Keynesian and monetarist theory of inflation

Inflation is a fed up increase in prices. The overall prices of goods and services are raised in general movement in and economy, which also means such goods and services are being cost more than the actual value of money. It is usually the change of measurement between Consumer Price Index and the Producer Price Index. The more increase in those cost of goods and services, the more decrease in the currency value of that country as the public could not able to buy as much dollar anymore as they could before. Inflation can be caused by offering very few goods for sale.

Here in task (2) , I would like to describe about the two different cause of inflation : The Demand-pull inflation and the Cost-push inflation by using the Monetarist' and Keynesians' point of views.

Demand-pull Inflation by Monetarist

The Monetarist basically believes that the demand-pull inflation happens when the level of cumulative demand increases and almost entirely influence to the fundamental level of supply. This kind of inflation is born out of the relation between the consumers demand and the supply of products. As an example, even if the consumer demand are just focusing on the rate materials or just on one kind of the product, and the supplier are not able to provide the market with the equal amount of required demand, there will naturally become the inflation and this is named is the demand-pull inflation. Monetary explained that it is easier to think of the supply as the rank of ability. If the suppliers just only have the ability to produce is 10 % and the demand of the consumer market moving at the same rate of supply, there will not be the problem as the consumers are provided all they needed. On the other hand, if the supplier can supply 10% to the market and the rate demand of consumers are about 50%, the products will not be enough for the customers to consume. This will leads to the Demand-pull Inflation. The Demand-pull inflation of the Monetarist's view can be expressed as the diagram below.

Cost-push Inflation by Keynesian

According to the Keynesian view, the cost-push inflation can be occurred when the cost of production gets higher rapidly but the demand for those products and services remains the same. Such extra costs of production will be added to the price of goods and services which passed through the consumer, means that there is the increase in selling prices. As an example, if there is an unexpected decline in the supply of oil or gas, the prices of such products or resources will be high as the producers of such materials, especially the imported goods are added the additional costs and finally provided the consumers in terms of higher prices. Moreover, there is also another explanation mentioned by the Keynesian which cause the cost-push inflation. The wholesale price of the products is usually depends on the recent wages and salaries of the workers who produce it. That's why, when the payments of the wages for the workers are increase according to the current economy of less supply, the production cost are going to increase as well as the company must make a profit by the products they manufactured. If not, the company must not be able to pay for the salaries for workers and employees. Consequently, the cost-push inflation comes about because of those factors.

Task – 3

The significant increase in inflation will reduce the purchasing power of money, which means it will slowly make the value of money to become worthless depending on the increasing amount of inflation year by year. Depending on such facts, the three types of examples that will be affected by high inflation are as follow:

For an individual who just keeps all his money in a box under his bed

The savings or the wealth will decline for such kind of people who just keeps their money under the bed without doing anything. Here is the formula for calculating the real amount of inflation and by using it, we can see that how much money are become worthless after increase in inflation.

Inflation rate = (CPI of current year – CPI of previous years) / CPI of previous year x 100

CPI = Consumer Price Index

According to that equation, if the inflation occurs, the person who does not make any investments will actually become decline in his or her savings. In my opinion, those people should invest their money in buying land or gold in order to prevent inflation. Because the value of such kinds of things, like land or gold will not decline and even just ascend in its value of money invested, however the change in inflation is. But for those kinds of investments are higher risk as those can get higher return as well as higher loss. Another way of investing money is saving in banks because it is safer than others and it still can get the interest from the banks, however it only gets the least return. So, it will be so much better to make some investments just rather than keeping inside.

For a borrower which the money at the current rate of inflation but who does not have to pay back for a number of years

Someone who borrows money with the rate of current inflation but who does not have to pay back for a long time with a fixed rate, such people will get benefits from inflation as it is in fact reduces the cost of future interest payments.

Debt servicing burden = (Debt payment rate – Growth in wage) + Price inflation rate

According to the debt payment formula, we can see that only the price inflation does not lessen the amount of debt taken by the borrower however the income or the wage of those people are increasing according to the change of inflation rate. But the payments or the borrowed money rates are still remain as the same prices. As an example, if someone borrows money for about $10 in the current rate of inflation and he or she does not need to repay for a long time. After 10 years, the inflation rate will not be as the same as the past and the previous amount of money $10 that he borrowed will be worth about $1000 at the current rate. But however the value of currency is changing, the amount of money that the borrower needs to give back is still remain as $10 even it is worthless at the current time. As from the point of nominal interest rate, it will still remain even the inflation gets higher and the borrower might even gets the benefits from interest rate according the equation (Real interest rate = Nominal Interest rate – Inflation in current year) . Moreover, in my point of view, the borrower is better to make an investment with the money that he had borrowed , this will lead him to get more benefits when the rate of inflation is higher.

For the lender who will not be repaid their money for a long-term with the current inflation rate

For the lender, he or she will be affects oppositely from those of borrowers which had explained above. As the inflation become higher and the money which is lent to the borrowers is not paid back by them for a long time, as a result, even when the borrowers paid back to them after many years, the amount of money will not change as he had borrowed in the past, however there is an increase in the rate of inflation. So, they would be lost large amount of money if they calculate with the current value of currency. On the other hand for the interest rate, he or she will lose money when the inflation gets higher but there also will be the chance of deflation and thus that can lead to gets return again, by the formula shown above.

