An Inflationary Economy Introduction

Inflation is an economic phenomenon in which the prices of all commodities increase while the value of money decreases. In other words, in an economy with higher inflation rates people, especially the poor and middle-class people struggle to find enough money for meeting their expenses. Both low inflation and high inflation rates are equally dangerous. Higher inflation rates make ordinary people’s life difficult because of higher prices of commodities whereas low inflation rate results in output loss, unemployment and distorted investment and consumption decisions. Below 5 or 6 percent inflation rate is acceptable everywhere. However, when the inflation crosses beyond that, people and the government become panic. Only the government can do something to control the inflation rates in a country since government policies are responsible for controlling the prices of commodities in a country. This paper analyses the Government’s role in managing an inflationary economy.

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According to Poterba & Rotemberg (2007), there is a positive correlation between tax burdens and inflation rates (p. 1). In other words, when tax rates increase inflation rate also increases and vice versa. Since Government is responsible for fixing tax rates in a country, they can definitely control the inflation rates with the help of adjustments in tax rates. For example, when the government increases taxes on petroleum products, the prices of petroleum products increase, and subsequently the prices of all commodities increases. It should be noted that price hike in petroleum products may increase the transportation costs of the commodities and hence prices of commodities increase. Only the government can effectively interfere in such situations to control the prices of commodities by controlling the prices of petroleum products.

Han & Mulligan, (2001) argued that inflation is evidence of a government that cannot make credible promises (p. 9). Price hikes always make ordinary life difficult. The credibility of the government will be lost when price hike happens in the country. It should be noted that the governments will lower the interest rates to control inflation. Lowering of interest rates will help the public to borrow more from the financial institutions so that economic activities may increase. Increase in economic activities may bring the inflation rates down. At the same time, lowering of interest rates may cause problems to the investors as they may not get adequate returns on their investments. In short, the government is responsible to decide the interest rates and tax rates which have direct relations with inflation rates.

“ While some scholars are of the belief that increasing public expenditure enhances economic growth and inflation, others are of the view that, increase in government spending have the tendency to slow the performance of an economy in both developing and developed countries’ (Olaiya, et al., 2012, p. 65). In short, it is the duty of the government to decide the optimum level of inflation rate needed to boost the economic growth based on the economic climate of the country.

Even though inflation rates increase rapidly over the last couple of decades, consumer price index is not increasing at that rate. " In the past 12 months, the Consumer Price Index has risen just 1. 5%—a remarkably low rate. Many economists will point out that wages are also rising by less than 2% a year”

(Why You Can't Trust the Inflation Numbers, 2011). It is a fact that along with inflation rates, wages also increases every year. When wages increase, people may not feel the negatives of inflation hikes. It is the duty of the government to adjust wages based on the inflation rates in a country. People may feel pressure when the inflation rate goes in the higher direction and the salaries remain stable. In short, the government is responsible for controlling the inflation rates in a country.

It is possible for the government to print more money to reduce inflation rates. However, “ When the government makes new money and spends it, the effect on prices and the supply of goods and services is no different than when a private counterfeiter does so” (Younkins, 2000). In short, the government has to take more money, they cannot raise the taxes beyond certain limits and they cannot increase or decrease the interests rate beyond the certain limit. In short, inflation is a situation which should be handled carefully by the government.

Conclusions

Only the government can interfere effectively to control the inflation rates in a country. Ordinary people have nothing to with it. The government should adjust interest rates, tax rate, and wages judiciously to keep the inflation rate within the acceptable range.

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