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MONEY ILLUSION: THE INCURABLE AND NON-EXCEPTION FINANCIAL PHENOMENON (A CASE OF JAKARTA METROPOLIS MIDDLE-LOWER GROUP)

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ABSTRACT

This study examined the money illusion phenomenon among middle-lower income people living in Jakarta. By using a modified questionnaire, which was used in the prior similar theme, a sample of 90 respondents was used to observe the attitude of object study on two aspects i.e. income and transaction. The respondents' demographic characteristics, such as education, occupation, living expense, and family pattern of monthly living expense were used to find the phenomenon's determinants. The results revealed that metropolises, which were living in the big city like Jakarta and were assumedly sufficient-educated, were not illusion free on transaction. Meanwhile, the family pattern on monthly living expense did not influence the transaction aspect. Another interesting empirical finding was the losing immune of the entrepreneurs' logical mind (i.e. the ability to measure economic matters from the relative perspective), which was indicated the significance regression coefficient of diluted-perception on nominal number, contributed to a big portion of the occurrence of this phenomenon. The study argued that habitual family pattern on monthly living expense played important role to the increasing influence of money illusion on those lived in urban city and were previously assumed well-educated and comprehend the concept of time value of money (TVM).

Keyword: Money Illusion, Demographic Characteristics, Urban People

INTRODUCTION

It is like a small stone swung by David flies a cross and hits Goliath face, the small amount of individual-level irrationality, such as money illusion, can have large effects (Akerlof & Yellen, 1985; Haltiwanger & Waldman, 1985, 1989). The modern economics' discredited view on money illusion
has un-deliberately made this mistake in discounting not only lead to wrong decisions and inefficient equilibria, but also the notion of money illusion, which is seemed to be thoroughly discredited in modern economics, unfortunately its presence and impact on most people daily life become profound and wide-spread.

A good example of this phenomenon in a country scale is the effect of two financial crises in Indonesia, i.e. the Asian financial crisis 1997 and the global financial crisis 2008. The Indonesia’s post-economic global crisis panorama, based on the Indonesia’s Central Bureau of Statistic (BPS) released data 1998, reported a unique phenomenon in financial and economic perspectives and theory, i.e. the inflation and consumption index was relatively high even though it was reported that the economic condition was in financial distress.

The BPS also reported that it was a shifting pattern in people’s private consumption, where the number of secondary needs’ sales was increasing drastically BPS, 2009). The producers of motorcycles, mobile phones, electronic goods, and other luxurious goods were enjoying a big demand while many people said that the world economy still was in a global crisis 2008. This phenomenon is the main factor to examine the effect of money illusion phenomenon on the Jakarta metropolises’ perception on the value of money, the most-assumed educated people in Indonesia since they live in capital city, and their living-cost spending management. We predicted that people spent more money on the secondary needs consumption in 2008 due to the “cheaper price illusion” has diluted their basic aptitude in measuring economic matters in relative value.

Prior studies revealed that this illusion normally occurred in less-educated people (Shafir, Diamond, & Tversky, 1997; Susianto, 1998; Ariani, 1999; Cahyadi, 1999; Prihastuti, 2001). However, these empirical findings were not fit with the current fact when most of Indonesian people rejected the Indonesian Central Bank proposed to redenominate the Rupiah (Indonesian currency). They argued that redenomination will give a lesser real value when the nominal value was reduced (Kompas.com, 2010).

This situation gives us more insights on how the illusion affects all levels of society. However, to our knowledge, very few studies focus on the effect of money illusion on educated people with middle-lower income, like Jakarta metropolises. Our study will fill in the gap of prior studies, by using Jakarta as the representation of other 33 provinces’ capital city in Indonesia, to test the illusion in the most-vulnerable affected people.

We want also to examine the work of Bakshi (2009), which reports relatively sufficient-educated people are not free from the money illusion. If our study results confirm this argument, it will be important for the government to create a certain policy and implementable programs that educate people on good knowledge of measuring economic matters correctly. Hence, at the end, the policy and programs will influence the national competency in economic.

