113 Inflation and deflation

The meaning of inflation

INFLATION is a general **rise** in prices in the economy. A 5 per cent inflation rate over the past 12 months, for example, means that the average increase in prices across the economy during the past year was 5 per cent.

DEFLATION is a **fall** in average prices. Deflation means that, on average, the products are cheaper to buy than before. Note, however, the term 'deflation' is also used to describe a recession in the economy, when the inflation rate is falling but inflation is still positive.

Figure 1 shows inflation since 1959 for the UK economy. There have been considerable fluctuations in the yearly rise in prices, from a low of 0 per cent in 1959 to a high of 24.1 per cent in 1975. At its worst in 1975, a basket of products which cost £1 at the start of the year had risen in price to £1.24 at the end of the year. Today, the Bank of England is given the responsibility of keeping inflation at around 2.5 per cent per year.

Figure 2 shows price changes for Japan since 1990. It experienced deflation in a number of years during the 1990s and 2000s. Average prices were falling in Japan.

The measurement of inflation

In the UK, inflation is usually measured by calculating the change in the CONSUMER PRICES INDEX (CPI). Another commonly used measure of inflation is the RETAIL PRICES INDEX (RPI). Both the CPI and the RPI are measures of average prices calculated from the same data source. Each month, around 12,000 prices of more than 600 goods and services are taken around the UK, and from all different types of business which sell the products to consumers. An average price for that month is then worked out and converted into index number form. The month's figures can then be compared to last month's average price, or that of 12 months ago, to calculate the percentage rise in prices (i.e. the inflation rate) over the period.

Over time, the products which are priced each month change. The exact basket of products is derived from an annual survey of households (the Family Expenditure Survey). Each household taking part has to record everything it spends over a period. From the data, a profile of the 'typical household' in the UK emerges and how it spends its money. Researchers then go out and price up this average basket of products bought by the average family each month.

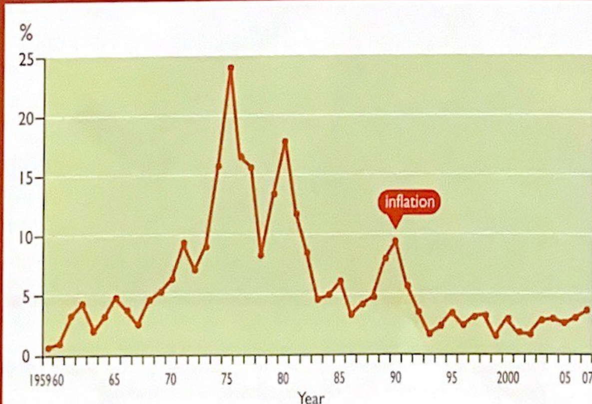
One key difference between the two measures of inflation, the CPI and the RPI, is that the RPI places more weight on changes in house prices.

The causes of inflation

Inflation can be caused by two main sets of factors – demand and costs.

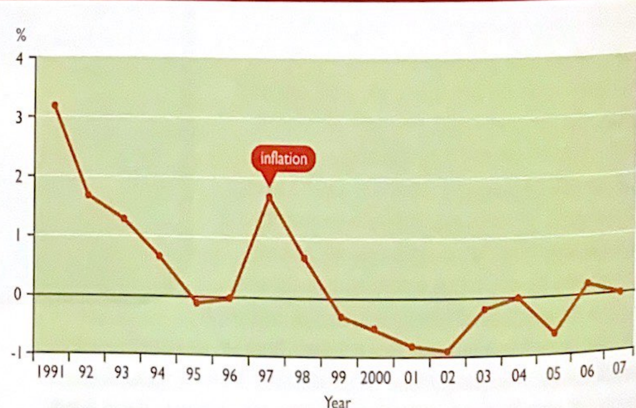
Demand-pull inflation DEMAND-PULL INFLATION is caused by too much demand in the economy as a whole. Typically, the economy is booming and output (AGGREGATE SUPPLY) is not keeping up with the spending of consumers and businesses (AGGREGATE DEMAND). Shortages may develop in some parts of the economy because businesses are working at maximum capacity. In these circumstances, businesses are under little pressure to give discounts to buyers. So prices rise towards their list price. Many might also put up their list prices without losing customers.

