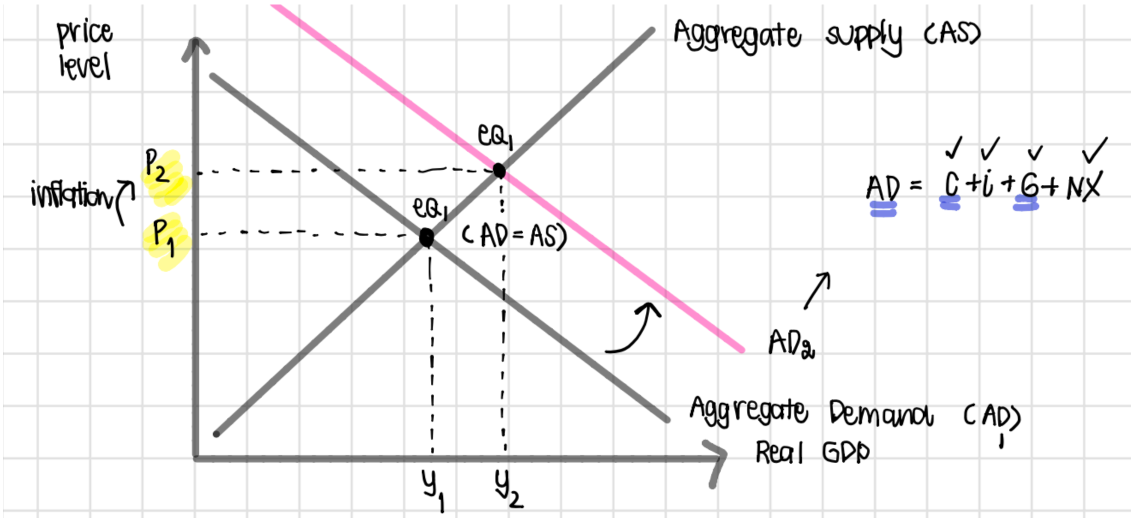
CHAPTER 26 : Inflation (Causes and effects)

Key terms

1. Anticipated inflation : increases in prices that economic actors are able to predict with accuracy.
2. Cost-push inflation : inflation caused by increases in the costs of production in the economy
3. Deflation : fall in the price level
4. Demand-pull inflation : inflation that is caused by excess demand in the economy
5. Disinflation : fall in the rate of inflation
6. Inflation : a general rise in prices

1. Causes of inflation

1.1 Demand-pull inflation



Eg. Central bank reduced interest rate from 10% to 2 %

: Savers receive less benefits from saving

: Savers will spend more and save less

: Consumption will be increases and hence AD will be higher

: AD shifts right and New EQ2, Price level increases from P1 to P2 (Demand-pull inflation)

Or Lower interest means lower cost of borrowing

: Borrowers will borrow more

: It leads to higher investment, AD will be higher

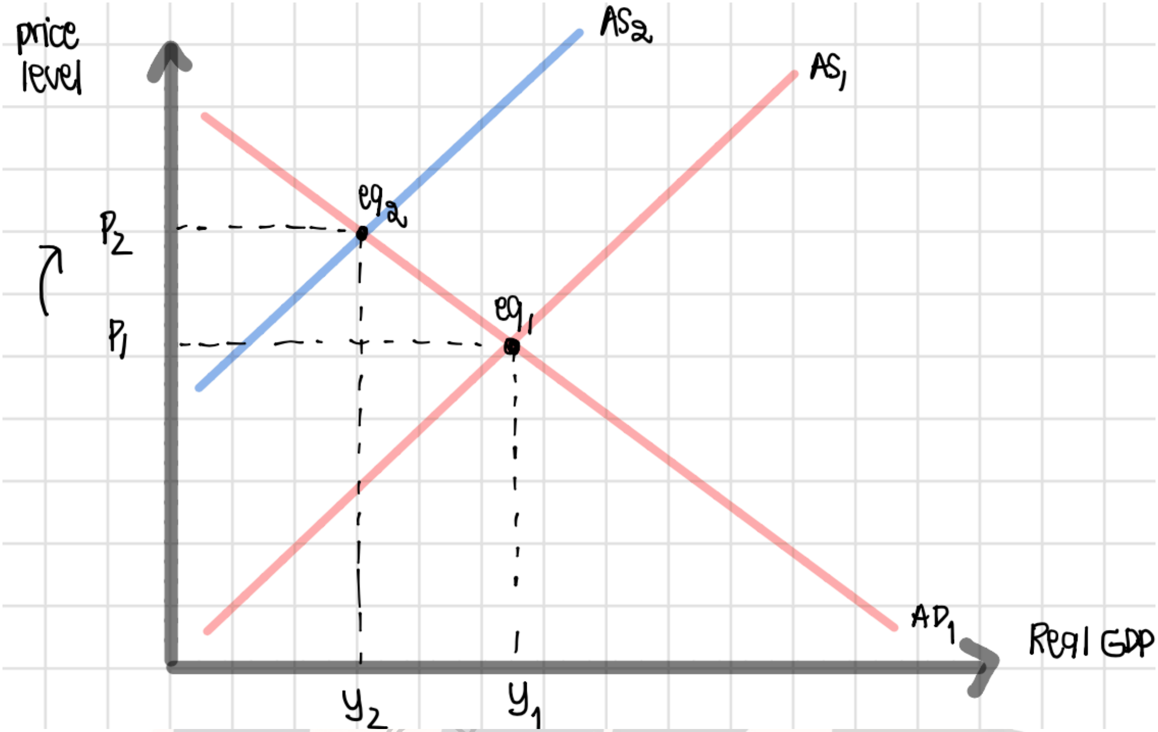
: AD shifts right and New EQ2, Price level increases from P1 to P2 (Demand-pull inflation)

1.2 Cost-Push inflation

: eg. If government increases in minimum wage , cost of production will be higher

: So, Aggregate supply shifts left

: New EQ2, Price level will be higher to P2 which is called cost-push inflation.



1.3 The excessive growth of money supply

: Central bank print out money to buy financial asset from commercial bank

: Commercial bank have more money and then lend money to individual

: Individual consumers have more money to spend more goods and services

: Consumption will be higher, AD shifts right and creates demand-pull inflation.

2. Advantages and disadvantages of inflation

Advantages	Disadvantages
1. Workers will gain more wage during inflation : if the rate of wage increases higher than inflation rate, consumers receive higher real rate of income 2. Borrowers can pay lower real interest of cost of borrowing 3. Producers can more revenue if they sell necessity goods 4. Government may have more revenue if producer receive more profit.	1. Consumers have less purchasing power, : People have less ability to buy products and standard of living will be lower 2. Workers who have fixed income become lower purchasing power. 3. Savers and lenders receive less real interest. 4. Producers who sell some unnecessary goods may receive lower revenue. 5. Domestic producers become less competitive : cannot export to other countries : export will be lower, lower AD and lower economic growth 6. MNC/FDI disincentive to invest in the domestic country because of high production cost or lower purchasing power. 7. Shoe-leather costs : At times of rising prices, consumers and firms will be less clear output about what is reasonable price. This will lead to more “ shopping around”, which in itself is a cost 8. Menu cost : If there is high inflation, restaurant need to change menus to show higher price. Firms have to calculate and issue new price list.