**Consequences of Inflation 12th October 2010**

**A Level Revision notes**

**Inflation**

There is a persistent tendency for prices to rise. This increase in the price of goods and services is known as **inflation.** Inflation results in a decrease in the **real value** of money. The amount of goods and services that the money can buy will fall.

**What causes inflation?**

**Cost-push inflation**

An increase in the cost of production forces firms to increase their prices to protect profit margins. An example of this is when workers negotiate a pay rise or if suppliers increase their prices. They do this because they have **anticipated** inflation.

**Demand-pull inflation**

This occurs when there is an increase in **disposable income**. As a result demand for products increases. Firms are already producing to near capacity **(overheating)** and they cannot supply the goods quickly enough to meet demand. Firms may increase their prices. As the cost of production doesn’t increase profit margins may go up.

**How is inflation measured?**

**Retail Price Index (RPI)**

This measures the change in the cost of the average person’s ‘shopping basket’ over each month. It is calculated as a percentage using a weighted average method.

**Consumer Price Index (CPI)**

This is calculated in the same way as RPI using a slightly different selection of goods and services. It is usually between 0.5% and 0.75% below RPI and the main difference is that it doesn’t include housing costs such as mortgage interest and council tax.

**The inflationary spiral**

The inflationary spiral is a result of workers **anticipating inflation**. Due to this they negotiate pay rises thereby increasing production costs. To protect profit margins the firm increases prices. Then workers negotiate another pay rise so that they can maintain their standard of living, costs of production increase and so on...

**What happens when inflation is high?**

* **Spending temporarily goes up** as consumers rush out to buy things before the prices go up even more. However if wages don’t go up, spending slows down as people have less disposable income.
* High inflation **encourages borrowing** especially if interest rates are lower than inflation rates. For firms with a high level of borrowing the **real value** of the debt will reduce, meaning it will be easier to repay the loan towards the end of its life.
* As the costs of production increase, firms may **increase their prices.**
* As the disposable income available to consumers decreases they will become **more price sensitive.** Consumers may spend more time trying to get better **value for money**. As a result they may buy from competitors.
* As workers try to maintain their standard of living they may be more likely to take **industrial action** to negotiate pay rises.
* As **suppliers** anticipate further inflationary rises they may **increase their prices** resulting in an increase in production costs.
* **Forecasting** is likely to become **less reliable**.
* If UK inflation is higher than inflation elsewhere in the world, UK products become less **competitive in the international market**.
* The government may use monetary policy to try and slow down inflation rises. This may lead to an **increase in interest rates**.

**Firm strategies to combat high Inflation:**

1. Cut internal costs to keep price rises down.

Evaluation of strategy:

* This strategy may be painful in term of job losses or restructuring.
* If improvements in productivity are made, this may come at the cost of investing in capital.

1. Source from cheaper suppliers.

Evaluation of Strategy:

* Will the source of supplies be as reliable as existing suppliers?
* Will the quality be lower- and could this be indentified by consumers?
* Potential risk of lost reputation

1. Cut profit margins by not raising prices as much as costs.

Evaluation of Strategy:

* The impact of this strategy may depend of price elasticity of demand for the products
* Lower profits may hinder future investment and growth plans of the business.

1. Raise profit margins if inflation is largely caused by ‘demand pull’ pressure – increase prices by more than costs.

Evaluation of Strategy:

* The impact of this strategy may depend on price elasticity of demand for the firm’s products. Elastic products would be affected a great deal.
* Will consumers resent firms taking advantage of economic conditions?

**Hyperinflation**

Rapid and uncontrollable price rises leading to a rapid decrease in the value of money. The value of money decreases so quickly that people lose confidence in it.

**What happens when inflation is low?**

* **Inefficient firms disappear.**
* **Interest rates are likely to be low**, this benefits most businesses.
* As the cost of production is lower firms are **more competitive in the international market.**
* Businesses are able to plan ahead because there is a greater level of **certainty** in the economy.
* As prices don’t change as often **marketing and administration costs will be lower.**
* More time will be available for **long term strategic planning**.

**Deflation**

A decrease in the general level of prices within an economy. It could be said to be negative inflation. The purchasing power of money goes up during periods of deflation.