1.Discuss with suitable examples the concept of “change in price and ‘inflations’

Money and price are important parts of an economy. Knowing how money and price work in the economy is important for making market-oriented policies. As a result, being aware of changes in price levels is crucial in an economy. Since the market's demand and supply determine the concept of "change in price," a rise or fall in an economy's demand and supply will also alter the economy's price levels. Because of the shifts brought about by the forces of supply and demand in the market, changes in an economy's price levels never follow a straight line. On the other hand, this price change can also be attributed to particular sectors or industries, and external crises can raise a commodity's price level. For instance, as silicon is a crucial component in the assembly of automobiles and computer equipment, the COVID-19 pandemic's silicon shortage resulted in an increase in car and computer equipment prices. This was because of the pandemic, when people preferred to drive their own cars to public transportation for safety reasons. This led to a high demand for automobiles, which eventually resulted in a short-term increase in automobile prices. This illustration demonstrates two things: 1) how the factors of demand and supply affect the price level of a particular commodity in a market; and 2) how the price levels of only one commodity may rise at a time depending on the market's external circumstances. However, a shift in price levels is not the same as a shift in inflation. While inflation refers to an increase in the market's overall price levels, a change in the price level can be related to a specific commodity. Price indexes like the GDP deflator and the Consumer Price Index (CPI) can be used to calculate this overall price increase. A rise in the rate of inflation results in a decrease in the value of money and its ability to be purchased because inflation is a problem that pervades every economy. Because of this, we can also refer to inflation as an ongoing rise in price that can be observed over time (for instance: over the course of a fiscal year). The aforementioned price indexes, which vary from nation to nation, illustrate this price rise. For instance, inflation can be defined as the change in price or the apparent decrease in the value of the Nepalese currency when goods like clothing or food in Nepal during our parents' time do not cost the same as they do today. In conclusion, factors like high demand and low domestic supply affect inflation, which then puts pressure on foreign exchange. To meet internal demand, a country imports more goods, drains foreign reserves, and the country enters an economic crisis.

2. What are the purposes of inflation targeting, and how does this monetary policy strategy achieve them? Should Nepal follow inflation targeting regime? Support your arguments with suitable examples.

Price levels rise as a result of inflation, which also reduces the value of money. The main goal of monetary policy in an economy is to control inflation and achieve price stability in the market because of this phenomenon. Inflation targeting is said to be the most effective monetary policy strategy for maintaining price stability. The term "inflation targeting" refers to a situation in which monetary authorities specify the inflation target explicitly and create precise institutional arrangements to achieve it. To put it another way, inflation targeting is a way to implement monetary policy in which decisions are influenced by expectations of future inflation in relation to the stated inflation target.

The following is a list of the goals and purposes of inflation targeting in monetary policy:

1) The need to achieve price stability is one of the primary goals of monetary policy and a primary purpose of inflation targeting;

2) Inflation targeting also serves the purpose of increasing the transparency and accountability of monetary policy; and

3) Inflation targeting also makes it possible to easily monitor inflation targets and also serves as an anchor for inflation expectations.

4) In conclusion, inflation targeting also serves the purpose of giving the monetary policy more credibility.

There are two main prerequisites and two additional prerequisites for inflation targeting.

1.The first prerequisite is the presence of a competent central bank that is able to independently carry out monetary policy.

2. In the absence of any firm commitment on the part of the authorities to target any additional variable, such as the exchange rate.

Additional requirements include the following:

1) The central bank must have effective instruments for monetary policy;

2) The central bank must have characteristics like independence, along with increased accountability, transparency, and public communication.

A nation can choose to use the inflation targeting method if these conditions are met.

Yes, Nepal ought to adhere to the inflation-targeting regime in the context of the country. This is because, in the current state of affairs in Nepal, as the rate of inflation continues to rise and prices rise, the country has moved to an inflation-targeting regime to keep inflation in check by properly announcing inflation targets and expectations. The NRB can begin formulating monetary policy around the established targeted and expected inflation after finalizing the inflation expectations and target, and it can use the appropriate monetary policy instruments to achieve the established target. Nepal can theoretically implement an inflation-targeting policy and effectively combat inflation through monetary policy in this manner. However, in reality, Nepal is unable to choose an inflation-targeting regime because it does not meet the requirements, and the absence of institutional changes geared toward inflation targeting makes it difficult for Nepal to switch to inflation targeting immediately.

3.What do you understand by the term Neutrality of money?

The idea that "changes in the money supply will only bring changes in the price levels and do not affect the level of output or employment" can be used to describe the neutrality of money. The neutrality of money is one of the important propositions of an inflation-targeting regime in light of this definition. Controlling the money supply would directly control the economy's inflation and price levels without affecting the economy's output or employment levels, which is an assumption that policymakers can make when formulating monetary policy to target inflation.

4. When the money supply increases, it causes a price level effect on interest rates.

a) What is the price level effect?

b) What is the direction of its impact?

The phenomenon known as the price level effect occurs when inflation alters the price level, which in turn alters the economy's interest rate.

This is further explained by the equation MV = PY.

Assuming that both V (money velocity) and Y (output level) are constant,

we can see that M = P indicates that a change in the money supply (M) results in a change in the price level (P), which in turn results in an increase in the interest rate.

