Inflation

An increase in the average price level of goods and services, resulting in a fall in the value of money.

£ ~~$~~20 in 1999

Train fare (£4)
Cinema ticket (£5)
Burger king (£ ~~5~~ 4)
£13
(£7)

£ ~~$~~20 now

Train (£8)
Cinema (£9)
Meal (£6)
£23

Measuring Inflation

Countries use 'indexes' (e.g. RPI – retail price index) to measure average price changes year by year.

In the UK each month Government statisticians record the prices of c.6000 items that commonly feature in the average yearly household budget.

The average of these changes is calculated and results in a % increase (inflation) or decrease (deflation) for the year.

Causes of Inflation

COST PUSH

- Monopoly – get away with it
- Costs rise
  - materials
  - rates/bills/rent
  - wages – demanded

DEMAND PULL

- Greater demand from customers (wealthy)
- Prices ↑ = Customers can afford
  - profit maximisation
- Control supply so we can match demand
- Overcuts

Business Impacts of Inflation

BENEFITS

If there is still demand, profits should rise (elasticity)

Stock values rise, so higher profit margins made on stock bought previously

Assets appreciate – business is worth more on the balance sheet

Liabilities, like debt, decrease in value, we end up paying back less

DRAWBACKS

Higher wage demands – trade union pressure

Lower demands, less competitive (customers switch to 'lesser brands'

Cash flow problems – uncertain and unreliable forecasting

New loans more expensive

Business Impacts of Government Responses

Refer to page 117

Is deflation good?

Not necessarily…

- Consumers delay purchases in the hope that prices fall further = reduced demand
- As prices fall, costs fall…but so do profit margins
- Previously bought stock and assets lose value
- Less money for capital investment (expansion etc.)

Conclusion

- Businesses will be disadvantaged in periods of RAPID inflation or deflation
- If changes are steady and gradual, the business has more time to respond appropriately
- Businesses must observe carefully and plan responses in advance of changes
- UK and Eurozone targets of inflation are around 2%/year.