What are the effects of inflation on an economy?

Inflation can be defined as a sustained rise in general price levels. This is a very general definition as there are so many factors that have to be taken into account when considering the General price level of an entire economy.

In the UK, inflation figures published and announced once a month give certain percentage rates of inflation. These are annual percentage rates indicating the change in inflation between the current year and the previous of the same month. The **Retail Price Index (RPI)** is the most famous, but the government prefers to quote the **RPIX**. Although other measures are used for calculating inflation, these are the most widely used methods in the UK.

The RPI is a set of numbers that show the monthly change in the average of a sample of goods and services. There is an annual family expenditure survey that is used to decide which services are to be used in the sample and which are most important of those. In this sample typical household expenditure such as, food and housing costs would be considered whereas tobacco would not. Therefore, The inflation figures that form the RPI is the annual percentage change in this index from the most recent month compared with the same month in the previous year. This is known as the **headline rate of inflation.**
Alternatively the government will regularly publish the **underlying rate of inflation**, otherwise known as the RPIX. The 'X' doesn't actually mean anything; it's just a symbol that allows us to differentiate between the RPI and the RPIX. This comprises of exactly the same, as the headline rate of inflation except it does not include mortgage interest repayments. though this is a very important part of household expenditures, interest rates and inflation are directly linked. When it is felt that future inflation will rise above the government target, interest rates are raise to reduce **aggregate demand** and dampen inflationary pressures. The problem is that raising interest rates **directly affects** the RPI (through higher mortgage interest), so the instrument that is being used to control inflation affects the inflation rate itself. Thus the government prefer to target inflation based on the RPIX, because the mortgage interest payments are excluded.
The final presentation of the retail price index is the RPIY. This takes the RPIX one further. This is the same as the RPIX, but excludes **indirect taxes** as well. This is also a government-controlled factor, which means that it can be considered to not represent true rates of inflation; especially the government can increase taxations for environmental reasons. Arguably one could say that removing all these factors in calculating inflation would give an inaccurate indication of consumer spending and the price of their spending.

Taking a carefully selected sample of outlets and finding an average price for the each product in the list then calculates the RPI. These values are then multiplied by their respective weights in the list. This value is then divided by the number of products on the list. This number is then converted into an index. All indexes have a base year, or a base month in this case, which is 100. Thus if the base year began in January 2000, and the RPI rose by 4% by February then the index will be 104. This change is plotted onto a graph, which will illustrate inflation rate of change.

The costs of inflation

With continuous changes in the interest rates, time is initially lost, as consumers will shop around for the cheapest possible price of products. There are also the continuous costs of changing packaging and price tags on products as prices change, thus increasing the price of products slightly. These however are the lesser of the problems that arise from fluctuating interest rates. There are more important redistribution effects of benefit from savers to borrowers. This means that if you are a net saver, then you will lose on your savings, however if you are a debtor, then the overall debt will be lower, this posed to be a great advantage to home buyers about 10 years ago as the value of their properties have most likely quadrupled in value. There is also the danger that with constantly changing inflation rates; investors will not be willing to risk investing in businesses or that country's economy because there is a high risk that with a change in inflation they could lose money. With this lack of investment, economical growth begins to slow down, because high interest rates deter foreign traders from buying from that country.

Inflation can be caused by various changes in the economy. Usually an increase in prices is linked either to demand for a product, this is known as a demand-pull inflation, or price of production, this is known as cost pull inflation. If a product costs more to produce, then suppliers increase their prices to meet these extra costs. It is also likely that if a product increases in popularity, companies feel it is possible to increase their profits by raising their prices because consumers will still be willing to pay a higher price.

Another cause of inflation can be an increase of money into the economy. This can be derived, by first assuming that M = amount of money in the economy, V= velocity of circulation, P= price level, and y= level of output. When money circulates in the economy an this equation appears:

$$MV=Py$$

Which can be interpreted as, **money spent = what money is spent on**. Economists believe that V is relatively constant, and that y changes quite predictably therefore any change in M would imply a change in P and visa versa.

With all these factors in mind The Bank of England, and until 1996 the UK Government, has had to monitor inflation rates to prevent the economy from falling into recession. Therefore at the beginning of the year certain economical indicators are agreed upon on the target of economic growth, and consumer spending. The government cure inflation levels by either reducing aggregate demand, or reducing aggregate supply.

There are two popular ways of the government reducing aggregate demand, and they are either by tightening fiscal policies; which involves reducing government spending and/or increase taxation, which leads to reduced consumer spending. Alternatively the

Bank of England can tighten monetary policies, which today means increasing interest rates. Interest rates are directly and inversely link to inflation rates, which means consumer spending will also decrease.
There is also the possibility that through improving education, training and flexibility in trade and business developments, that production would become more efficient, thus reducing market prices and inflation in the long term. This is the method of reducing aggregate supply.

Evidently high inflation rates can have both positive and negative results on traders and consumers. The process of change can in turn have either positive or negative effects on the economy. Hence it is the government, and the Bank of England's interest to control the fluctuating behaviour of inflation rates to maximise economic growth of the UK on a global scale.

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