CIE Economics AS-level

Topic 4: The Macroeconomy

b) Inflation

Notes

- **Inflation** is the sustained rise in the general price level over time. This means that the cost of living increases and the purchasing power of money decreases.
- **Deflation** is the opposite, where the average price level in the economy falls. There is a negative inflation rate.
- **Disinflation** is the falling rate of inflation. This is when the average price level is still rising, but to a slower extent. This means goods and services are relatively cheaper now than a year ago, and the purchasing power of money has increased.
- For example, a 4% increase in the price level between 2014 and 2015 would be inflation. A change from 4% to 2% is still inflation, but there has been disinflation where the price rise has slowed. If the change in the price level is now -3%, there is deflation.

Distinction between money values and real data

- The money value of data is the nominal value. The real value of data is adjusted for inflation. For example,

  Real GDP is the value of GDP adjusted for inflation. If the economy grew by 4% since last year, but inflation was 2%, real economic growth was 2%.
  Nominal GDP is the value of GDP without being adjusted for inflation. In the above example, nominal economic growth is 4%. This is misleading, because it can make GDP appear higher than it really is.

Causes of inflation

- **Demand pull:** This is from the demand side of the economy. When **aggregate demand** is growing unsustainably, there is pressure on resources. Producers increase their prices and earn more profits. It usually occurs when resources are fully employed.
  The main triggers for demand pull inflation are:
  - A depreciation in the exchange rate, which causes imports to become more expensive, whilst exports become cheaper. This causes AD to rise.
  - Fiscal stimulus in the form of lower taxes or more government spending. This means consumers have more disposable income, so consumer spending increases.
  - Lower interest rates makes saving less attractive and borrowing more attractive, so consumer spending increases.

- High growth in UK export markets means UK exports increase and AD increases.

- **Cost push:** This is from the supply side of the economy, and occurs when firms face rising costs. This occurs when:
    - Raw materials become more expensive, such as when oil prices rise.
    - Labour becomes more expensive. This could be through trade unions, for example.
    - Expectations of inflation- if consumers expect prices to rise, they may ask for higher wages to make up for this, and this could trigger more inflation.
    - Indirect taxes could increase the cost of goods such as cigarettes or fuel, if producers choose to pass the costs onto the consumer.
    - Depreciation in the exchange rate, which causes imports to become more expensive, which pushes up the price of raw materials.
    - Monopolies, using their dominant market position to exploit consumers with high prices.

- **Growth of the money supply:** If, for instance, the Bank of England printed more money, there would be more money flowing in the economy. Extreme increases in the money supply usually cause **hyperinflation**, when the rate of inflation is incredibly high and uncontrollable. It is only inflationary if the money supply increases at a faster rate than real output.
  Quantitative Easing has been used by the European Central Bank to help stimulate the economy. Since the interest rates are already very low, it is not possible to lower them much more. This means the bank had to adopt another measure: pumping money directly into the economy. The bank bought assets in the form of government bonds using the money they have created. This is then used to buy bonds from investors, which increases the amount of cash flowing in the financial system. This encourages more lending to firms and individuals. The theory is that this encourages more investment, more spending, and hopefully higher growth. A possible effect of this is that there could be higher inflation.

The effects of inflation on:

- **Consumers**
    - Those on low and fixed incomes are hit hardest by inflation, due to its regressive effect, because the cost of necessities such as food and

water becomes expensive. The purchasing power of money falls, which affects those with high incomes the least.

- If consumers have loans, the value of the repayment will be lower, because the amount owed does not increase with inflation, so the real value of debt decreases.
-

- **Firms**
  - Low interest rates means borrowing and investing is more attractive than saving profits. With high inflation, interest rates are likely to be higher, so the cost of investing will be higher and firms are less likely to invest.
  - Workers might demand higher wages, which could increase the costs of production for firms.
  - Firms may be less price competitive on a global scale if inflation is high. This depends on what happens in other countries, though.
  - Unpredictable inflation will reduce business confidence, since they are not aware of what their costs will be. This could mean there is less investment.
- **The government**
  - The government will have to increase the value of the state pension and welfare payments, because the cost of living is increasing.
- **Workers**
  - Real incomes fall with inflation, so workers will have less disposable income.
  - If firms face higher costs, there could be more redundancies when firms try and cut their costs.