The direction of the impact can be described as having a direct relationship due to the fact that when the price level shifts, the money's purchasing power shifts as well. This phenomenon is known as the price level effect. For instance, an increase in the price level reduces the value and purchasing power of money, causing people to demand more money to meet their normal consumption levels. This increased demand for credit eventually results in an increase in interest rates. We can say that the direction of the impact is directly related to interest rates and price levels through this example.

5.‘Inflation, an increase in the price level, is considered an economic evil because it not only distorts prices but also erodes savings, discourages investment, stimulates capital flight, inhibits growth, makes economic planning a nightmare, and in its extreme form, evokes social and political unrest. Do you agree with this statement? Discuss with examples.

Yes, the answer provided in the question is agreeable. In economics, inflation is considered to be a persistent evil. This is due to the fact that the value of money decreases as a result of the rise in prices brought about by inflation. As a result, the amount of money saved in the economy loses value as a result. Even though the price of goods and services increased, the amount of money saved did not change, and as prices rise in the economy, the value of the savings will undoubtedly decrease. When it comes to investments, an increase in inflation results in a decrease in the currency's purchasing power, which discourages investment and eventually results in low investment levels during periods of high inflation. Capital flight occurs when assets and money rapidly leave a country due to high inflation for these reasons. The economy stagnates as a result of the aforementioned three factors, which limit or halt growth. And as a result of all of these issues brought on by inflation's evil, planning policies like monetary policy and fiscal policy become extremely challenging for the state and central bank to implement. People would take to the streets as a result of inflation making it difficult for them to meet basic needs like food, leading to social and political unrest and even civil wars. These issues, as well as the lack of growth and the difficulty of planning, would cause this. We tend to agree with the response provided in the question for these reasons.

The case of Sri Lanka provides the best illustration of how to interpret this statement and accept it as true as of July 12, 2022. The Sri Lankan people decided to take matters into their own hands and stormed the president's house in a show of massive civil dissatisfaction and unrest after months of increased inflation and falling foreign reserves, which resulted in lower savings and investments, capital flight, and eventually the economy's stagnation. To this day, Sri Lanka remains the best case to study the economic and political effects of inflation.

6.Discuss the propositions that guide Inflation Targeting.

We talked about how monetary policy targets inflation in the questions above. In order to implement inflation targeting in monetary policy, four propositions must be followed. The following are the four ideas:

1) Money's neutrality: The idea that change in the money supply would only bring about changes in the price levels and does not affect the level of output or the level of employment

2) The idea that inflation is costly, which can be understood from the perspective of resource allocation

3) Money is not neutral in the short run: The idea that changing the money supply would only result in changes in the levels of prices and would not affect the level of output or employment Because of this, fluctuations in the money supply can have a short-term impact on output, employment, and price. This also demonstrates that point (1) is viewed in the long run.

4) With lags of a certain length, monetary policy influences the rate of inflation: This indicates that the monetary policy's effects take time to manifest. In the case of Nepal's monetary policy, for instance, changes typically occur three months after the announcement of the policy. However, in order to observe the full change, we must evaluate the changes at the end of the fiscal year, also known as the 13th month. These four propositions serve as the foundation for inflation-targeting.

7. CPI = 5.5 - 0.131 GDPR - 0.055M1 + 0.292 M-1 + 0.239ρ\* + 8.403 DM1

(1.34) (−0.5 ) (−0.36) (2.08) \*\*\*\* (1.69) (2.44)\*\*\*

R2 = 0.68 F = 5.76 DW = 1.16

R2 = 0.56 (adjusted R2)

\*\*\* Significant at 5 percent

\*\*\*\* Significant at 10 percent

The inclusion of expected inflation ρ\* as one of the explanatory variables does not seem to improve the explanatory power of the equation. The coefficient on expected inflation, however, is significant at 20 percent. Here M is narrow money.

Try Interpreting the above results.

The dependence of CPI (inflation) on independent economic variables like real GDP (GDPr), narrow money supply (M1), last year's money supply (M-1), expected inflation rate (), and deflated value of money (DM1) is shown in the above regression or CPI equation. In the given equation, the values of the t-statistics for GDP and narrow money (i.e., -0.5 and -0.36) show a negative relationship, which can also be written as

Moving on, the expected inflation rate is only significant at a 20% significance level, and the expected inflation rate has no significant relationship with CPI at a significance level of 5%. As stated in the question, including expected inflation as an explanatory variable does not increase the equation's explanatory power. This indicates that we can disregard (\*) at the current significance level of 10%. The only two independent variables that show a significant relationship with CPI at a significance level of 10% are the money supply from the previous year and the deflated value of money. with their respective t-statistical values of 2.08 and 2.44.

The values of R2 = 0.68 and R2 = 0.56 (adjusted R) as well as F = 5.76 (calculated value of F) and DW = 1.16 (value of Durbin Watson test) have been provided in the question. We can determine whether the model of the equation provided in the question is unbiased or biased by utilizing these values of the Durbin Watson test, the calculated value of F, and the coefficient of regression (R).

In addition, the calculated F value of 5.76 demonstrates that the calculated value of F is greater than the table value of F, indicating a significant difference, leading us to conclude that the model is biased.

In addition, the value of DW can be used to ascertain whether the dependent variable is influenced by the relationship between the equation's independent variables.