Inflation and deflation

What is inflation? Inflation is a sustained rise in the price level. This means that, on average, the prices of products in an economy are going up over time. As the price level rises each pound buys fewer products. This means the value or purchasing power of money falls.

What is deflation? Deflation refers to a sustained decrease in the price level. Purchasing power increases and households can buy more products with their income.

How is inflation measured? Inflation is usually reported as the percentage change in the price level over the last 12 months. Economist talk about the annual rate of inflation.

Define the inflation rate. The percentage change in the price level over a given period of time.

What is inflationary pressure? Upward forces on the price level from cost push or demand pull inflation factors. Firms may opt to hold or raise prices to maintain margins.

How is the annual rate of inflation measured? The annual rate of inflation is found by calculating the percentage change in a given price index eg the CPI, over the last 12 months.

Define the price level. The average of the prices of all products in the economy.

How is the price level measured? The price level is reported as an index value eg 103.

What is an index? An index measures the weighted average of a group of items compared to its base year value of 100.

What is a price index? A price index measures the price level of a weighted basket (group) of products. The index value of 100 in the base (first) year is the benchmark against which to measure subsequent changes. Eg a rise in the index in year 2 to 105, means a 5% rise in general prices. The annual rate of inflation is five per cent.

List main UK price indices. The Consumer Prices Index (CPI) and the Retail Price Index (RPI)

How are indexes like Consumer Prices Index (CPI) constructed?

- A base year is chosen during which prices were relatively stable eg 2005
- The ONS conduct a Living Costs and Food Survey to identify a representative basket of consumer goods and services bought by a typical household.
- Each item in the shopping basket is weighted to reflect its relative importance to a household. Eg food has higher weighting than transport.
- Each month, the ONS observes prices of products in the basket in a range of UK shops. Survey results are fed into a computer that calculates an CPI value for that month.
- The initial value of the CPI in the base year is 100. A rise in from 110 to 112 means an increase in the price level as measured by the CPI.

What is the difference between the CPI and RPI? The CPI excludes housing costs such as council tax & mortgage interest payments, included in the RPI. RPI inflation generally exceeds the CPI's.

Is a price index reliable indicator of all prices? An index is an average, ie, the one number which best describes an event. Different households have a different experience of inflation as:

- Different regions may face different rates of inflation.
- Different households have different tastes. Can one basket of goods represent all households spending patterns, eg that of pensioners and a young family?
- Given different consumption patterns, can one set of weightings represent all social groupings? Do pensioners and young families place equal weight on nappies?
- New or improved products and may not be captured in the current index.
- It is perfectly possible for essential items such as food to rise in price while less essential items such as plasma TVs fall. On average, the price of most items is rising.

Identify the economic costs of inflation. A sustained increase in the price level results in
**Menu costs:** re-pricing cost to firms eg changing price lists and displays or printing new catalogues

**Shoe leather costs:** eg making additional trips to the bank to put cash into interest bearing accounts

**Income may be redistributed** eg creditors lose if the interest charged does not compensate for inflation

**Inflation generating inflation** eg firms raise prices and staff demand higher wages anticipating inflation

**Inflationary noise:** economic agents are unsure if a price rise is due to inflation or an rise in the relative price of a product eg a car

**Uncertainty** about future prices increases risk and so discourages investment.

**Fiscal drag:** rising incomes draw workers into higher fixed tax brackets causing a higher proportion of income to be paid in tax

**Lost international competitiveness** if domestic inflation rates exceed rivals

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**List potential benefits of inflation.**

- Low stable rates from demand pull inflation may encourage firms to increase output.
- Firms can use inflation to adjust real wages. Staff may resist nominal wage cuts but accept a wage increase below the rate of inflation

**What determines the impact of inflation?** The overall effects of inflation depend on its:

- **Rate:** a 1% annual inflation rate doubles prices every 72 years. A 10% inflation rate doubles the price level every 7.2 years.
- **Duration:** the longer inflation lasts, the greater its impact
- **Trend:** accelerating or fluctuating inflation is a bigger threat than stable inflation rates.
- **Relative international rate.** If UK inflation rates are higher than our trading partners, price competitiveness is lost. Imports are encouraged; exports are discouraged.

