Inflation - Causes & Impacts

# Starter - Recap Question

**Instructions:** Test yourself with the below quick question

What is meant by inflation?

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How is inflation measured?

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What is the CPI?

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What is the difference between deflation and disinflation?

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# Presentation 1 – Causes of Inflation

Complete the activities below so as to have a complete set of Notes:

**Recap Definition:** *Inflation*

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**Key Notes:** *The three general causes of inflation*

*Demand Pull:*

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Occurs in SR and LR

**N.B.** Occurs in the LR if there only if limited spare capacity (Classical/vertical Keynesian)

*Example:* UK Inflation rates of 25% in 1914 and 17% 1939 due to increased G to fight World Wars

Diagram 1: SR demand pull inflation Diagram 2: LR demand pull inflation

*Cost Push:*

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Occurs in the SR, but can persist into the LR, if workers come to expect higher wages

**N.B.** Does not occur in the LR under the classical model as wages and factor input prices are fully flexible (an increase in CoP will not persist)

*Example:*OPEC Oil price increases in the 1970s

Diagram 1: SR cost push inflation Diagram 2: LR cost push inflation

*Wage Price Spiral:* The circular process in which wage increases cause price increases which in turn cause wage increases, potentially continuing ad infinitum

**LCA Task:** Complete the LCA to explain how the wage price spiral occurs to exacerbate inflationary pressure

Initial Inflationary shock

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This causes workers to demand a higher wage again, the process repeats!

*Monetary Inflation:*

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This is because there will be more money in circulation per unit of output, and thus a higher price will be paid

Fisher’s equation of Exchange: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

***M*** is the nominal quantity of money (the amount of cash circulating in an economy, aka the money supply)

***V*** is the velocity of money (the regularity of money changing hands in transactions)

***P*** is the general price level

***T*** is an index of the real value of all transactions (the amount of ‘stuff’ being made in an economy)

In simple terms: ‘money spent’ = ‘money received’

**Key Question:** How can this explain inflation?

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*Example of monetary inflation:* Weimar Germany

Germany massively increased its money supply in an attempt to pay off debts from their war effort, as well as large reparations to pay to the victors, reducing the Mark’s real purchasing power.

Bread costing around 160 Marks in late 1922, cost 200,000,000,000 Marks by late 1923!

# Task: Types of inflation

**Instructions:** Categorise the following causes of inflation into the correct type

* Low interest rates: ………………………………………..
* Increase in the National Minimum Wage: ………………………………………..
* Rise in the global oil price: ………………………………………..
* Fall in the value of the pound: ………………………………………..
* Increased money supply: ………………………………………..
* Increased government spending: ………………………………………..
* Increased business regulations: ………………………………………..

# Presentation 2 – Impacts of Inflation

Complete the activities below so as to have a complete set of Notes:

**Elaborate:** Elaborate on the below costs of inflation

Erodes value of savings/fixed incomes:

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*Fisher Equation:*

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*E.g.*

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*N.B.*

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Fall in exports:

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Increased uncertainty:

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Income distribution issues:

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Distorted price mechanism:

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Menu costs:

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Shoe-Leather costs:

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Psychological and Political costs:

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**Key Question:** Why do we not want Zero Inflation?

i.e. What are the benefits of inflation?

*Elaborate on the below impacts:*

Wage Flexibility:

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Further from deflation:

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Erodes value of debt:

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Money Illusion:

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Increased tax revenues -‘fiscal drag effects’:

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# Article Task: SPECIAL REPORT - Return of the inflation nightmare!

**Instructions:**

* Read, highlight and annotate the article
* State the advantages & disadvantages of inflation to each group, with relevant examples
* Make a **judgement** on whether inflation makes the group better or worse off
* Discuss your answers as a class

**Article**

*‘Inflation is defined as persistent rise in the general price level. The effect of inflation is a fall in the real value of money.’*

What does 5.3 pc inflation really mean? Well, it’s as if the Government took £100 from you last year and handed you back just under £95 to go shopping with today. Inflation can have a devastating effect on our finances, especially for those such as pensioners who are on fixed incomes. The Government uses two main measures for inflation: the consumer prices index (CPI), which excludes housing costs, and the better-known retail prices index (RPI), which is the one that really matters for most of us. Not only does it include housing costs, it also governs increases on pensions, benefits, student loans, index-linked gilts and National Savings & Investments’ index-linked certificates.



