Edexcel Economics AS-level

Unit 2: Macroeconomic Performance and Policy

Topic 1: Measures of Macroeconomic Performance

1.2 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.
- It is important to note that deflationary government policies aim to reduce AD, and do not necessarily result in deflation.

Interpret price indices (RPI and CPI) and the rate of inflation

- In the UK, the rate of inflation is calculated using the **Consumer Prices Index (CPI).** It measures household purchasing power with the Family Expenditure Survey. The survey finds out what consumers spend their income on. From this, a basket of goods is created. The goods are weighted according to how much income is spent on each item. Petrol has a higher weighting than tea, for example. Each year, the basket is updated to account for changes in spending patterns.

- In the UK, it is a government macroeconomic objective for inflation to be at 2% + or – 1%. This is to maintain price stability.

- The key points when answering an exam question on CPI are:
  - A survey is used
  - Weighted basket of goods
  - Measures average price change of the goods
  - Updated annually

Limitations of CPI when measuring inflation

- The basket of goods is only representative of the average household, so it is not accurate for households who do not own cars, for example, and therefore do not spend 14% of their income on motoring.

- Different demographics have different spending patterns.
- Housing costs account for about 16% of the index, yet this varies between people.
- CPI is slow to respond to new goods and services, even though it is updated regularly. Moreover, it is hard to make historical comparisons, since technology twenty years ago was of a vastly different quality, and arguably a different product altogether, than now.

- **Retail Price Index (RPI)**

- This is an alternative measure of inflation.
- Unlike CPI, RPI includes housing costs, such as payments on mortgage interest and council tax.
- This is why RPI tends to have a higher value than CPI.

- **Real and nominal values, constant and current prices**

- **Real values** are adjusted for inflation. For example, real GDP is the value of GDP adjusted for inflation. For example, if the economy grew by 4% since last year, but inflation was 2%, real economic growth was 2%.
- **Nominal values** are not adjusted for inflation. Real 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.
- Real and nominal values are applied to data using constant and current prices. Constant prices consider inflation, whilst current prices do not.

- **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:
        - Changes in world commodity prices can affect domestic inflation. For example, raw materials might become more expensive if oil prices rise. This increases costs of production.
        - 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 and pushes up the price of raw materials.
        - Monopolies, using their dominant market position to exploit consumers with high prices.

The impact of inflation on 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. This could cause inflation to increase further, since firms have to put up prices to make up for the higher costs of labour.
- 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 impact of inflation on individuals:

- **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.

- **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.