

A phenomenon of
rising prices
economics essay



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One of the macroeconomic objectives is to have a steady rate of inflation. Inflation can be defined as the persistent and continuous rise in the general price level over a period of time. The impact of inflation on an economy is a rise in the cost of living and a reduction on its purchasing power of the population.

As a phenomenon of rising Prices:

Definitions given by the economists like Crowther, Gardner Ackley, and H. G. Johnson regard inflation as a phenomenon of rising prices.

According to Crowther, inflation is a “ state in which the value of money is falling, i. e., the prices are rising.”

In the words of Gardner Ackley, “ Inflation is a persistent and appreciable rise in the general level or average of prices.”

Harry G. Johnson states, “ I define inflation as substantial rise in prices.”

As a Monetary Phenomenon:

Economists like Friedman, Coulborn, Hawtrey, Kemmerer, define inflation as a monetary phenomenon.

According to Friedman, “ Inflation is always and everywhere a monetary phenomenon.”

Coulborn defines inflation as “ too much money chasing too few goods.”

Hawtrey defines inflation as the “ issue of too much currency.”

According to Kemmerer, “ Inflation is too much money and deposit currency, that is, too much currency in relation to the physical volume of business being done.”

Paul Einzig defines inflation “ as a state of disequilibrium in which an expansion of purchasing power tends to cause or is the effect of an increase in the price-level.”

Prof. E. James defines inflation as a “ self-perpetuating and irreversible upward movement of prices caused by an excess of demand over capacity to supply.”

Prof. Ackley has defined inflation “ as a persistent and appreciate rise in the general level or average of prices.”

Monetary inflation “ Inflation is always and anywhere a monetary phenomenon in the sense that it can only be produced by a more rapid increase in the quantity of money in output.”

Is inflation harmful or desirable?

A mild rate of inflation is beneficial for an economy by 1-2% through which economic growth can be achieved gradually. Every government aims to preserve a mild inflation rate because the benefit of the economy lies on it.

A hyper-inflation rate or galloping inflation is disastrous for a country and can be the cause of breakdown in a nation such as in Zimbabwe where their money has no value on the international ground.

Monetary policy

Monetary policy is one of the core policies that appropriately suit to curb inflation. It is the manipulation of the amount of money and credit available, and the cost of that credit to borrowers, that is, interest rate in an attempt to influence total demand in a particular (Lipsey & Harbury 1992). The policy is usually implemented by the central bank on behalf of the government.

Hence, it is one of the traditional macroeconomic tools by which the government attempts to achieve its objectives. It should be noted that changes in the rate of interest is now the main government policy measure being used to influence the macro economy on a day to day basis. The rate of interest affects the economy through its influence on aggregate demand.

The higher the rate of interest, the lower the level of aggregate demand.

Generally, to stimulate aggregate demand during a recession, the appropriate monetary policy would be an expansionary policy. Conversely, to curb spending during a boom, a contractionary monetary policy would be appropriate.

The Classical Approach

From the classical economic perspective, the main assumption was that the market economy was believed to automatically operate at full employment. This is because they accept Say's Law (J. B. Say), that is " supply creates its own demand." In simpler terms, there must be the output first in the market to enable consumers to demand for them. Hence, it assumes all output is sold. Due to scarce resources, the amount supply is limited, thus the aggregate supply curve will always be vertical at full employment. This can be illustrated as follows:

From the above diagram, initial aggregate demand and aggregate supply are AD and AS respectively, intersecting at point E. According to this school of thought, money is a veil and is neutral in its economy. Therefore, the real and monetary sectors are separated which is known as classical dichotomy. According to the Quantity Theory of Money, that is Fisher's equation where

$$MV = PT.$$

The equation simply says that 'the amount spent is equal to the amount received.' Besides the equation hold V and T constant. If the equation goes in line with these assumption, it can be said that a doubling of the money supply must be associated with a doubling of the price level. Hence, the classical economists believe that a change in the supply of money would lead to a proportion change in the price leaving real variables unchanged.

