**Causes of Inflation**

**Activity 1**: Answer the questions below

Define inflation (3 marks)

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What is the UK government’s inflation target?

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Who is in charge of achieving this target rate of inflation?

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Fill in below the main components of aggregate demand.

AD = \_\_\_ + \_\_\_ + \_\_\_ + (\_\_\_ - \_\_\_)

* **Activity 2:** Complete the table below to show the impact on AD

|  |  |  |  |
| --- | --- | --- | --- |
| **Event** | **Effect on AD?** | | **Reason?** |
|  | Component of AD | Rise, fall or stay the same? |  |
| 1. The Bank of England reduce interest rates | C |  |  |
| I |  |  |
| G |  |  |
| X |  |  |
| M |  |  |
| 2.The government cut the basic rate of income tax | C |  |  |
| I |  |  |
| G |  |  |
| X |  |  |
| M |  |  |
| 3. The exchange rate appreciates significantly against all major currencies | C |  |  |
| I |  |  |
| G |  |  |
| X |  |  |
| M |  |  |

**1) Demand Pull Inflation (caused by increasing AD)**

* **Activity 3**: Draw the impact of a rise in AD on the following diagrams:

i) Classical diagram with AD and SRAS ii) Classical diagram with AD and LRAS (full capacity)

iii) Keynesian diagram with AD and AS in recession iv) Keynesian diagram with AD and AS in a boom

* **Extension activity:** Complete the table below to show the main causes of demand pull inflation:

|  |  |
| --- | --- |
| **Cause of demand pull inflation** | **What causes this?** |
| Rising consumption | Low interest rates, low income tax, high consumer confidence, rise in disposable income, greater access to credit, rising asset prices |
| Rising investment |  |
| Rising government spending |  |
| Rising net exports |  |

**2) Cost Push Inflation (caused by rising costs and reductions in AS)**

* **Activity 4**: Draw the impact of a fall in AS on the following diagrams:

i) Classical diagram with AD and SRAS ii) Keynesian diagram with AD and AS

**Cost Push inflation** tends to be affected by short-term changes in aggregate supply**.** The following events would mean that firms have higher cost of production and therefore less incentive to produce.

* Rising oil prices and commodity prices
* Rise in indirect taxation e.g. VAT
* Rise in other costs for firms e.g. wages
* Rising cost of imported materials e.g. due to a fall in the exchange rate

**Wage-Price Spiral**

* **Activity 5**: Complete the following paragraphs using the words listed below

This is most likely to happen when the economy is nearing its \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_, in other words near full employment. When this happens, any increase in demand implies that firms need to expand output to meet the demand. If firms are at or near their full capacity they will seek to attract resources to \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ - labour being part of these resources. Any skilled labour is likely to be \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_and so firms have to offer more attractive packages to persuade people to move from one job to another thus increasing their\_\_\_\_\_\_\_\_\_\_\_\_\_.

Employees will want to be compensated for the higher prices, as they don't want to see their \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_power fall. They will then push for higher wages. The higher wages push up costs again, and so the firms put up prices again. If prices go up again, then people will ....... and so it goes on. The higher wages push up prices, which in turn push up wages, which in turn push up prices …..

A wage-price spiral can be very difficult to get rid of, as people quickly build the increased level of inflation into their\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_. That is why it is called a spiral as inflation spirals up and up fuelled by increased wages.

employed, expectations, expand, costs, productive capacity, purchasing ***fill in the gaps with these***

* **Activity 6:** Cost push or demand pull?

|  |  |
| --- | --- |
| **Event** | **Demand Pull/Cost Push** |
| Increase in government spending |  |
| Rise in national minimum wage |  |
| Adverse weather conditions |  |
| Reduction in interest rates |  |
| Fall in the value of the Pound |  |
| Reduction in labour productivity |  |

**Macroeconomic Policies to control inflation:**

Inflation can be reduced by policies that i) slow down the growth of AD (to avoid demand pull inflation) or ii) boost the rate of growth of aggregate supply (to avoid cost push inflation)

**Extension activity**: research (using text books) the following government policies

* **A) Fiscal Policy:**

What is it?