**Distinguish between anticipated and unanticipated inflation.** Anticipated inflation is the expected rate of inflation for the near future. Economic agents take account of anticipated inflation in decisions eg wage demands. Unanticipated inflation is unexpected inflation. Economic agents misjudge future inflation rates creating uncertainty and economic instability.

**What causes inflation?** There are two main explanations: cost push and demand pull inflation

**Cost push inflation**

![Cost push inflation diagram](image)

Cost push inflation is caused rising input prices eg energy costs. Firms raise prices to protect profit margins, shifting the AS curve to the left. The price level rises to P2

**Demand Pull inflation**

![Demand Pull inflation diagram](image)

Demand pull inflation results from increases in aggregate demand unaccompanied by an increase in aggregate supply, shifting AD to the right. The price level rises to P2

**List potential sources of cost push inflation.** An increase in wage rates, import prices or prices of raw materials, fuel, energy and components used in production

**Distinguish between first round and second round effects.**

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*Image references:*
- [Image 68x18 to 143x40] (Menu costs)
- [Image 72x185 to 285x344] (Shoe leather costs)
- [Image 303x185 to 516x344] (Income may be redistributed)
- [Image 211x787] (Inflation generating inflation)
- [Image 303x787] (Inflationary noise)
- [Image 77x787] (Uncertainty)
- [Image 211x743] (Fiscal drag)
- [Image 77x774] (Lost international competitiveness)

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*Graphical references:*
- [Graph 1](Cost push inflation diagram)
- [Graph 2](Demand Pull inflation diagram)
• **first round effect**: the direct immediate impact of a change. Eg The first round effect of higher oil prices are raised costs for firms and higher petrol prices for consumers
• **second round effect**: the indirect long term consequences of a change. Eg firms may opt to pass on higher costs to consumers by raising prices; workers demand wage increases

**Do higher input prices always lead to cost push inflation?** Firms may opt to absorb cost increases and accept lower profit margins if a recession means demand is weak, limiting the second round effects of higher input prices

**Is deflation a problem?** Impact depends upon rate, duration and if deflation is anticipated.

- One-off falls in prices increase purchasing power stimulating consumption, and AD.
- **Falling asset prices** (eg houses & equities) reduce personal sector wealth. Households may *increase savings* in attempt to restore previous wealth levels
- Sustained price falls can set off a deflationary spiral. Consumers postpone purchases in anticipation of further price falls. Firms then cut prices in the hope of stimulating sales.

### Unemployment

**Define unemployment.** Individuals willing and able to work but unable to find a paying job.

**What is the working age population?** The working age population are those aged 16 to 64

**Define the labour force.** The labour force is the total number of people *employed* and those registered as *unemployed*.

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\text{Labour force} = \text{number of employed} + \text{number of registered unemployed}
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**What is economic inactivity?** The *economically inactive* are those not seeking a job through early retirement, being carers, long-term sickness or in full-time study.

**Explain the unemployment rate.** The unemployment rate is the proportion of the labour force unemployed and is found by the formula \( \frac{\text{total unemployed}}{\text{number in the labour force}} \times 100 \).

**Define the employment rate.** The percentage of the labour force who are currently employed

**How is the level of unemployment measured?** There are two main measures:

- **Claimant count**: the total of all those claiming unemployment benefit
- **Labour Force Survey (LFS)**: all those who have looked for work in the past month and are able to start employment in the next two weeks. An internationally used measure

**Is the claimant count method reliable?** This method is quick and inexpensive but understates the ‘true’ level of unemployment because those interested in finding work but who do meet all of the criteria for claiming Job Seeker’s Allowance are excluded

**Is the Labour Force Survey method reliable?** The LFS is an internationally used broader, if slower and more expensive, method of measuring unemployment. Discouraged workers who want a job but have given up looking are excluded from the LFS measure of unemployment.

**What are the consequences of unemployment?**

- **Productive inefficiency** through lost output (opportunity cost)
- **Lost government tax revenue** and increased expenditure on unemployment benefits
- Some jobless, particularly the young and skilled, may emigrate reducing potential GDP
- **Trading partners** experience reduced demand for their exports
- **Poverty and social exclusion** can lead to alienation, external costs that affect society.