Big Question: Inflation or deflation: which is worse?

Webnote 232

syllabus Reference: 3. 3 Inflation

Problems caused by: inflation + deflation

Focus:
- Price index - see page 2
- Damaging effects of inflation

B causes of inflation

1. cost-push
2. demand pull
3. excess money supply (see webnote 319)

examples:
imported inflation e.g. raw materials from abroad (cost push)
currency devaluation (cost push)
inflation psychology
fiscal/budgetary policy

A Some negative effects of inflation

1. **Price Mechanism distorted: price mechanism serves to allocate scarce resources. This process is disturbed by inflation. The price mechanism has a major role to play in resource allocation. If the mechanism does not work due to problem inflation then the economy will function less effectively. Why might allocation be distorted? See item 9 in box C**

2. **Uncertainty: business and consumer confidence is affected. This impacts upon I and C in terms of the AD model. Important to note here is that investment may fall because firms don't know the cost of undertaking investments/expansion of the firm.**

- **Business Confidence**
- **Consumer Confidence**

These are important components in any economy.

Be sure to take a note on these variables. It is common in G20 countries to measure these indices

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C Some More problems with inflation- *see descriptions of inflation in box D*

some issues arising from consistent inflation as measured by the CPI

1. **Income distribution: fixed income holders e.g. old age pensioners may suffer see summary below.**
2. **borrowing is encouraged (but confidence is low): borrower benefits in periods of inflation (loses during deflation as the real burden of debt rises- people find it harder to repay loans see box G below for deflation)**
3. **Fiscal Policy: inflation affects government fiscal policy. More is collected in indirect taxes. Greater demand also occurs for deficit current account spending**
4. **Hedging**
5. **Savings: high inflation will necessitate high interest rates or the risk of negative interest rates could occur**

Inflation rate < interest rate

6. **Balance of Payments: inflation affects the competitiveness of exports. Currency exchange rate could fall. Imports become more expensive**
7. **Firms may take advantage: Inflation can promote inflation psychology putting prices up unnecessarily.**
8. **National Debt: cost of repaying the debt can fall substantially if the debt is repayable in the domestic currency.**
9. **Functions of money: are eroded**

- **Store of value**
- **Medium of exchange**
- **See Fischer equation in webnote 319**

Any question about these?

D *some important terms*

1. anticipated (expected) inflation: whereby inflation can be indexed to avoid any redistributional effects
2. unanticipated(unexpected) inflation can be very damaging as it is unforeseen
3. creeping inflation:2-3 %
4. hyperinflation: circa 100%+

HL paper 1 2009-May

2 a Explain the possible causes of a rise in the inflation rate in an economy. 10/25 marks

b Evaluate the possible impact on economic performance that may result from a government dexision to bring inflation under control. 15/25 marks

E policy measures to combat inflation

- Price control (Prices policy)
- Fiscal policy
- Legislation
- Incomes policy
- Exchange rate policy
- Monetary policy

Note: "policy conflicts" can however occur limiting the effect of the above

See webnote 409 for policy conflicts

F –measuring inflation

Price Level: how is inflation measured?

- CPI / RPI
- Simple vs composite price index (weighted index)
- To express any number as an index or a % of the base year do the following:
-

$$\frac{1 \quad \text{new price}}{2 \quad \text{old price}} \times 100$$

G Deflation:

1. Define clearly that it is a fall in the average price level sustained over a period of time.
2. watch the Paj clip on deflation (VID 6)identifying 3 problems with deflation:
   - **demand collapse**
   - **monetary policy weakened as rates of interest cannot extend below zero**
   - **borrowers lose as the real burden of debt rises- people find it harder to repay loans**
   - **money has more buying power (prices falling)**
   - **wages may fall and/or**
   - **unemployment rises**
   - **business/consumer confidence falls**

Method1: Simple Price Index –expresses numbers in % terms

See webnote 233 + 234 for simple and composite price indices

Year	2001 prices	2002 prices	2003 prices	2004 prices
Index Number	100	95	120	130

Note: for exam questions please see **webnote 339**