Inflation

Definitions:

Inflation is a sustained increase in the general price level.

Disinflation is a fall in the rate of increase in the general price level.

Deflation is a sustained decrease in the general price level.

Types of Inflation:

Cost-push inflation occurs when costs of production increase across the economy, resulting in a decrease in short run aggregate supply, which pushes up the price level. This can occur due to changes in unit labour costs (such as wages and productivity), prices of factors of production (influenced by exchange rates) and government taxes. Workers will negotiate for higher wages to retain their real disposable income, further increasing production costs and leading to a wage-price spiral.

Demand pull inflation occurs when either consumption, government spending, investment or net exports increase. Supply struggles to meet demand, and older, less efficient factors of production are employed. Workers are paid more overtime but can only produce so much more, leading to a rise in the price level.

Monetary inflation results from an increase in the money supply. This is shown through the equation $MV = PT$. If we assume V (velocity of circulation) and T (total output) remain constant, we see that an increase in M (money supply) leads to an increase in P (price level).

Alternatively, this can be shown on the loan market. An increase in supply of money lowers the cost of borrowing (interest rates), which will increase consumption and investment in the economy.

Imported inflation is a general and sustainable price increase due to an increase in costs of imported products. This price increase concerns the price of raw materials and all imported products or services used by companies in a country. Imported inflation is also referred to as cost push inflation, if the imported products are raw materials.

Effects of Inflation:

Inflation makes **borrowing** more attractive to households and helps those owing money, as the real value of their debts decrease. However, the value of savings will erode, and those on fixed incomes will see a fall in real disposable income. Households face shoe-leather costs (Metaphorically, shoe leather cost is the cost of time and effort that people expend by holding less cash in order to reduce the inflation) as they move their money between financial institutions and invest in real assets that keep their value (such as gold).

Inflation also makes borrowing more attractive to firms, as real interest rates may become negative, effectively meaning that they are being paid to borrow money. This can increase investment. Firms may also be able to save money for investment without cutting nominal wages to workers, which would be unpopular. Workers will be more likely to accept flat wages when inflation is at 3% than a 3% wage decrease when there is no inflation. In addition, consumers will be more willing to accept price rises even if they are greater than the rate of inflation, resulting in higher profits. Inflation may signal strong demand throughout the economy, boosting business confidence. Importing firms find the products they sell are more competitive in the domestic market

However, there could also be a fall in **confidence in the economy**, leading to lower investment and growth. The prices of factor inputs increase and workers bargain for higher wages. Firms face shoe leather costs as they move money between financial institutions and menu costs as pricing information is changed. Exporting firms are now less competitive in the global market.

Governments see the real value of their debts decrease and a fall in the exchange rate as a result of lower net exports. However, there may be political instability. If investment falls, then long term economic growth is harmed.

Is Inflation harmful?

Overall, whether or not inflation is harmful depends on the rate and whether or not is anticipated. An accelerating rate is bad as people will bring about what they fear by consuming now to avoid price rises, resulting in demand pull inflation. This will be compounded by a wage-price spiral as workers bargain for higher wages. There will be economic uncertainty and people may lose confidence in the government or even in the currency itself. Low confidence reduces investment and long term economic growth.

Inflation is bad if unanticipated as parties will have no time to take action and protect themselves from its effects. Savers will be worse off and borrowers will benefit, and a redistribution of income will occur. Fixed income earners suffer a loss of disposable income.

On the contrary, if inflation is anticipated, people can take action to minimize its effects. Firms have time to change pricing information and households can transfer money into assets which are more likely to hold their value (such as gold). Wage rises can be negotiated in advance.

Measuring Inflation:

Inflation is commonly measured by a Consumer Price Index. The CPI is a weighted price index measuring the changes in prices of consumer goods. Weights are used to give a more accurate measure of inflation by reflecting the relative importance of different products to consumers.