Finally, this study will be done in two steps, in which the answer of first question will determine whether we continue to the second step or not. The first question is, “Does the money illusion phenomenon really affect the Jakarta metropolis’ middle-lower income?” If the phenomenon
occurs, then the second question to be answered is, “What are the competing determinants of the illusion? Is it the education background, the type of job, the living expense, or the family pattern of monthly living expense?” The answer for second question will imply on the recommended policies.

LITERATURE REVIEW

The Money Illusion

In principle, the phenomenon of money illusion arises whenever people misestimate the real value of their nominal wealth. Fisher (1928:4) defined this illusion as "the failure to perceive that the dollar, or any other unit of money, expands or shrinks in value". Therefore, money illusion refers to individual or aggregate economic behavior that consists in failing to distinguish transactions in terms of either nominal or real monetary values. In context of financial market, someone suffering from money illusion regards his stock of nominal assets as convertible into potentially more or less real goods and services ("commodities") than market prices actually allow.

Kane and Klevorick (1967) argued that the essence of money illusion laid in such misperceptions of the price level (P, a weighted average of individual commodities' prices), the rate of exchange between nominal assets (W) and commodities. Meanwhile, Safir et al. (1997) simply defined it as the tendency to think in terms of nominal rather than real monetary values. This inability can be simply analogized similar to the test of block illusion as seen below.

Figure 1. The Illusion Blocks.

If most people assume that the block at the most left side is higher than the other two blocks at the right side, therefore, he or she gets the illusion. In reality, all blocks have the same size and height. Unfortunately, most people suffer money illusion due to the principle of money neutrality does not apply in our world, especially when inflation does not cause the assets and debts to rise as well as cause commodity prices to rise.
Economists generally assume that money illusion is an error that can be easily eradicated through education and learning. The Shiller’s (1997) survey on why people dislike inflation shows that there is a significant difference between the general public and the professional economists in how they view inflation when they were asked about prices and inflation explicitly, i.e., when prices and inflation were made salient in the survey. On the other hand, psychological research suggests that ‘transfer of learning’ across situations is surprisingly weak.

In the last century, economic psychologists have identified several irrational money-related beliefs and behaviors exhibited by consumers (Furnham & Argyle 1998). Prior studies done by Gamble Garling, Charlton, and Ranyard (2002), Modigliani (1986), Pantikin (1965), and Shaffir et al. (1997), among others, have demonstrated the persistence of this behavioral bias—known as the money illusion—in various contexts including currency redenomination.

This mis-perception shows that not only individuals are prone to money illusion, but they believe other people’s behavior is affected by money illusion. The work of Soman, Wertenbroch & Chattopadhyay (2002) reported that economic literature had focused on understanding possible macro-economic implications of money illusion without much attention to the psychological mechanism behind that illusion. Therefore, by this indirect effect, even if on the individual basis money illusion is small, the great impact on aggregate demand/supply etc. is possible (see Fehr & Tyran, 2001).

The challenging influence of money illusion or its other derivation has been sourcing for multi perspective studies, especially due to the little explanation of the money illusion, such as proposed to account for the typical reactions by consumers to currency redenomination including perceived increases in the prices of goods and services (Brachinger, 2006; Hobijn Ravenna, & Tambalotti, 2006; Ranyard, 2007), errors in the monitoring of personal expenditures (Ranyard, 2007; Routh & Burgoyne 1989, 1990), disturbance on consumer evaluation of transaction (Soman et al., 2002), and some increases in the giving of money at church (Cannon & Cipriani, 2006).

In their examination of the phenomenon of money illusion, Jonas, Greitemeyer, Frey & Schulz-Hardt (2002) found that the nominal value of currency biases its subjective value in a number of ways. People perceived currency with lower nominal value than the familiar currency was to be of lesser value, thus leading to an increase in consumer prices so as to be compatible with the nominal value of prices in the familiar currency.