Figure 1: Inflation in the UK



Source: adapted from Monthly Digest of Statistics, Office for National Statistics.

Figure 2: Inflation in Japan



Source: adapted from Monthly Digest of Statistics, Office for National Statistics.

Cost-push inflation COST-PUSH INFLATION occurs when costs of production rise without there being a rise in aggregate demand in the economy. Costs may rise for a number of reasons.

- Over the past 50 years, cost-push inflation in the UK has occurred mainly due to sharp rises in the cost of imported goods, such as oil. In 1973-74, for example, the price of oil quadrupled, from around $5 a barrel to $20 a barrel. These 'supply-side shocks' led to large price increases throughout the economy. Inflation in 1975 reached 24.1 per cent, for instance.
- Rises in wages might cause cost-push inflation. In the 1960s and 1970s, there was an increase in trade union militancy. Some argue that this caused wages to rise more than they would otherwise have done. On the other hand, in the 1980s, tough new laws were introduced by government that limited the powers of trade unions and strike action. It can be argued that reducing the power of trade unions reduced cost-push inflationary pressures.
- Other causes of cost-push inflation can be rises in taxes or profits. If the government increases taxes on goods and services, inflation will rise. In 1979, for example, the government increased VAT from 8 per cent to 15 per cent. This added around 5 per cent overnight to the inflation rate for that year. Equally, if the economic climate changes, as it did in the 1980s, and businesses decide that they need to earn more profit, this is likely to come about through price increases.

Wage-price spirals and expectations Cost-push inflation and demand-pull inflation tend to feed off one another. This is known as a WAGE-PRICE SPIRAL. It often starts through a supply-side shock, such as a sudden increase in import prices. Businesses put up their prices to remain profitable. Higher prices lead to workers demanding large pay rises. If they don't get wage rises which are at least as large as the increase in inflation, their standard of living will fall. This is because their wages won't be able to buy as much as before at the new high prices. Large wage increases lead to an increase in aggregate demand as workers spend their pay increases. However, businesses are forced to put up their prices again because their wage costs have increased. This leads to more wage demands and so on.

Wage-price spirals might be restricted by government policy to control inflation. However, at the end of the spiral, inflation tends to stabilise at a certain level anyway, for example 2 per cent in the late 1990s or 5 per cent in the mid-1980s. Stable inflation is maintained through the role of expectations. If all economic agents in the economy expect inflation to be the same as before, then they will act in a way which ensures that it is achieved. For example, if everyone expects inflation to be 2 per cent, then workers will negotiate pay rises of 2 per cent plus a little more to give them higher spending power than before. If workers expect inflation to be 20 per cent, they will negotiate for wage rises in excess of 20 per cent.

Similarly, businesses will base their price rises on expected inflation. If expected inflation is 2 per cent, businesses will tend to raise their prices by a few per cent. If expected inflation is 20

Question 1.

Zeenat is a small garment manufacturer in Nottingham, with 15 employees. It makes up clothes for a variety of buyers, including a couple of high street chains. The past four years have been very difficult for the company. Prices paid have been falling consistently as retailers have increasingly sourced clothes from the Far East. Last month, for example, official statistics were published showing that the price of clothes on the high street had fallen by 1.8 per cent the previous month.

It had all been different when the company was started up ten years previously. Then, prices could be increased each year to cover increased costs such as wage increases or raw material price rises. Today, costs were still going up but prices were falling. Take, for example, the minimum wage which the company has to pay its remaining workers. This had increased by 4 per cent last year and would be going up another 3.5 per cent next year.

(a) Why are falling prices a problem for a company such as Zeenat?

(b) Discuss whether high inflation would pose worse problems for Zeenat than mild deflation would.

per cent, they will put up their prices by around 20 per cent. The whole system can be stable if every economic agent acts on common expectations. But it can be unstable if different economic agents have different economic expectations. For example, a wage price spiral may begin if workers suddenly demand and obtain pay increases of 10 per cent when expected inflation has been 5 per cent.

