To What Extent is Inflation a serious Economic Problem

Before considering whether Inflation has serious Economic Problems, we have to get to grasp what it exactly is. Inflation is defined as a sustained general rise in prices in the Economy. Obviously the government can't measure every single price change for every single good in the economy, so therefore they take a basket of goods and by using a price index measure a change in it. The basket of good has a representative range of goods and services and it needs to be recorded at a regular basis, to measure how inflation is changing. The UK government currently use the RPI (Retail Price Index) as a measure, which measures, in theory, each month, 150 000 prices for 600 items. Surveyors are sent out to a random set of households and measure it on the same day of each month to record a fair reading. The goods and services in the basket of goods are also weighted, which means the goods and services which use the most household spending are more important than the goods and services which use the least and therefore the larger proportion of total household spending has the largest weight. This all makes the measure of Inflation more accurate.

However, although inflation is a useful measure for the government, as they can see how the general price level affects other economic factors, it still is considered to be a problem. The higher the rate of inflation the greater the economic cost is what economists see and the reasons for this follow.

Stable prices give the consumer a general idea of what a fair price is for a product and which suppliers charge the least for them. With inflation being high, both the consumers and competitive firms will be uncertain what the reasonable price is. This is bad for the economy as this will lead to more "shopping around" to find the lowest prices, which could slow down Growth. As inflation erodes the value of cash, households are more likely to keep their money deposited in banks. Nominal interest rates will be high as the real value of interest payments will be eroded with inflation, so banks and financial institutions will have to raise their nominal interest rates in order to try to persuade more people to keep their money deposited within banks. This means the cost of acquiring credit is higher and firms will have to cut back on investment, which slows down Growth. This time households take to find the financial institution with the largest interests also is a cost to the economy. In economic terms this is called the **Shoe Leather Cost**.

Another cost when inflation is high is called the **Redistributional Cost**. This merely means that inflation can redistribute income and wealth between households, firms and the state. For instance, a fixed income receiver will suffer, if inflation increases. Pensioners on fixed private pensions will lose real income in inflation doubles and their pension stays the same. The value of the money they have received has decreased. Also if real interest rates fall, due to inflation there will be a transfer of resources from borrowers to lenders. The saver will lose the real value lf savings each year, whilst a borrower will see a real reduction in the amount of dept owed per annum. Taxes and government spending has to change in line with inflation and if it doesn't households could be better off with such goods, such as excise duty goods like alcohol and tobacco, as long as their incomes have risen at the same rate as inflation if not more. However households could be worse off if the government fail to increase personal income tax allowances in line with inflation, then the burden of tax will increase for households.

High inflation rates can cause, as economists say, **Psychological and Political costs**, as price increases as deeply unpopular and people will feel they are worse off. The distribution of income, which I talked about above, has to be in line with inflation for real income to stay the same.

An important cost of high inflation is they way it affects unemployment and growth. The shoe leather cost mentioned how high inflation can slow down growth. Inflation increases costs of production and creates uncertainty. This lowers the profitability of an investment and makes the company less willing to take the risk associated with any investment project. This again slows down long-term growth and also means less long-term employment as no one is required to use the investment. High inflation hampers long term planning.

With all these costs of high inflation it must seem apparently clear that low inflation is what the government want. Yes is the answer, but it doesn't mean that low inflation is perfect. It has costs as well as high inflation. Too low inflation is not only a disincentive for production decision but it can also delay consumer spending in anticipation of further fall in inflation and dampen demand at a time when its revival is critical for triggering the upturn. Low inflation also conveys inflexibility to nominal wages and labour markets, causing higher unemployment and deepening the recession. In a period of falling inflation the ability of firms to make adjustment in real wages is severely constrained and this leads to inefficiency in the allocation of resources and a rise in unemployment. However in general low inflation is good to the economy for the following reasons.

Firstly both consumers and businesses are better able to make long-term plans because they know their money is not losing its purchasing power year after year. This is a contrast to high inflation. Interest rates, both in nominal and real terms, are lower, meaning more people will spend. This will encourage investment to improve productivity and allow businesses to prosper without raising the prices. This will be better for the government and consumer. The economy should find a decrease in unemployment and an increase in Long-term growth. From this evidence we can establish that higher inflation causes more of a serious problem to the economy than lower inflation, which in fact has more benefits.

Inflation can also suffer periods of behaviour, such as long term sustained low inflation or hyperinflation or deflation and these scenarios are slightly different to when inflation is just low or high. They have different short term and long-term costs.

Hyperinflation is where inflation levels are very high. Most economists class inflation to be at hyperinflation when there is a monthly increase of at least 50%. The costs of hyperinflation add to the costs of inflation. The shoe leather cost is experienced much greater. Energy is diverted from production to avoiding loss from inflation. This means that more energy is put into coping with the high prices, so businesses will have to cut down in production, which will slow down growth to a very small number. Menu costs will increase as prices are changing constantly. This will happen even when inflation is just high and not just at hyperinflation. This is just when companies merely change price lists and restaurants change menu prices due to inflation. The relative prices, due to such high levels of inflation will not reflect the scarcity of a good, as everything will seem to be expensive. Goods could lose their

image and individuality. Tax systems could also lose their revenue, as taxes will constantly have to be changed to keep in line with inflation, again the same with just high inflation. Hyperinflation on the other hand will have to use a much larger volume of money and the cost of printing will be more for the government, which will be a burden for taxpayers who have to pay for the governments funding. If the government are spending more money printing money, less money will go on the public sector and services will lack. Hyperinflation will cause a negative knock on effect to the economy.

Sustained Low Inflation is the name for long-term low inflation. It has all the benefits of low inflation, however it could cause some problems. If inflation remains low, businesses may find it hard to maintain there profits and therefore have to release workers in order to stay in profit. This could cause high unemployment across the economy.

Deflation is the opposite of inflation and is when there is a fall in the Price level. It can also be used to describe a slowdown in the rate of the growth in the economy. This is basically a name for a fall in the rate of inflation. When deflation happens workers are going to lose their jobs and wages will be cut. This high unemployment will have to be countered by the government using time and resources. Also as prices have gone down there is less incentive for businesses to produce due to smaller profits, so production will fall and the GDP will fall (Less growth).

Inflation doesn't just affect the economy if it is too high or too low; it also affects it if it is not anticipated. Much inflation is unanticipated and households, firms and government are uncertain what the rate of inflation will be in the future. When planning they therefore has to estimate as best they can the expected rate of inflation. To mitigate the effects of inflation the government uses a process called INDEXATION, which allows inflation to be anticipated. This gets rid of some of the costs of inflation however causes some. The indexation builds in cost structures, such as wage increases, which reflect past changes in price.

I have looked at a range of aspects involved with inflation and what the costs to the economy are when the scenarios are different, hyperinflation, sustained low inflation etc. and I conclude that inflation will always have some costs if it is both high and low, but higher inflation, which could lead to hyperinflation has more costs to the economy and therefore causes a greater economic problem.