What are the economic effects of inflation?

Inflation is defined as a persistent increase in the general price level. It can take the form of creeping inflation of several percent per year. This is viewed as healthy for the economy because it means that some level of economic growth is occurring in the economy. On the other hand, hyperinflation can take place in an economy. There is no figure at which inflation can be deemed hyperinflation but a figure of annual inflation as high as 100% could be regarded as such. The economic effects of each of these are different so it will be important to note that I will be looking at creeping inflation.

Inflation affects a large number of economic factors within the economy such as unemployment, growth, the balance of payments, distribution of wealth and taxation revenues.

There are two different causes of inflation. It can be caused by excess demand in the economy. If this occurs it means that too many people are chasing too few goods. It causes a shift to the right of the demand curve. This is not a problem if there are necessary resources to cope with the extra demand and create more goods accordingly. However, if the economy is already operating at full employment or if there is high factor immobility then no more goods will be able to be produced and *demand-pull inflation* will occur. The other type of inflation *cost-push inflation* is caused by an increase in the costs of production. This means that it can be caused by a huge variety of factors. If raw materials are imported from abroad and the cost of importing increases then this type of inflation can occur or if the minimum wage is increased then it is likely to occur to some extent. This means that it is particularly volatile when a raw material that is universally used is increased in price. An example of this is oil as it is used in a wide range of industries. It can also affect the price of most goods in the economy as it causes the cost of transportation to increase.

An economic cost of inflation is that resources are redistributed become economic agents. This can be between savers and borrowers or between households and the government. In the case of resources being transferred between savers and borrowers, this occurs when inflation is higher than interest rates. It means that the real value of people's savings falls. It also means that people gain when they borrow money because the real value of the money they have to pay back will fall. When resources are transferred between the Government and households it is through tax and public sector salaries. The amount that people earn tax free will fall in real terms and the government does not have to necessarily increase public sector workers salaries at a greater rate than inflation so in this way it gains from increased revenue. It can also be transferred between the Government and people on fixed incomes. If the Government do not increase the fixed incomes at the same rate as inflation then resources will be transferred from the people on fixed incomes to the Government. People on fixed incomes are at a great risk from inflation. Examples of these types of people are groups that are often on low-incomes and vulnerable anyway such as pensioners, people claiming various social security benefits. If inflation occurs at a fairly high rate and their income is not increased at the same rate then they will find their real income falling. This is a particular problem for people on low-incomes because it means that they can find it difficult to afford goods that are commoditites.

Inflation also affects unemployment. If demand-pull inflation occurs, then theoretically unemployment will not occur because this type of inflation is caused by a use of all resources in the economy. Unless there is factor immobility when it would be possible for unemployment. However, if cost-push inflation occurs then unemployment can occur. This is because the cost to suppliers of putting their good on the market would increase. If it is not possible for them to make up the shortfall by increasing the price of the good accordingly then workers would be made unemployed. Unemployment can also occur as a result of a worsening in the balance of payments deficit. If British goods become more expensive then fewer people abroad would purchase them. The other side of this is that British people would also purchase more foreign-made goods. This would cause unemployment to increase and the Balance of payments to worsen.

Economic growth is also affected by inflation. The problem with imports becoming more competitive and exports less competitive is that British firms' profits are not as high leading to lower growth. Also, firms are less likely to invest more in the business during a period of high inflation because costs are greater so profits will be lower and overall there is a lower incentive to invest. Greater menu costs can also affect growth. For a large company these increased menu costs would affect the total cost of production and could reduce profitability. Another factor that could affect growth is the fact that speculative investment rather than productive investment can take place during a period of high inflation. This is because people believe that they can benefit from inflation by investing to profit from and paying back less money in real terms rather than investing productively and benefiting the economy as a whole.

Two problems that do arise as a result of inflation and cause inflation to continue are the wage-wage spiral and the wage-price spiral. The wage-wage spiral is a spiral that exists because if one set of workers witness another group experiencing wage increases then they themselves will want their own wages to be increased. Similarly, the wage-price spiral is a problem that is caused by the fact that increased wages cause the price of the good to increase because it is a factor of production. The problem with these is that they are caused by inflation and peoples' desire for their wages to keep up with inflation yet they cause more inflation to take place as they cause the price of goods to increase further.

Overall the economic effects of inflation affect a lot of different factors but have a differing effect on them. Some groups gain from it whereas others are affected badly. Borrowers, people with mortgages and the Government can benefit from inflation whereas lenders, people on fixed incomes and exporting industries are hit badly by inflation.