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Subject: **Economics** Grade & section **11A**

Unit: **6**

Main topic: **Fundamental Concepts of Macroeconomics**

Sub topic/s: **Benefits and adverse effects of inflation**

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Benefits and adverse effects of inflation

There are a number of possible costs of inflation but also some potential benefits. The potential costs include:

1. A reduction in net exports: Inflation may reduce the international competitiveness of a country's products and so increase import expenditure and lower export revenue. This may result in balance of payments problems.

2. An unplanned redistribution of income: Some people may gain and some people may lose as a result of inflation. For instance, if the rate of interest does not rise in line with inflation, borrowers will gain and lenders (savers) will lose. This is because borrowers will pay back less in real terms and lenders will receive less.

3. Menu costs: These affect firms and are the costs involved in changing prices. For example, catalogues, price tags, bar codes and advertisements have to be changed. This involves staff time and is unpopular with customers.

4. Shoe leather costs: These are the costs involved in moving money from one financial institution to another in search of the highest rate of interest.

5. Fiscal drag: This is now sometimes referred to as 'bracket creep'. It occurs when the income levels corresponding to different tax rates are not adjusted in line with inflation. As a result, people and firms are dragged into higher tax brackets. It can be argued, however, that this is a cost of an inefficient tax system rather than a cost of inflation.

6. Discouragement of investment: Unanticipated inflation can create uncertainty and so make it more difficult for firms to plan ahead. This may dissuade firms from investing, which will have an adverse effect on economic growth.

7. Inflationary noise: This is also called 'money illusion'. This arises when inflation causes consumers and firms to confuse price signals. Inflation can make it difficult to assess what is happening to relative prices. A rise in the price of a product may not mean that it has become more expensive relative to other products. Indeed, the product may have risen in price by less than inflation and so may have become relatively cheaper. Inflationary noise can result in consumers and firms making the wrong decisions. For example, firms seeing the price of their products rising may increase output when the higher price is the result of inflation rather than increased demand for their products. This may result in a misallocation of resources.

8. Inflation causing inflation: Inflation may generate further inflation as consumers, workers and firms will come to expect prices to rise. As a result, they may act in a way that will cause inflation. For example, workers may press for higher wages, firms may raise prices to cover expected higher costs and consumers may seek to purchase products now before their prices rise further.

The potential benefits include:

1. Stimulating output: A low and stable inflation rate caused by increasing demand may make firms feel optimistic about the future. In addition, if prices rise by more than costs, profits will increase, which will provide funds for investment.

2. Reduce the burden of debt: Real interest rates may fall due to inflation or may even become negative. This is because nominal interest rates do not tend to rise in line with inflation. As a result, debt burdens may fall. For example, those who have borrowed money to buy a house may experience a fall in their mortgage payments in real terms. A reduction in the debt burden may stimulate consumer expenditure that, in turn, could lead to higher output and employment.

3. Prevent some unemployment: Firms in difficulties may have to reduce their costs to survive. For many firms, wages form a significant proportion of their total costs. With zero inflation, firms may have to cut their labour force. However, inflation would enable them to reduce the real costs of labour by either keeping nominal (money) wages constant or by not raising them in line with inflation. During inflation, workers with strong bargaining power are more likely to be able to resist cuts in their real wages than workers who lack bargaining power.

The effects of inflation depend on:

1. The cause of inflation
2. Its rate
3. Whether the rate is accelerating or stable
4. Whether the rate is the one that has been expected
5. How the rate compares with that of other countries

Demand-pull inflation is likely to be less harmful than cost-push inflation. This is because demand-pull inflation is associated with rising output whereas cost-push inflation is associated with falling output.

A high rate of inflation is likely to cause more damage than a low rate especially if the high rate develops into hyperinflation. Indeed, hyperinflation can lead to households and firms losing faith in the currency and may bring down a government.

An accelerating inflation rate, and indeed even a fluctuating inflation rate, will cause uncertainty and may discourage firms from undertaking investment. The need to devote more time and eff ort to establishing future inflation will increase costs.

Unanticipated inflation, which occurs when the inflation rate was different from that expected, can also create uncertainty and so can discourage some consumer expenditure and investment. In contrast, if households, firms and the government have correctly anticipated inflation, they can take measures to adapt to it and so avoid some of its potentially harmful effects. For instance, firms may have adjusted their prices, nominal interest rates may have been changed to maintain real interest rates and the government may have adjusted tax brackets, raised pensions and public sector wages in line with inflation.

It is possible for a country to have a relatively high rate of inflation but if it is below that of rival trading partners, its products may become more internationally competitive.