

Chapter 25 Inflation

Answers to Knowledge checks

- 25.1** 104.
- 25.2** The CPIH measure includes housing costs of owner-occupiers and the council tax, so it is more representative of how changing prices affect households.
- 25.3** Perhaps the main reason for pensioner households showing a different pattern of consumption is that in many cases house owners will have paid off the mortgages on their property. This will make a difference to the RPI in particular. Pensioner households may also spend on different goods and services.
- 25.4** This would be disinflation. Deflation would only be used when the rate of change of prices is negative.
- 25.5** Cost-push inflation is initiated on the supply-side of the economy, in contrast to demand-pull inflation, which (as its name suggests) starts with an increase in aggregate demand.
- 25.6** When inflation is running at a high rate, firms have to keep changing their prices. This raises the costs of transactions.
- 25.7** Oil is a key input to many production processes, as well as being an important source of energy for transport. An increase in the price of oil therefore means increases in costs to firms (not to mention motorists), which has a major impact on the economy.

Answers to Exercises and Case studies

Exercise 25.1

- a** Table A25.1 shows index numbers based on March 2015 for each of the variables.

Table A25.1 Index numbers (March 2015 = 100)

Date	Oil price (\$ per barrel)	Average petrol price, South East region (£ per litre)	Average supermarket petrol price (£ per litre)
March 2015	100.0	100.0	100.0
March 2016	64.5	92.2	91.3
March 2017	84.0	107.7	101.5
March 2018	107.0	107.9	106.3

Comparing the price of petrol in the South East region with the oil price, it is apparent that the correlation between the two series is not strong. The oil price fell substantially (by 35.5%) between March 2015 and March 2016, but petrol prices in the South East fell by only 7.8%. By March 2017, oil prices had recovered somewhat, being only 15% below the March 2015 level, but the petrol price in the South East was now 7.7% above the 2015 level. In March 2018, the differences compared with March 2015 were much less marked.

- b** Table A25.2 shows index numbers comparing the price of petrol in the South East with the average supermarket price.

Table A25.2 Index of petrol prices in the South East compared with the average supermarket price

Date	Petrol price in the South East (Index, average supermarket price =100)
March 2015	101.7
March 2016	102.8
March 2017	107.9
March 2018	103.3

These index numbers show that petrol prices in the South East were higher than the average supermarket price in each of the years, although the extent of the difference varied from year to year, being at its highest in March 2017.

Exercise 25.2

- a Table A25.3 shows inflation rates for each country from 2007 to 2016.

Table A25.3 Inflation (rate of change of CPI, % p.a.), 2007–16

Year	UK	USA	Brazil
2007	2.35	0.74	3.62
2008	3.61	1.68	5.70
2009	2.11	1.76	4.85
2010	3.31	1.63	5.04
2011	4.50	3.20	6.60
2012	2.78	2.03	5.44
2013	2.61	1.42	6.23
2014	1.45	1.69	6.28
2015	0.00	0.00	9.06
2016	0.72	1.38	8.74

- b See Figure A25.1.

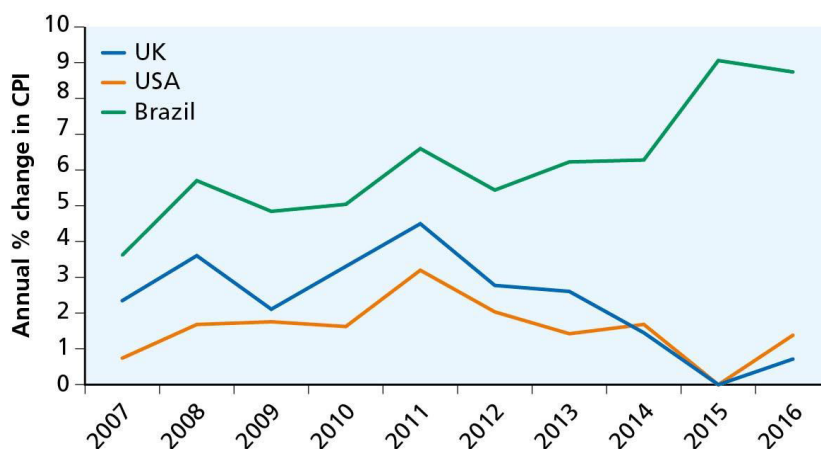


Figure A25.1 Inflation in the UK, USA and Brazil, 2007–16

- c Between 2006 and 2016, the percentage change in prices over the period was 26.0 in the UK, 16.6 in the USA and 81.5 in Brazil.

- d All three countries demonstrate some variation in the inflation rate over this period — indeed, both the UK and the USA experienced zero inflation in 2015. The USA showed a bit more stability (less volatility) than the other two countries. However, Brazil clearly experienced the strongest rise in prices over the whole period, and showed much higher inflation throughout. The USA had the lowest overall increase in prices between 2006 and 2016.