Thus, from the above diagram an increase in money supply would shift the aggregate demand to the right at AD1 cause the price to increase from OP to OP1. Hence, the additional money supply causes the price of output to move in a proportional manner at full employment.

However, the classical approach did not last forever. Before the Great Depression was experienced, the classical doctrine was almost universally accepted by economist and policymakers; henceforth the classical approach has been given less importance.

The Keynesian Approach

Keynes had argued that, in times of profound depression, monetary policy might be totally useless as a means of motivating aggregate demand. By the time of the Radcliffe Report in 1959, most Keynesian economists held the

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view that there was no fundamental link between quantity of money and aggregate demand. The Keynesian totally opposed the classical economist in the sense that an economy is always below full employment and supply responds to demand. At full capacity the supply curve would be vertical. Keynes believes that the link between money supply and real GDP are of reverse direction. This can be explained by an achievement of expansionary monetary policy where there is an increase in money supply. The latter will lead to a diminution in interest rate. Hence, discouraging people to put aside money and support people to take loan to benefit from low rate of interest. Therefore aggregate expenditure on investment and interest sensitive consumption goods generally increase. Thus, there will be too much money in movement in the economy which harms purchasing power causing real GDP to rise. Hence an expansionary monetary policy influences the real GDP unfavorably.

Keynes believes that the economy is proficient where the aggregate demand is equivalent to aggregate supply. There will be a condition of disequilibrium when there is surplus demand over supply. To bring that disequilibrium to equilibrium, an increase in money supply is needed which lead to an increase in price level. However, there will be a situation where the economy operating at full capacity. Therefore, the supply curve would be vertical. This can be demonstrated as follows:

The Monetarist Approach

Monetarism is a macroeconomic theory stood of criticism of Keynesian economics. Nominal GDP is determined to some extent of the supply of money as well as the price level are the basics of the monetarist approach

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which are highly crucial in interpreting the monetarist. Milton Friedman is one of the economists that largely contribute to monetarism, thus known as the “ Founding Father” of monetarism. It is much related with the classical school of thought. Much of the monetarist’s theory is a progress of earlier classical theoretical work.

According to the monetarists, inflation is said to occur when the increased supply of money exceeds the rate of growth of national income. Obviously, there would be too much money in liquidation that must be restored by increasing the value of goods and services. Besides, changes in the rate of interest do not affect the demand of money since it is constant. Therefore, to increase aggregate demand, surplus of money is required so that households can quickly spend by adopting an expansionary monetary policy. Unlike classical economists, the monetarists have a more realistic view such that an economy operating at full employment level of real GDP is quiet impossible. Hence, increasing aggregate demand by adopting an expansionary monetary in the short run will result in an increase in the level of real GDP. On the other hand in the long run, all factors of production are fully utilized which render the economy to be at its efficient level, therefore the relationship between the supply of money, the real GDP and the price level remains a good guess from the classical quantity theory point of view. Expansionary monetary policies only escort to inflation and do not have an effect on the level of real GDP in the long run.

New Classical Economic

The theory is based on the role of rational economic agents and the theory of rational expectations, emerging during the 1970s. It all depends on the

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future expectations, for instance, prices of products are expected to increase in the future; producers might stop production or slow production actually in order to make profit when the price goes up. New Classical Economic uses the standard principles of economic analysis to understand how a nation's total output is determined.

New Keynesian

New Keynesian economics is a school of contemporary macroeconomics that strives to provide microeconomics foundation for Keynesian economics. Two main assumptions define the New Keynesian approach to macroeconomics. New Keynesian macroeconomic analysis usually assumes that households and firms have rational expectation. New Keynesians assume that there is imperfect competition in price and wage setting to help explain why prices and wages can become “ sticky”, which means they do not adjust instantaneously to changes in economic conditions

THE QUANTITY THEORY OF MONEY

The quantity theory of money was developed by Irving Fisher in the 16th century, also known as the equation of exchange. Gold and silver which were always valuable, were being transferred from America to Europe and converted into coins, as a result there was a significant rise in inflation. In 1802, economist Henry Thornton believed that as there is more money in circulation within the economy means a rise in the general price level and an increase in economic output do not necessarily mean an increase in money supply. Hence, an increase in the supply of money within an economy equally gives rise in the price level of goods and services which according to the quantity theory of money imply a direct relationship. That is an increase

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in money supply leads to rise in level of prices causing inflation. This is because the same quantity of the good and service will be paid at a higher price that is a decrease in the purchasing power. The theory recognizes that money is like any commodity; hence an increase in money supply will decrease marginal value that is one unit of currency will have a much weaker value. Hence, an increase in money supply will require more amount of money for the same commodity for the purchasing power.