Task – 4 (20 Marks)

As inflation is regarded as a bad process which leads to the financial and currency problems in an economy, government of all countries are trying to stop or prevent it in time. Inflation can be mentioned as the general increases in prices of goods and services. But even there is increase in such prices the income still remains the same. Because of those facts, the currency in the country becomes worthless and thus the government may wants to undertake that problems of inflation for some more reasons.

Inflation can be affected to the allowance of public income. This problem is usually occurs within the public among the lenders and borrowers. Because if a lender lends the money to a borrower at the time of keeping on inflation rate, the loan that acceptable previously are paid back later in terms of inflated dollars. So, this can mentioned problems for the lenders and the maximum amount of such problems can lead to the inflation crisis in a country.

The country of high inflation will lose much attention on the productivity which means the higher productivity is one of the ways of improving the overall living standards in the country and thus it is important to take care of it. With high inflation, the increase in salaries and wages of employees or industrial workers will be overwhelm according to the high inflation and finally, the productivity issues will become less attention and even neglected by the government or the business owners.

The high inflation leads the country’s economic condition to be more changeable because as the rate of inflation could varies any time and this lead the government and business people to predict the future cost and prices. That’s why they tend to do the slower decision making of business investments. As for a long term, this will going to affect contrarily on growth of economy.

As inflation makes to value of money to be reduced and thus it will affect to the people who do not make any investments and just keep their money under the bed which is more common among the seniors or the pensioners.

These are some of the reasons of high inflation which could impact on the economy.

I would like to describe the two different types of inflation as the examples, and the key to solve the each type of inflation.

Firstly, the government can use the Deflationary policies in order to solve the problem of demand-pull inflation. Deflationary policy can be used by managing the level of increasing demand in the economy, or by reducing government expenses, or by increasing tax rates or increasing interest rates in a country.

Secondly, as for the cost-push inflation, the Incomes policies can be used to reduce cost-push inflation. Fundamentally, it can use by controlling the high wages payments and making higher amount of supply or raw materials for the industries. Moreover, the government should also effort to make higher competition in all parts of economic segments, deregulation, privatization and liberalization to some economic policies.

Task – 5

Supply-side Economics

Supply-side economics, which is also known as trickle-down economics, is an economic theory that a reduction in tax rates, especially for businesses and wealthy individuals, stimulates and promotes growth in the economy by the government. It includes the incentives, the low tax rates so that the investors and the entrepreneurs may invest their money towards production.

Supply-side policies used in United Kingdom's economy during the 1980's

The causes and the costs of inflation in the UK economy occurred in the Macroeconomics History. The pre-1979, UK economy suffered from supply-side failures which the UK government and its economic market could not get rid of. But the government of 1980s got achieved goals by improving the policies of earlier supply-side. The year between 1945 and 1979, it is shown that the economy growth in UK is slower than the other countries and this will affect the lower rate of production per person. This caused as the major weakness for the inflation concerned with labour market among other countries. During the 1980s, the productivity of the UK is significantly decreased and the government changed some policies of supply-side economics as follows:

Most major utilities such as Gas, Water and Electricity were sold out to other countries by the government and some were let to remain in the stock market. The lack of such natural resources had led to more competition, the lower prices promotions and the better quality of services among the industries such as telecommunications.

The income tax was cut mostly to the wealthier businesses in the 1980s. It is shown that the top rate of income tax decreased from 60% to 40%. The overall amount of tax has not fallen as the government had already raised the indirect taxes such as Value Added Tax (VAT).

According to the new supply side policies, it was become more difficult for the employment union to operate among the manufacturing industries as there was declined in productivity and thus the power of that union has fallen and it will prevent the inflation problem that has been happened like in 1970s.

During the 1980s in UK, the government allows the irregular financial services markets which mean they ordinary building of civilization can operate like banks and moreover, there were also the organization which could provide mortgages and these will results as the competitive market and lower borrowing costs among the economy.

There was also the new arrangement of reducing the amount of unemployment. That was such jobless people could get the benefits from the government in the more difficult ways and those benefits were already mention as the price of inflation and thus those were less than the wages. That’s why, we can say that it will encourage the people more to get the job.

According to those polices, the references mentioned that the inflation in UK during 1980’s got success by using the Supply-Side Economics Policies such as a large fall in unemployment and it is also shown that the UK current employment is recorded as the highest rate in EU. Moreover, we can see that the inflation rate in UK can also be successfully controlled by using such policies.

The United States applied the Supply Side policy in the 1980s

In the United States during the 1980s, the supply-side polices were applied to improve the US economy and maintain low unemployment. The fundamental procedure includes the methods of changing employee workforce skills, the arrangements for tax cuts, benefit cuts for the unemployed, motivating the labour to work hard and produce better goods or services. In addition, there are also more supply-side policies in order to keep up and improve the US economy in the 1980s and 1990s. The new policies are based on :

- Creating hard-to-employ jobs and those employees will get more benefits compare to the unemployed
- Reducing business taxes in order to let the business people to make more investments in business and thus the production of goods and services will get higher
- The instructions or rules that are set up by the national government are become lesser
- Reducing the government expenditures
- Controlling the money supply

By changing such policies made the US economy to be more improvements and secure. The consequences by using those supply-side policies and regulations led its economy to increase the supply and decrease in large demand. The reduction of the rates of taxes also motivated the people to work hard. Controlling and limiting the government expenditures saved more extra nations' income and also increase in productivity. According to the findings, it showed that the US economy had increased significantly in productivity and its inflation rate also went down near to zero levels after setting up the supply-side policy.