Inflation, deflation and businesses

Inflation is not necessarily a problem. If prices are rising by a few per cent each year, and the inflation rate is fairly constant, inflation is likely to have little impact on businesses.

The situation is different if inflation is high. At 5 per cent and over, businesses have to be managed to cope with inflation. When inflation gets over, say, 20 per cent per annum, there are serious consequences for businesses. This is particularly true if inflation is fluctuating. For example, if yearly inflation goes from 5 per cent to 25 per cent to 150 per cent and then back down to 10 per cent in a four year period, then a business could easily be forced to close.

Equally, even quite low levels of deflation can have a significant impact on business. So there is considerable difference between 2 per cent inflation per year, which has little or no effect on business, and 2 per cent deflation.

Effects of inflation on businesses

High and particularly fluctuating inflation is likely to be damaging to business for a number of reasons.

Increased costs High or fluctuating inflation imposes a variety of costs on businesses.

- With suppliers' prices rising all the time, but at different rates, time must be spent researching the market for the best deals. Equally, more time has to be spent tracking the prices of competitors to decide when and by how much to increase your own prices. These costs are called **shoe leather costs,** because before the age of the telephone and the Internet, businesses would have to send their employees round on foot to gather this information.
- Raising prices costs money. Customers have to be informed of the new prices. Brochures might have to be reprinted and sent out. Websites might have to be updated. The sales force has to be made familiar with new prices. These costs are called **menu costs** because, for a restaurant, increasing prices means that it has to reprint its menus.
- Management is likely to have to spend more time dealing with workers' pay claims. Instead of being able to sign a two or three year deal, annual pay negotiations are likely to be the norm. If there is **hyperinflation**, where inflation is running into 100 per cent per annum or over, pay negotiations may have to take place each month. There is also a much larger risk of strikes because workers and managers will probably have different views of future inflation rates. Workers will be worried that any deal they make will leave them worse off after inflation. So they might be more willing to take industrial action to get high pay settlements.

Uncertainty With high and fluctuating inflation, businesses don't know what prices will be in three or six months' time, let alone in one or five years. But decisions have to be made now which will affect the business in the long term. For example, businesses need to invest to survive. But how much should they invest? The price of a new machine, a shop or a new computer system will probably be higher in six months than today. But are they worth buying if interest rates are at very high levels? What if the new machine is bought, financed by very high cost borrowing and there is a **recession**, where demand for goods and services falls?

Another problem with uncertainty is linked to entering long-term contracts. A customer might approach a business wanting to buy products on a regular monthly basis for the next two years. How can the supplier put a price on this contract if it doesn't know what the inflation rate will be over the next 24 months?

Borrowing and lending Borrowing and lending becomes an opportunity and a problem for businesses. On the one hand, the real value of debts incurred in the past can become quickly eroded by inflation. If inflation is 100 per cent per annum, the real value of money borrowed a year ago is halved in one year. Inflation initially benefits borrowers and harms lenders.

But in an inflationary environment, interest rates rise to match inflation. If inflation is 100 per cent, interest rates might be 110 per cent. If there is prolonged inflation, interest rates are likely to become INDEX LINKED – linked to the index of prices. So interest might be charged at the rate of inflation plus 5 per cent or plus 10 per cent.

Consumer reactions Consumers react to inflation as well as businesses. Prolonged inflation tends to lead to more saving. Inflation unsettles consumers. They become less willing to borrow money, not knowing what will happen in the future. The value of savings tends to fall as inflation erodes their real value. So people react by saving more to make up savings to their previous real value. Increased saving means less spending and so businesses will sell less.

If inflation is very high, consumers will adopt different spending patterns which may affect businesses. For example, if there is hyperinflation, prices will be changing by the day. Consumers will then tend to spend wages or interest as soon as they receive them. On 'pay day' there can be huge activity in shops. Supermarkets have to be geared up to selling most of the weekly or monthly turnover in just a few hours. Suppliers of fresh produce to supermarkets have to be geared to delivering most of their goods on one day a week.

International competitiveness High inflation poses problems for businesses that buy or sell abroad.