Irving Fisher's version of the quantity theory can be explained in terms of the equation of exchange:

$$\mathbf{MV = PT}$$

Where; M= Nominal stock of money in circulation (money supply)

V= Velocity of circulation of money

P= Average price level

T= the number of transaction

MV refers to the value of total expenditure and PT refers to the value of goods and services sold. Thus, Fisher's equation of exchange is really an identity which must always be true. The theory assumes that both V and T are constant in the short term; the price level is determined solely by the nominal money stock. An increase in money stock will lead to a relative increase in the price level.

The Rational Expectation Theory

Inflation can also be determined significantly by the level of expectation and in recent years according to economist and core parties have taken this factor into account. In Economics, people based their options on their rational viewpoint, available information and past experiences and this kind of expectations as being the same to the best guess of the future that uses all existing information. One of the main motives expectations is important because people are concerned about their wage claims. If the general price level is expected to rise, this will reduce the purchasing power of the income earners. Hence the employees require an increase in their wages to compensate for the increase rate of inflation. This increases firm's overheads and so can in itself cause inflation. Moreover, if a firm considers that the price for its products will be superior in the future, being profit motive, the producers will react in a certain manner that will fully be advantageous to them such that buy the raw materials and manufacture the products now and retain the commodity until there is a rise in price as per their expectation. The company declines supply while demand keeps on the same, price will rise. In simple words, price is believed to increase in the future by producers that affect the production patterns and decision which somewhat affects what happens in the future.

John M. Roberts (2002) inspects the degree to which shifts in monetary policy can report for an important change in the liaison between unemployment and inflation. The belief that monetary policy should have an effect on inflation dynamics is an old one, dating at least to Friedman's dictum that "inflation is always a monetary phenomenon" (1968). John M.

Roberts investigates the effects of more realistic changes in procedure on inflation dynamics. He first of all, considers monetary policy may have become more hasty to output and inflation instability around the early 1980s (Clarida, Gali, and Gertler, 2000). Secondly, monetary policy may have become more knowable, meaning smaller shocks to a simple monetary-policy reaction function and lastly, Orphanides et al. (2000) argue that policymaker calculates approximately of potential output may have become more precise. Additionally, he examines the forecasts of these changes in policy for inflation dynamics and the economy's unpredictability using stochastic simulations of two macroeconomic models. Consequently he brings to a close that changes in monetary policy can explain for most or all of the reduction in the gradient of the reduced-form Phillips curve as well as changes in policy can also account for a large section of the reduction in the volatility of output gap, where the output gap is the percent difference between actual output and a measure of trend or potential output. Finally in his studied, he concludes that monetary policy's capability to account for changes in the economy is improved when changes in monetary policy are enlarged to comprise improvements in the measurement of likely GDP.

The purpose of Lumengo Bonga-Bonga and Alain Kabundi in their study of "Monetary policy instrument and inflation in South Africa" is to evaluate the scope to which the monetary policy instrument, namely the repo rate, manipulates inflation rate. They make use of the structural vector error correction model to illustrate the dynamics of inflation to monetary policy instrument shocks. In the early 2000, the South Africa Reserve Bank approves the inflation rate targeting as its monetary policy with the aim to

mark a range of 3-6% within two years. This study found that positive monetary policy shocks are incapable to negatively involve inflation after a period of more than 20 months. This pointed to the futility monetary policy in affecting inflation in South Africa. Likewise, monetary policy in South Africa seems less persuasive in restricting demand for money, though this should be an important channel through which monetary policy should have an effect on inflation. These facts provide evidence that economic agents in South Africa are to a large extent tactless to short-term interest rates. Credit demand by the private sector remains resistant to central bank policy. However, this study demonstrates that monetary policy does affect the real output in South Africa. A positive monetary policy shock drops off manufacturing production after six to seven months. The study concludes that inflation rate targeting as practical in South Africa does not help to rein in inflation and credit demand by the private sector remains invulnerable to central bank policy. The study then proposes that like in the USA, a dual inflation and employment (real output) target may be an alternative to deem for monetary policy in an emergent country such as South Africa