Soman et al. (2002) showed, through a number of experiments, that the numerosity of the nominal difference between prices and reference standards that were salient in the evaluation context. Although consumers evaluate transactions in the context of budgetary constraints, they do assess their purchasing power by using the numerosity heuristic. That is, they judge the numerosity of the nominal difference between prices and the number of units into which the difference can be divided. The work of Soman et al. (2002) found that the numerosity heuristic, more so than the anchoring and adjustment heuristic, offered a better explanation of money illusion.
Money Illusion and Numerosity Heuristic

In prior studies, the numerosity heuristic (see, for example, Pelham, Sumarta & Myaskovsky, 1994; Showers 1992; Pelham & Swann, 1989; Wilder 1978, 1977)—the tendency among animals and humans to over infer quantity from numerosity—tends to be activated when people's cognitive resources are taxed or they are unable to make use of higher order cues for inferring quantity. Under such circumstances, people rely disproportionately on numbers as cues for inferring quantity.

Although Pelham et al. (1994) argued that the numerosity heuristic was a strategy of last resort when individuals are cognitively taxed; they were open to the interpretation that the strategy could also be one of first resort. However, once again, in general, economists have no hesitation in assuming that economic agents are rational, which one aspect of these rationalities is free from money illusion. The general institution is that economic decision affects real outcome that directly determines agent's well-being in question.

When the making of highly systematic judgment requires the use of correct decision rule and the available cognitive resources to apply the systematic decision rule, finding out the real price of goods and services that requires one to calculate it by adjusting inflation over the period of years can hardly be accomplished without access to economic data (Ramoniene & Brazys, 2007). In these circumstances, it is not surprising for people to rely on some form of numerosity heuristic as a first resort (Pelham et al. 1994). The work of Pelham et al. (1994) reports that if inferring quantity from numerosity is less cognitively demanding than the engagement of more systematic reasoning, then it is possible numerosity is a “default” strategy people rely on in making spontaneous judgments in their daily lives.

The work of Soman et al. (2002) clearly explains to us how a change in the numerosity of the scale can and does result in changes in spending behavior and total spending the heuristic. Therefore, it is important any parties, such as government (political economy decision maker) and business to take note the direct and indirect aggregated economic effects of money illusion. For example, Dusansky and Kalman (1974) observed that in addition to changes in purchasing behavior, disturbances in commodity prices can influence consumer utility.

The Money Illusion Studies in Indonesia

Some prior money illusion studies in Indonesia revealed that contradicting results. Susianto's (1998) study on income factor showed that the proportion of respondents who experienced both types of money illusion did not differ significantly. Meanwhile the work of Ariani (1999) on certain aspects, such as income, transactions, accounting and mental perception in hypertensive against foreign currencies revealed that middle-class housewives were free from money illusion.

Those findings are different from the work of Cahyadi (1999) that finds the lower-income people are exposed to money illusion in context of the transaction aspect. Based on the unclear findings of money illusion in Indonesia, our study will expand the coverage by adding demographic
characteristics, such as education, occupation, living expense, and family pattern of monthly living expense to detect the phenomenon’s effect in middle lower and assumedly educated group, i.e. the Jakarta metropolis middle-lower income group.

RESEARCH METHODOLOGY

Our study interviewed and gave a simulated case randomly to 90 selected respondents, which were assumed falling to these criteria, as follows:

1. Aged between 21-60 years, assumed as the decision maker or be responsible for having money and supporting the family expenditure
2. The maximum family monthly expenditure Rp3,500.000 (equal to US$ 406)
3. Level of education at least elementary school
4. Employed or worked (either permanent, part-time or hourly-based salary)
5. Lived in Jakarta

This study deployed a case-based questionnaire consisting of 2 cases. The respondents were required to respond those two cases, to detect whether they were affected by money illusion or not. The first case is related to the effect of money illusion on income factor. In this case, it is depicted that an employee receives an increasing salary, however this increase is still below the inflation rate. Another employee assumedly receives the same increasing salary with a lesser nominal value than the first one, within assumption there is no any no inflation circumstance. Then, the respondent was asked to choose among those two employees who are wealthier (labeled as income 1) and happier (labeled as income 2) is.

The second case is related to transaction aspect of money illusion. In this case, it is narrated that there are two people buy gold in the beginning year. At the end of the year, one of them sell his own gold with a higher nominal price (about 23% higher than the it’s purchasing price) under the scenario of the inflation rate is 25%. In the other scenario, the second employee sell the gold at a lower nominal price (about 1% lower than its purchasing price) with assumption there is no inflation circumstances.