This index started at 100 in January 1987. By March this year, it was 220.7 and rose almost 1 pc to 222.8 in April. It is RPI which has hit 5.3 pc, while CPI is at 3.7 pc.

So how does inflation affect us?

WORKERS

Inflation has exposed the yawning gap between public and private sectors. While public sector workers enjoyed an average pay rise of 4 pc last year, many in the private sector saw their pay frozen or accepted cuts to keep them in a job. Overall, British workers have suffered the biggest ‘pay cut’ since records began. The gap between the average pay rise — just 1.2 pc — and inflation, at 5.3 pc, has never been greater, according to the Office for National Statistics. A worker on the average annual salary of £25,800 has, in effect, seen the spending power of their wage packet fall by £1,057.80. Public sector workers could suffer a pay freeze this year as the Government aims to cut public spending. Azad Zangana, European economist at fund manager Schroders, says: ‘High inflation is like a stealth tax on wealth. The winner in all this is the -Government, as they inflate their way out of record debt.’

BORROWERS

A long-term bout of high ¬inflation can be a boon for ¬home-buyers because it erodes the real value of debt. Anyone in their 50s who took on a mortgage in the Eighties will ¬remember how a £20,000 loan seemed like an impossible debt. Now, it is less than the national average wage. But for high inflation to work its magic, borrowers also need their ¬salary to rise or they risk being crushed by rising interest rates, bills and food prices. So for borrowers to benefit, they need Bank of England base rate and, more importantly, their mortgage rate to stay low until their income starts to rise. Credit card borrowers are more at the mercy of sudden increases in their interest rate at the whim of their lender.

SAVERS

Savers have never had it so bad. The average easy-access savings account pays 0.18 pc and the worst 0.04 pc or less after basic-rate tax. To maintain the value of their money, basic-rate taxpayers need to earn 6.63 pc and higher-rate taxpayers 8.83 pc, while those paying the top 50 pc rate must earn 10.6 pc. Those in the very best accounts have lost around £2 for every £100 to the inflation pick-pocket over the past year, while the worst have cost savers £5. It’s ironic that among the few who are just about keeping pace are those who took fixed rates of more than 6 pc with the failed Icelandic banks. Under a compensation deal they were allowed to keep their money — earning around 5 pc after basic tax — invested for the term of the bond. The Rev Dr John Strain, from the campaigning action group Save Our Savers, says: ‘Those who have been prudent and saved for their futures are fast becoming the ¬victims of the downturn. ‘People on fixed incomes who rely on their savings are being squeezed and are now finding that their ¬savings are being drastically diminished as inflation eats away at the real value of their funds.’

SPENDERS

The price of clothing and shoes — particularly for women — has been one of the largest risers, providing ammunition to husbands and ¬boyfriends around the country. Goods in textile, clothing and footwear stores increased by a whopping 9.4 pc on last year. Motorists are also being hammered, with the cost of fuel increasing by just under 10 pc over the past year. Prices at the pumps have reached a record £1.22 per litre for unleaded petrol. It’s not all bad news, though. ¬Official figures show the cost of food has increased by just 0.5 pc while energy bills have dropped 2.9 pc. The Daily Mail Cost of Living Index, compiled by mySuper¬market, shows the cost of a typical shopping basket, including frozen peas, sugar and fresh chicken, has dropped 11 pc over the past year from £17.30 to £15.46. And the average household’s energy bill has dropped from £1,251 last year to £1,195, according to uSwitch. But they are still almost a third higher than in January 2008, when the average bill was £912.