Many industrialized countries have only just adopted a tactic for monetary policy known as “inflation targeting”. Ben S. Bernanke and Frederic S. Mishkin (1997) argue that it is best understood as an extensive outline for policy, which permits the central bank “constrained discretion” rather than as an ironclad policy rule in the Friedman common sense. The feature of inflation targeting is the statement by the government, the central bank, or some combination of the two that in the future the central bank will attempt to hold inflation at or near some numerically specified level. They

furthermore talk about the potential of the inflation-targeting approach for making monetary policy authority. In making inflation, a global variable, the focus of monetary policy, the inflation-targeting approach in most cases considerably reduces the role of formal transitional targets, such as the exchange rate or money growth. They say that the agenda has the potential to serve up two important occupations: improving communication between policy-makers and the public, and proving increased discipline and accounting for monetary policy. According to them, it is too premature to offer a final verdict on whether inflation targeting will develop to be a vogue or drift but a number of advantages have been illustrated from the approach.

Jordi Gali (2002) tries to provide an general idea of some of the recent improvements in the literature on monetary policy in the existence of nominal inflexibilities as well as to accentuate the existence of several dimensions in which the recent literature provides a new angle on the linkages amongst monetary policy, inflation, and the business cycle. He presupposes the natural assumption that it performs as a compassionate policy. A common dispute against the practical importance of a monetary policy rule strains the fact that its execution requires having far additional information than those available to actual central banks. According to Jordi Gali (2002) the research program has surrendered several new insights, as well as a number of results that one may view as unanticipated, regarding the linkages between monetary policy, inflation and the business cycle. On the contrary to what some economists might have forecasted, the effort to incorporate Keynesian-type elements into a dynamic GE structure has gone beyond . providing rigorous microfoundations to some pre-existing, though

largely ad-hoc, framework. Furthermore, that investigate program is making significant evolution towards the development of a typical framework that can be used expressively for the purpose of assessing other monetary policies.

In this paper, we use a small empirical model of the US economy to examine the performance of policy rules that are consistent with a monetary policy regime of inflation targeting. Inflation targeting in these countries is characterized by (1) a publicly announced numerical inflation target (either in the form of a target range, a point target, or a point target with a tolerance interval), (2) a framework for policy decisions that involves comparing an inflation forecast to the announced target, thus providing an “inflation-forecast targeting” regime for policy, where the forecast serves as an intermediate target (cf. Haldane 1998; King 1994; Svensson 1997a), and (3) a higher than average degree of transparency and accountability.’

Dr Paul Dalziel (1996)’s paper presents a model of inflation that is engendered by an overload supply of credit money without any base impulse from government but depends on three variables: the marginal debt-capital ratio of firms, the money-wealth ratio of households and the economy’s supply-side growth rate. Therefore, the model of the paper is apprehensive accurately with the subject; namely the relationship between private sector money creation and inflation. The input result of Dr Paul Dalziel is supported on the following equation:

$$P = [(d-h)/h] g$$

Where p denotes common price of investment goods and equities, g is the certain growth rate, d is the marginal debt-capital ratio of firm and h is the money-wealth ratio. The equation refers to changes in the average price of equities, which is understood to equal changes in the average price of capital goods by appeal to the long-run value of Tobin's q -statistic. Furthermore, according to Dr Paul Dalziel from the above equation, it is obvious that a pre-existing inflation can constantly be reduced by slowing down the economy, since, *ceteris paribus*, a reduction in the growth rate, g , generates a reduction in the inflation rate, p . The model, yet, advocates alternative options for supplementary research attempt.