Example of policies:

* **B) Monetary Policy:**

What is it?

Examples of policies:

* **C) Supply Side Policies:**

What are they?

Examples of policies:

**Deflation**

Define deflation (3 marks)

…………………………………………………………………………………………………………………

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**Video: Japan grapples with deflation and demographics (**[**http://www.bbc.co.uk/news/business-11878314**](http://www.bbc.co.uk/news/business-11878314)**)**

Notes on video; factors causing deflation in Japan:

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**Economic consequences of deflation:**

**Activity 7:** Match the following consequences of deflation with the correct definition

Holding back on spending

Debts increase

Real cost of borrowing increases

Lower profit margins

Confidence and saving

Falling asset prices (e.g. the house prices) cause a negative wealth effect

Consumers may postpone consumption if they expect prices to fall in future

The real value of what individuals and firms owe to banks rise

Lower prices mean reduced profits for businesses – this can lead to unemployment

Real interest will rise if nominal rates of interest do not fall in line with prices

* **Extension activity:** Case study 8.2, p 217 – Are lower prices a good thing?

**Effects of Inflation**

**1. Effect on Investment & Growth**

* Low and stable inflation creates a stable environment for investment, benefiting the economic growth of an economy. Therefore higher, volatile inflation may discourage investment.
* Any boost to investment will increase AD and AS, therefore increasing UK economic growth

**2. Effect on Competitiveness**

* Other factors being equal, a higher price level in the economy will make UK exports less competitive and imports into the UK more competitive. This will have an adverse effect on the balance of payments.
* However, this assumes the exchange rate does not change and does not take into account the quality of exports and imports.

**3. Redistribution Effects**

* Inflation has a large redistribution effect on an economy, leading to changes in income/wealth for households, firms and the state.
* Inflation causes real interest rates to fall and therefore affects savers & borrowers.
* It also erodes the value of money overtime affecting people on fixed incomes.
* The winners and losers of inflation therefore are…

1. Borrowers will see the value of their debt shrink in real terms ☺
2. Savers will be made worse off as a result of inflation, as the real value of their savings will go down ☹
3. Those on fixed incomes (e.g. pensioners) will see the **real incomes** fall ☹

**4. Some Inflation is Beneficial (e.g. Avoids Deflation, Wage Changes Easier)**

* Having some inflation is better than deflation. If prices are falling then consumers will put off purchases, as will businesses. However, this reduces AD and price levels further and means even less consumption and investment. This is a **deflationary spiral**.
* It also helps to allow real wages to fall as workers are more willing to accept them than nominal wage cuts. This can help the labour market clear and aid employment.

**5. Shoe Leather Costs & Price Signalling:**

* If prices are rising in an economy individuals may be unsure as to what fair price is. This will lead to more shopping around (wearing out their shoe leather) which itself is a cost.
* Individuals will also want to hold less cash (as it will lose its value quicker with inflation) and instead use interest bearing accounts. Therefore more time will be spent ‘shopping around’ for the best accounts, increasing shoe leather costs.
* Overall, the price signalling function of the price mechanism is less effective.
* However, the increase in price comparison sites could reduce the show leather costs associated with inflation and increase the information consumers have.

**6. Menu Costs**

* If prices change often then firms will have to change their menus/price labels more often, which obviously costs time and money.
* Some firms could be hit particularly hard such as vending machine or parking meter operators where the cost of changing the machine is much higher than simply changing the price label.

**7. Psychological & Political Costs**

* Some people will feel they are worse off if prices are rising, even if their income is also rising. Therefore, bouts of severe and unexpected inflation can be politically damaging for the presiding Government. Low inflation may increase confidence in the Government.