The respondent was asked to choose which one of those two employees had made a good selling. Based on the answer of both cases, we were able to determine whether the respondents were exposed to the money illusion phenomenon or not. To see the effect of the demographic characteristics and the respondent’s role on family financial planning, this study adopted the modified model from prior researches, i.e. Pujiastuti (2001) and Shafir et al. (1997).

RESULTS AND DISCUSSION

After getting the data, therefore, it is important do the exploratory data analysis. The results showed that our study has successfully gotten an intended sample, which most of the respondents were low-income people (75.2% income < Rp 2 million = US$ 200), employed (53.2%), responsible for the household finances (66.1%), high school educated (45.5%) and be at a productive age.
Based on the results of questionnaires that have been deployed, it is noted that most people are free from money illusion phenomenon on income aspect. While, on transaction aspect they are not free from the phenomenon. The complete result is presented on the table 2

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<th>Aspect</th>
<th>Free</th>
<th>Not Free</th>
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<tr>
<td>Income 1</td>
<td>71.1%</td>
<td>28.9%</td>
</tr>
<tr>
<td>Income 2</td>
<td>73.0%</td>
<td>27.0%</td>
</tr>
<tr>
<td>Transaction</td>
<td>39.8%</td>
<td>60.2%</td>
</tr>
</tbody>
</table>

Referring to previous studies, this empirical finding in the context of income aspect is in line with Shafir (1997), Susianto (1998), Ariani (1999), and Prihastuti (2001) which there is more than 60% people unattached from the illusion. However, whether the income earned is connected to someone's happiness level, as it is on label income 2, the result is different from Shafir's (1997) which indicate more people are not free from the illusion. Perhaps, people in Jakarta were exposed by many economic crises. So, they gain the knowledge automatically due to the discussion on it was available through mass media.

Furthermore, the result in the context of the transaction aspects shows a similar result to Shafir et al. (1997) and Cahyadi's (1999) work, but it is different from the works of Ariani (1999) and Prihastuti (2001). Perhaps the respondents still believe that it would be the best to sell something at higher price than it buying price regardless the inflation rate. To give a more comprehensive picture on the transaction aspects of the money illusion phenomenon, the following discussion examines the determinant of the phenomenon.
It is noted from the table 3 that 75% of the respondents are not free from the illusion are college or university educated level. It is also known that the smallest proportion on education background comes from Postgraduate people. However it fails to meet statistic criteria by using logit regression method. So, the finding is similar to Wong (2005) and Prihastuti (2001) study.

While, in the context of job background, the largest proportion comes from people who takes career as an employee. Moreover, it is very interesting that the entrepreneurs who are assumed to be illusion free people provide higher proportion than unemployed group. Perhaps, the job background is not the determinant of the illusion phenomenon as it is shown, by using logit regression the job background, on the Z score that is not statistically significant.

Yet, the monthly spending is positive significant as the determinant of the illusion when logit regression used. This finding supports previous study by Shafir (1997) and Cahyadi (1999). We argue that it is the evidence that the more money people have, the more they love their treasury. So, they prefer to sell their asset at higher price. Finally, by determining the chi square value, it is found that the probability of financial planner in the family exposed by the illusion is lower than them who are not since the financial planner will be more accustomed to financial transaction than people who are not the planner.
CONCLUSION

This study provides the picture how lower middle income people in Jakarta exposed by money illusion phenomenon. The phenomenon on transaction aspect is occurred among them, while it is not found on income aspect. It is also noted that the monthly spending and the role in financial planner in the family are statistically valid as the determinant of money illusion on transaction aspect. So, this finding supports the study of Shafir (1997), Susianto (1998), Ariani (1999), Cahyadi (1999), and Puijastuti (2001) on income aspect. Yet, the results are contradicted to Puijastuti (2001) on transaction aspect. The implication of the result that it will be fine for the good producer to make a price adjustment to people in Jakarta due they prefer to sell product at higher price than it's cost. However, further research is still needed to make the confirmation of the findings.

REFERENCES


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