Causes of inflation

• Inflation is a sustained increase in the general level of prices
• There are many possible causes of price inflation in an economy – for example
  1. Demand and supply-side causes
  2. Inflation from internal and external sources
  3. Inflationary effects of government / regulatory intervention in the economy
• Average rates of inflation vary widely across the world across countries at different stages of development
The consumer price index (CPI)

Annual % change in the Consumer Price Index

UK Consumer Price Inflation

- CPI Inflation target = 2%

Source: UK Statistics Commission

Mapping the main causes of inflation in the UK

- Basic Pay
- Bonuses + overtime
- Earnings
- Productivity
- Economic Cycle
- Secular Influences (e.g. ICT impact, quality of education)
- Import Prices
- Commodity Prices
- Unit labour costs
- Global Economic Cycle
- Exchange rate / Profit margins
- Fiscal Policy
- Economic Cycle
- Taxes
- Profit Margins

Rate of inflation
Demand-pull inflation

• Demand – pull inflation
  – When there is excess demand for goods and services
  – Positive output gap (where actual GDP > Potential GDP)
  – Businesses respond by raising prices to increase profit margins
  – Demand-pull inflation associated with boom phase of the cycle (SRAS becomes inelastic)
  – Root causes of demand pull inflation are usually monetary in origin (excessive lending / growth of the money supply – monetarist causes)

Main causes of demand pull inflation

• A large depreciation of the exchange rate
• A reduction in direct or indirect taxation
• Rapid growth of the money supply as a consequence of increased bank and building society borrowing
• Rising consumer confidence and an increase in the rate of growth of house prices
• Faster economic growth in other countries – providing a boost to UK exports overseas
Illustrating demand-pull inflation

SRAS responds to excess aggregate demand
Demand-pull inflation using a non-linear AS curve

The Output Gap and Consumer Price Inflation

Output Gap = Actual GDP - Potential GDP. CPI inflation - annual % change in prices

Source: UK Statistics Commission and OECD World Economic Outlook
Cost Push Inflation

- **Causes:**
  - External shocks (i.e., commodity price fluctuations)
  - A depreciation in the exchange rate (higher import costs)
  - Acceleration in wages / unit labour costs in the labour market
- Leads to an inward shift in SRAS curve
- Firms raise prices to **protect their profit margins** – better able to do this when demand is price inelastic
- “Wages often follow prices” - a second-round effects of an increase in the cost of living
- Rise in actual inflation can lead to an increase in inflationary expectations

Illustrating cost-push inflation
Illustrating cost-push inflation – with a non-linear SRAS

General Price Level

LRAS

P1

P2

SRAS1

SRAS2

Y1

Y2

Y3

Yfc

Real National Income

Oil prices and CPI inflation

Annual % change in the Consumer Price Index and monthly average for Brent Crude

UK Inflation and Crude Oil Prices

Annual % change in the Consumer Price Index and monthly average for Brent Crude

Source: UK Statistics Commission and IPE
Average Earnings and Consumer Prices in the UK

Annual % change in earnings and consumer prices

Wage Growth and Consumer Prices - A Link?

Import prices can have a direct effect on the rate of inflation

Index of UK Import Prices

Index 2003=100, source: Monthly Digest of Economic Statistics

Source: Reuters EcoWin
How does the exchange rate affect inflationary pressures?

Inflation and the Exchange Rate for the UK

Exchange rate index (top pane) and inflation (lower pane)

Source: Reuters EcoWin

Consequences of inflation
The costs of inflation

• ‘Taken together, the verdict of economics, history and common sense is that inflation and deflation are costly. It is clear that high inflation – in extreme cases hyperinflation – can lead to a breakdown of the economy. There is now a considerable body of empirical evidence that inflation and output growth are negatively correlated in high-inflation countries. For inflation rates in single figures, the impact of inflation on growth is less clear.’

• *Mervyn King adapted from a speech entitled “The Inflation Target – Ten Years On” given in 2002*

Costs and Consequences of Inflation (1)

• Money *loses its value or real purchasing power* and people lose confidence in money as the value of savings is reduced

• Inflation *can get out of control* - price increases lead to higher wage demands as people try to maintain their living standards. This is known as a *wage-price spiral*.

• Employees in poor bargaining positions lose out and suffer a reduction in their real living standards and relative income level (i.e. to other groups)
Costs and Consequences of Inflation (2)

• Inflation can favour borrowers at the expense of savers – because inflation erodes the real value of existing debts - if real interest rates are negative
• Inflation can **disrupt business planning** and lead to lower capital investment
• Exporters may suffer – if prices in the UK rise higher than those abroad – causing a deterioration in global competitiveness and a worsening of the balance of payments position
• A possible cause of higher unemployment
• Rising inflation is associated with higher policy interest rates - this reduces trend growth

**Economic Growth and Inflation**

UK Real GDP Growth and Consumer Price Inflation. annual % change

Source: UK Statistics Agency
Anticipated inflation

• When people are able to make accurate predictions of inflation, they can take steps to protect themselves from its effects
• For example, trade unions may exercise their collective bargaining power to negotiate with employers for increases in money wages so as to protect the real wages of union members

Unanticipated inflation

• Unanticipated inflation occurs when economic agents (people, businesses and governments) make errors in their inflation forecasts
• Actual inflation may end up well below, or significantly above expectations causing losses in real incomes and a redistribution of income and wealth from one group in society to another
Inflation Expectations
Bank of England/NOP, how do you expect prices to change over the next 12 months?

Inflation Expectations

Source: Bank of England

Some Inflation Web Resources
Join our Facebook Fan Page


Revision Workshops

Modern Cinema Screen Verses Experienced & Lively Presenters Great Materials to Takeaway

Quickfire Revision of Core Topics Timed Exercises & Quizzes No Boring Lectures!

AS & A2 ECONOMICS 12

Student Revision Workshops

Our Team of Top Presenters: Geoff Riley | Ruth Tarrant | Paul Bridges Mike Smallley | Andy Threadgold | Nicky King | Lisa Newton Andrew Irwin | Amanda Campion | Mo Tanerer | Ben White

tutor2u's intensive one-day revision workshops are the ideal preparation for AS & A2 Economics exams. Our experienced and enthusiastic presenter team show you what you need to know and how to develop a practice exam technique to maximise your performance on the day. We use modern cinema screens, high quality materials and interactive presentations to maximise the learning. Please book early - tutor2u workshops are incredibly popular!

Students - just £20 per place (+VAT), including workshop materials & revision CD Teacher places free, including buffet lunch
Tutor2u Economics

Keep up-to-date with economics, resources, quizzes and worksheets for your economics course.