If the inflation rate in the UK is 10 per cent, but is only 2 per cent in France, then UK **exporters** will become uncompetitive against French businesses. For example, if a UK product is priced at 58 pence, it would be sold at €1 in France (assuming the exchange rate is €1= £0.58). Now assume there is inflation in the UK and the manufacturer has to put its prices up by 10 per cent to 63.8p or €1.10. In contrast, competitors in France only experience 2 per cent inflation and put their prices up to €1.02. The UK exporter has therefore lost price competitiveness and will find it harder to sell into the French market.

UK businesses facing competition from French firms will also suffer because French imports to the UK will be relatively cheaper. UK companies might have to put up their prices by 10 per cent because of cost-push pressures in the UK economy when French competitors are only putting up their prices by 2 per cent. UK companies will therefore lose market share in their home market.

Effects of deflation on businesses

Deflation, a general fall in overall prices, can also lead to problems for businesses.

A stagnant economy Deflation tends to be associated with an economy which is not growing in size. It might even be shrinking. This is because falls in price are often associated with falling levels of demand. Consumers are reluctant to spend money. Businesses don't want to increase their investment because their output is stagnant. Demand for exports may also be stagnant, perhaps because of a recession in the world economy. In a stagnant economy, problems could be made worse by rising unemployment. This also tends to reduce the willingness of consumers to spend and borrow. Faced with deflation, businesses will find it difficult to expand their own production. Many could face falling demand for their products if they are selling into markets which are in decline because of changes in spending patterns.

Reducing costs Deflation means that businesses are being forced to cut their prices. When deflation initially occurs, businesses may choose to pay for the price cuts by simply cutting their profits or accepting a loss for the year. But if deflation is prolonged, businesses have to cut their costs to survive. Cost cutting year on year is very difficult. It may be possible to achieve lower costs through more efficient production methods. An alternative is to cut the wages of workers. This is likely to lead to demotivation and threats of industrial action. It is perhaps more difficult to manage a business that continually has to cut its prices than it is to manage one where prices can be slowly pushed upwards.

In recent years, some industries, particularly in the manufacturing sector, have seen the prices of their products fall when prices in the economy as a whole have been rising. They have been suffering from deflation when there has been mild inflation in the whole economy. The cause has been intense price competition, particularly from the Far East and countries like China. They have been forced either substantially to increase their productivity, or to move upmarket where price competition is less intense.

Strategy and inflation

If inflation is low, businesses are unlikely to need to have strategies to cope with changing prices. It is only when inflation rates rise considerably that businesses may need to adapt their strategies. The main strategic responses of businesses to high inflation should be to push up their own prices while at the same time attempting to minimise the rises in their own costs.

Pushing up prices Moderate to high general inflation in an economy is likely to mean that a business is facing increases in its own costs. Suppliers will be pushing up their prices while workers will be demanding higher wages. Businesses can respond strategically to these cost pressures by putting up their own prices and so maintaining their profit margins. Putting up prices will be much easier if competitors are also putting up their prices. Equally, if a business is selling a popular differentiated product, this will reduce the ability of customers to buy elsewhere when prices are raised. However, there is always a danger when putting up prices that sales will fall and market share will be lost.

Reducing costs An alternative strategy to inflationary pressures is to cut costs. For example, a business may buy labour saving equipment in order to cut the cost of labour. It may seek out alternative suppliers willing to charge lower prices. It may look at all its production processes and make changes to increase efficiency in production. Cost cutting is likely to most successful as a strategy when inflation is relatively low. When inflation is relatively high, the best a business might hope to achieve is to have lower cost inflation than its competitors.

KNOWLEDGE

1. What is the difference between inflation and deflation?
2. Explain the problems that a business might face if:
   (a) there is very high inflation of 25 per cent per year;
   (b) there is high inflation and it does not know whether inflation will rise or fall next year;
   (c) it has financial reserves of £2 million deposited with its bank and there is high inflation;
   (d) it is a major exporter and inflation is much lower in other countries;
   (e) prices in the economy are, on average, falling.
3. What strategies might a business use if inflation is high?