PENSIONERS

High inflation is a nightmare for Britain’s 12 million pensioners. The basic state pension was increased by just £2.40 last month to £97.65 per week. Had it been linked to April’s RPI figure, the increase would have been £5 a week — or £260 a year. Vital earnings-related top-ups to the state pension such as Serps were frozen, with an average annual loss of over £80. The good news for pensioners is they will benefit from a triple ¬guarantee that the basic pension will rise by the higher of wages or prices inflation and by at least 2.5 pc from next April. Neil Duncan ¬Jordan, from the National Pensioners’ Convention, says: ‘Inflation poses a great threat to pensioners. ‘The cost of living is rising at a time when the state ¬pension’s value in real terms has declined.’ He adds: ‘Pensioners who relied on supplementing pensions with ¬savings income have seen a -dramatic reduction due to falling interest rates.’ Inflation also exposes the dangers of fixed income pensions, which are bought by most people with ¬personal pensions savings. If inflation were to stay at 5.3 pc for ten years, the spending power of every £1,000 would fall to £597. Bob Bullivant, from Annuity Direct, says: ‘As happened in the Seventies when inflation was ¬soaring, the people hurt most are pensioners. ‘For many, there is the stark ¬realisation that they don’t have enough pension savings to cope.’

**Impacts of inflation: (+ or -)**

*Workers & Spenders:*

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| Positive and Negative Impacts on the group: |
| Judgement: does inflation make the group better or worse off: |

*Borrowers:*

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| --- |
| Positive and Negative Impacts on the group: |
| Judgement: does inflation make the group better or worse off: |

*Savers & Pensioners:*

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| --- |
| Positive and Negative Impacts on the group: |
| Judgement: does inflation make the group better or worse off: |

**Extension:** Is inflation generally good or bad for any economy? Are the points when it goes against your general rule?

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# Presentation 3 – Deflation

Complete the activities below so as to have a complete set of Notes:

**Definition:** *Deflation*

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**Definition:** *Disinflation*

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**LCA Task:** Explain how the Deflation suppresses economic activity and can severely harm output!

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This leads to further deflation, and a *spiral of deflation* and falling AD results.

**Question:** What is meant by the ‘deflation debt trap’?

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**Question:** Why is it so hard to escape deflationary spirals?

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# Article Task: What is deflation?

* Read, highlight and annotate the article
* Answer the key question
* Discuss your answers as a class

*‘If there is one word to get an economist quaking in their boots, it is deflation.’*

Many major Western economies are in recession and others are heading towards it. Some experts are warning that deflation could be next. It is what happened in the Great Depression of the 1930s and in Japan in the 1990s. "Deflation is, as it sounds, the opposite of inflation," said economist Diane Coyle on BBC World Services' Analysis programme. "It means that the general price level is falling consistently over quite a long period of time. "They're not just one-off price cuts, and we've seen those for a long time now in things like computers or electronic games. If it's just a few types of item, or it only happens for a short period of time, nobody's very worried. "But if it's longer lasting and more widespread than that, then it's deflation, and that’s a problem."

Falling prices

Falling prices might sound great for consumers, but in fact this is bad news for everyone. Economist and author of 'Credit Crunch', Graham Turner, says it can lead to a vicious circle of decreased spending and increased unemployment. "People wait as prices fall for goods to get cheaper before buying and in fact they become the buyers' strike. "Then that creates more deflation, more job losses and so on. The reason why economists also worry about deflation is because it's much harder to combat than inflation. If inflation rises there's no limit to how far you can raise interest rates, with deflation there is a limit to how far you can cut interest rates," he added. The most memorable deflation was during the Great Depression of 1929. "The 1920s was the first time in which a real mass production economy requiring mass consumption arose, and that's where the rub comes in," said Professor Robert McElvaine who is a leading expert on the Great Depression.

"The masses of people certainly didn't have enough share of the income to be buying all the goods and services that were out there. "The basic way in which that was kept going for a number of years was by letting people buy things they didn't have the money for, extending them credit, very similar, again, to what's been going on here. "So you had a bubble increasing and you finally reach the point before the stock market crash in 1929 where goods and services were not being sold at the level that was needed to keep the economy going. Credit had pretty much been exhausted and that starts a downward spiral," said Professor McElvaine. This deflation spiral, where buyers go on strike is what leads to growing levels of debt. "If you allow deflation you may find that you're busy trying to write off all your bad debts, but actually in real terms they grow because you've got deflation, and that becomes what we call a 'debt trap'," said economist Graham Turner. As debts grow in real terms they become more difficult to pay off, because as prices fall so does income. "A debt trap is the ultimate manifestation of deflation," added Mr Turner.