Exercise 25.3

Deflation occurred in 2009, when prices fell by 0.5%. Disinflation occurred in 2008, when inflation fell from 4.3% to 4.0%, and in 2009 when inflation fell from 4.0% to –0.5%. Inflation took place in all years except 2009.

Exercise 25.4

If inflation rises to 15% per annum next year but incomes rise by the same percentage, then, strictly speaking, the real purchasing power of income will not have changed, so why should anyone be worse off?

One reason is that the costs of undertaking transactions have risen. Firms find that to keep pace with changing prices they have to alter their prices more often — these are the **menu costs** of inflation. In addition, people will tend to leave their money in the bank for longer than previously, as there is a cost in holding money balances. They will therefore have to visit the bank or cashpoint more often — these are the **shoe-leather costs** of inflation. These costs reduce the efficiency with which markets are working, so there is some cost imposed on society as a result.

It is also possible that some people will lose out — say, if their incomes are not inflation-protected. For example, pensioners or others on fixed incomes may find that their incomes do not rise by the 15% needed for them to keep up with the rising cost of living. Therefore, there may be **redistribution costs** of inflation.

More important is the case when high inflation also means less predictable inflation. If firms become more pessimistic about the future, and revise downwards their expectations of future demand, they may be less prepared to undertake the productive investment that would increase the productive capacity of the economy. This may damage the rate of economic growth that can be achieved within the economy. Many commentators regard this as the most serious cost of high inflation.

Case study 25.1

The UK economy in mid-2008

Figure 25.5 (*see* page 356 of the book) shows inflation in the UK up to 2008, measured by the rate of change of the consumer price index (CPI). Remember that the government has set a target for inflation of 2% per annum, and if the inflation rate strays beyond one percentage point (in either direction), the Bank of England has to write an open letter to the chancellor of the exchequer explaining why it happened, and how it will be tackled. The first such letter had to be written in March 2007, when inflation briefly rose above the 3% critical figure. The situation in May 2008 seemed more severe, as inflation moved well above 3%, as you can see in the figure. To what extent was this a major concern? From one perspective, it could be argued that the rise in inflation partly reflected events occurring in the global economy — substantial increases in the price of oil and rising food prices. It was a question of judgement as to whether these changes would be long-lived, or just a temporary blip. On the other hand, in the domestic economy, house prices were falling, following the so-called ‘credit crunch’, and expectations about the future were looking gloomy.

Furthermore, Figure 25.6 (*see* page 356 of the book) shows an alternative view of the economy. This shows the unemployment rate, and the data do not seem to show any major cause for concern.

In order to come to a full judgement about the economy's performance, it is important to have information about other aspects of the domestic and global economy, as it may be dangerous to jump to conclusions on the basis of just two indicators. And, of course, the Bank of England's Monetary Policy Committee has regular discussions about the various aspects of the economy. It is this extra commentary on the economy that informs the formation of policy.

Answers to end-of-chapter questions

A Multiple-choice questions

- 1 b. Disinflation
- 2 c. The RPI uses a different basket of goods to the CPI
- 3 b. 4.76%

B Knowledge and understanding questions

- 4 Inflation is an increase in the overall level of prices in an economy.

A full explanation of inflation	2 marks
A vague or partial explanation of inflation	1 mark

- 5 Reasons may include:

- Business and consumer confidence
- To avoid an economic boom
- Exported goods could become uncompetitive

Two reasons explained	4 marks
One reason explained AND one reason identified	3 marks
One reason explained OR two reasons identified	2 marks
One reason identified	1 mark

- 6 Causes may include:

- Demand-pull inflation
- Cost-push inflation

Two causes explained	4 marks
One cause explained AND one cause identified	3 marks
One cause explained OR two causes identified	2 marks
One cause identified	1 mark

C Stimulus response question

- 7 a Deflation is a fall in the average level of prices (negative inflation).

A full explanation of deflation	2 marks
A vague or partial explanation of deflation	1 mark

b

AO1 Knowledge	1 mark
AO2 Application	1 mark
AO3 Analysis	5 marks
AO4 Evaluation	5 marks

Knowledge (1 mark) is likely to include:

- Deflation

Application (1 mark) is likely to include:

- Application to the UK economy

Analysis (5 marks) is likely to include:

Analysis of possible consequences of deflation in the UK economy, for example:

- Deferred spending
- Increase in the level of real debt
- Reduced real profits for businesses
- Reduced confidence from businesses and consumers
- Cost of debt increases

Evaluation (5 marks) is likely to include:

Evaluation that the consequences of deflation may not occur, for example:

- Depends upon the level of deflation
- Depends upon the state of the rest of the economy
- Depends upon the timescale
- Depends upon other factors influencing the economy

A judgement of the possible consequences of deflation in the UK economy