Lesson learnt

During the Great Depression unemployment soared to over 25% in the US and had huge ramifications for the rest of the world, which lasted almost a decade. However, with swift and deep cuts in interest rates globally, economist Diane Coyle says that lessons have been learnt from the past. "The thinking behind policy now is to do it quickly to prevent us getting into that kind of spiral at all, and that's the lesson from the 1930s and the lesson from Japan in the 1990s," she said. Japan's central bankers cut short term interest rates to combat the deflation there a decade ago. "That option is on the table for all central banks today in the West, and we may well see that over the next few months, one or two years, but that may not be enough," said Mr Turner. He feels that long term interests rates also may need to go down, to encourage spending and discourage buying up of government debt. The idea is to push investors away from safe investments such as government debt and encourage them to look elsewhere for a better return on their money and hence start investing in businesses that provide employment and goods and services thereby leading to a re-flation of the economy. The experience of the Great Depression has scarred a generation of policy makers and fear of a crisis of such proportions has already prompted an unprecedented coordinated global response. "Deflations of this kind are pretty rare and you must remember that we still have inflation," said Diane Coyle. "I think the response and the talk at the moment is more about making sure it doesn't happen, preventing it rather than having to cure it later. "On balance I don't think we are going to have a deflation now."

**Key Question:**

What, according to the article, is the best way to prevent deflation? Fully explain your answer.

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# Shrinkflation: for those struggling, it's about more than just chocolate bars | Frances Ryan | Opinion | The GuardianExtension Article: Shrinkflation - playing havoc with economists’ models

*‘In a world of sticky prices, firms use other means to respond to market conditions’*

Two years ago British chocoholics felt the pinch from the decision to leave the European Union. As sterling tumbled, global firms selling to the British market faced the same production costs as before, but got less money for each sweet sold. Rather than raise the price per chocolate, some chose to shrink the chocolate per price. The famous peaks on a bar of Toblerone grew conspicuously less numerous (though Mondelez, the bar’s maker, said Brexit was not the cause). Other products suffered the same “shrinkflation”: toilet rolls and toothpaste tubes became smaller. The threat of Brexit made the phenomenon more visible, but it is surprisingly common. Statisticians and policymakers need to take note.

Every first-year economics student quickly becomes familiar with charts of supply and demand, which place price on one axis and quantity on the other. Given a drop in demand, the charts show, firms can either sell fewer items at the prevailing price or cut prices to prop up sales. But online retailing, which makes it easier to collect fine-grained price data, reveals how poorly textbook models reflect real-world market dynamics. The prices of consumer goods, it turns out, behave oddly.

A forthcoming paper by Diego Aparicio and Roberto Rigobon of the Massachusetts Institute of Technology helps make the point. Firms that sell thousands of different items do not offer them at thousands of different prices, but rather slot them into a dozen or two price points. Visit the website for H&M, a fashion retailer, and you will find a staggering array of items for £9.99: hats, scarves, jewellery, belts, bags, herringbone braces, satin neckties, patterned shirts for dogs and much more. Another vast collection of items cost £6.99, and another, £12.99. When sellers change an item’s price, they tend not to nudge it a little, but rather to re-slot it into one of the pre-existing price categories. The authors dub this phenomenon “quantum pricing” (quantum mechanics grew from the observation that the properties of subatomic particles do not vary along a continuum, but rather fall into discrete states).

Just as surprising as the quantum way in which prices adjust is how rarely they move at all. Retailers, Messrs Aparicio and Rigobon suggest, seem to design products to fit their preferred price points. Given a big enough shift in market conditions, such as an increase in labour costs, firms often redesign a product to fit the price rather than tweak the price. They may make a production process less labour-intensive—or shave a bit off a chocolate bar.

Central banks are starting to see the consequences. Inflation does not respond to economic conditions as much as it used to. (To take one example, deflation during the Great Recession was surprisingly mild and short-lived, and after nearly three years of unemployment below 5%, American inflation still trundles along below the Federal Reserve’s target rate of 2%.) In its recently published annual report the Bank for International Settlements, a club of central banks, mused that quantum pricing and related phenomena help account for such trends.

But firms’ aversion to increasing prices may be as much a consequence of limp inflation as a contributor to it. When the price of everything rises a lot year after year, as in the 1970s and 1980s, firms can easily adjust the real, inflation-adjusted cost of their wares without putting off shoppers. A 5.5% jump in the cost of a pint after years of 5% increases does not send beer drinkers searching for other pubs in the way that a 0.5% hike after years of no change might. Thus falling inflation can make prices “stickier”. To compensate, firms instead find other ways to impose costs on buyers—such as making products smaller or lower-quality.

Labour markets are affected, too. Wages are notoriously sticky, especially downwards. In a world of low inflation, the ability to trim pay by raising wages less than inflation is lost to firms, with serious macroeconomic consequences. Economists blame sticky wages for causing unemployment during recessions. Facing reduced demand, firms that cannot cut pay to maintain margins while slashing prices instead reduce output—and sack workers.

But nimble firms have other options: the employment version of shaving a bit of chocolate from the bar. Some cut costs by boosting output per worker, often by driving workers harder. Tellingly, growth in output per worker now tends to fall in booms and rise during busts, precisely the opposite of the pattern 40 years ago, when inflation was high. Firms can respond to market pressures by reducing the benefits available to workers; Asda, a supermarket, recently announced plans to slash British workers’ holiday allowances. Or they can offer workers more tortuous schedules. Research published in 2017 suggests that being able to vary workers’ hours from week to week is worth at least 20% of their wages. On the flipside, during good times firms often opt to reward workers with office perks and one-off bonuses, rather than pay rises that cannot easily be clawed back during downturns.

The uncertainty principle

If it happens on a sufficiently large scale, the practice of tweaking quality in lieu of price could play havoc with essential economic data. Statistical agencies do their best to account for changing product quality, but if adjustments are unexpectedly common or subtle then muted inflation figures could easily be concealing a more turbulent economic picture. Central banks watching for big swings in inflation or wage growth as a sign of trouble could be reacting to figures that bear far less relation to business conditions than they used to.

What’s more, the substitution of quality for price as firms’ main way of responding to changing market conditions weakens the case for keeping inflation low and stable. Inflation makes relative prices less informative, economists reckon, making it harder to decide what to buy and how to spend. Rather than clarity, low inflation has brought a different sort of confusion: one of shrinking chocolate bars and lost holidays.

# Assignment

**Data response (Section B)**

**Figure 1: UK Consumer Price Index (CPI)**

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**Extract 1: Inflation**

Recessions are normally associated with falling inflation rates. However, since the recession started in 2008 the Bank of England’s Monetary Policy Committee (MPC) has overseen several periods in which inflation has exceeded the upper limit of the target inflation rate’s tolerance. There have been four sources of inflationary pressure. First, oil prices rose sharply because of popular unrest in many Arab nations which led to the development of uncertainty around the security of supply. Secondly, a period of bad weather resulted in harvest failure in many areas and wheat prices soared. In addition, the sterling exchange rate has weakened and since 2008 it has fallen by around 25% against the US dollar. A final factor was the increase in VAT from 15% to 17.5% in January 2010 and then in January 2011 it was raised to 20%.

The monetary tools available to the MPC of the Bank of England have most impact on the demand side of the economy, which has been weak and was not the source of the inflationary shocks. The danger with rising interest rates to achieve the inflation target in the short term is that they might weaken the economy further.

1. With reference to Extract 1, examine the significance of **two** likely causes of UK inflation over the period 2008 to 2012.

[8]

**Essay questions (Section C)**

1. Inflation as measured by the Consumer Price Index reached 5.2% in September 2013.

Evaluate the likely impacts of higher inflation on the UK economy.

[25]

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| **Planning Grid: Aim = 5 paragraphs - 2 KAA points (16); 2 Eval points (9) with a conclusion** | |
| **KAA Point 1 = signpost key point** |  |
| Application |  |
| Main concept & diagram |  |
| **Eval Point 1 = relate to your earlier point & re-read the title** |  |
| Context / evidence |  |
| **KAA Point 2 = signpost key point** |  |
| Application |  |
| Main concept & diagram |  |
| **Eval Point 2 = relate to your earlier point & re-read the title** |  |
| Context / evidence |  |
| **Conclusion = judgement** |  |
| Context; what does it depend on? |  |