



# **MACROECONOMICS - Inflation and Deflation**

By Kru P'Da and Kru P'Eve Knockout.Economics

# Overviews

1. Inflation and deflation
2. Measurement of inflation and deflation
3. Causes of inflation and deflation



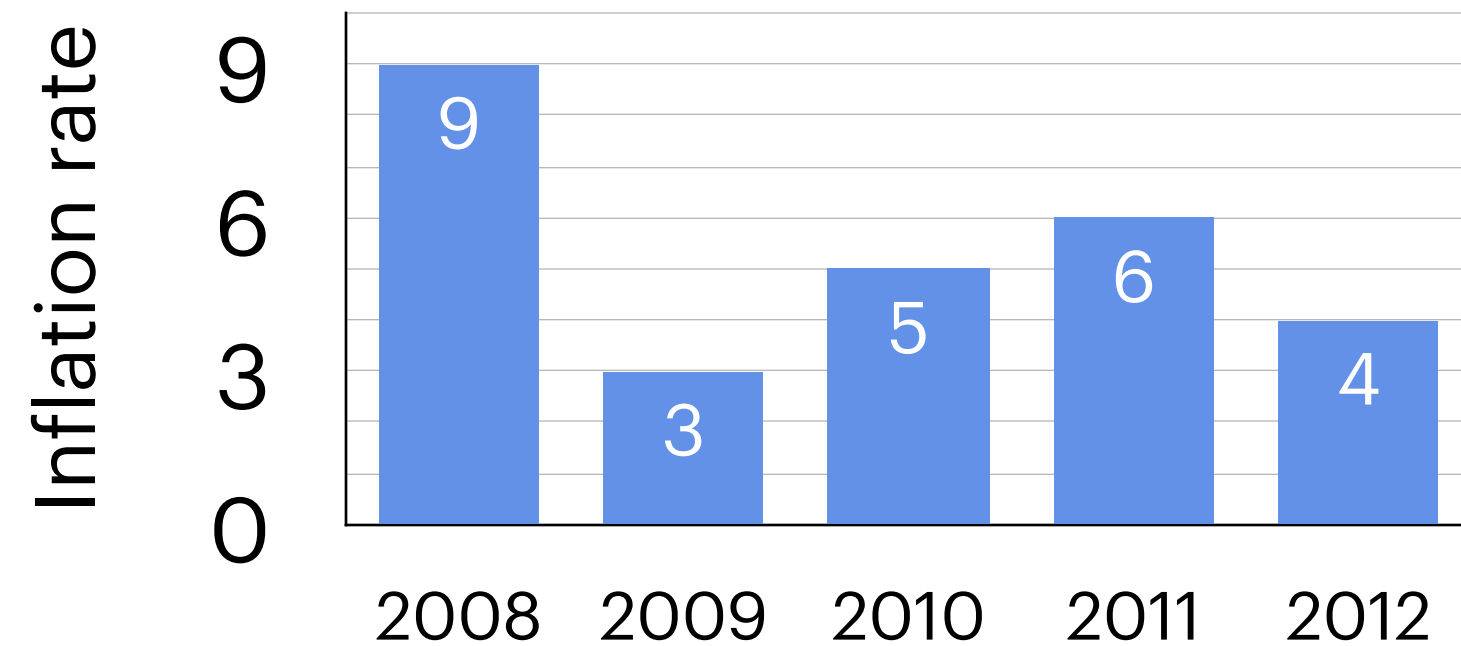
# 1. Inflation and deflation

## Inflation, deflation and disinflation

<b>Inflation</b>	A sustained rise in price of goods and services over period time
<b>Deflation</b>	A sustained fall in price of goods and services over period of time
<b>Disinflation</b>	A fall in the rate of inflation or a rise in price at slower rate

### Exam

Inflation rate in Thailand



(i) Describe what happened to the price level in Thailand between 2008 and 2009 [2]

(ii) Explain in which year the price level was highest in Thailand.

## 2. Measurement of inflation and deflation

### Measurement of inflation and deflation

**Consumer price Index (CPI)** : a measure of the weighted average of the prices of a representative basket of goods and services

### **Constructing a price index**

1. Selecting a base year
2. Choose products into the basket based on spending pattern of household.
3. Find out price changes and the weighted income spending on each product
4. Constructing a weighted price index (weighted income x % change in price)



Basket of goods	Weight income	Price changes	Weighted price index
Food	0.4	105	42
Housing	0.2	100	20
Transport	0.3	95	28.5
Entertainment	0.1	105	10.5
<b>CPI</b>	1.00		<b><u>101</u></b>

$$5. \text{ Inflation rate} = \frac{\text{CPI year} - \text{CPI base year}}{\text{CPI base year}} \times 100$$

$$\text{e.g. inflation rate} = \frac{(101-100)}{100} \times 100 = 1\%$$

# 3. Causes of inflation

Causes of inflation		
1. Cost push inflation	2. Demand pull inflation	3. Monetary inflation
<ul style="list-style-type: none"> <li>When cost of production increases, firms have to maintain profit by rising their prices of products.</li> </ul>	<ul style="list-style-type: none"> <li>When aggregate demand rises and aggregate supply cannot rise at the same rate as rising in AD. Then prices of goods and services increase.</li> </ul>	<ul style="list-style-type: none"> <li>Monetarists believe that inflation is caused by money supply increasing faster than output.</li> </ul>
<ul style="list-style-type: none"> <li>e.g. cost of raw material, wage, indirect tax, cost of capital</li> </ul>	<ul style="list-style-type: none"> <li>e.g. higher consumption, higher investment, higher government spending, higher net export.</li> </ul>	<ul style="list-style-type: none"> <li>When money supply increases, people will spend more leading to an increase in prices.</li> </ul>

# 3. Causes of deflation

Causes of deflation	
Supply-side (Good deflation)	Demand-side (bad deflation)
<ul style="list-style-type: none"> <li>• Price level may decreased by greater efficiency and lower cost of production. It leads to lower price level and deflation.</li> </ul>	<ul style="list-style-type: none"> <li>• A reduction in aggregate demand (<math>AD=C+I+G+NX</math>) leading to lower price level and deflation.</li> </ul>
<ul style="list-style-type: none"> <li>• e.g. technological advance and an increase in labour productivity (higher output per worker per time period).</li> </ul>	<ul style="list-style-type: none"> <li>• e.g. lower consumption, lower investment, lower government spending, lower net export.</li> </ul>
<ul style="list-style-type: none"> <li>• <b>Lower price</b></li> <li>• <b>Higher real GDP</b></li> <li>• <b>Higher employment</b></li> </ul>	<ul style="list-style-type: none"> <li>• <b>Lower price</b></li> <li>• <b>Lower real GDP</b></li> <li>• <b>Lower employment</b></li> </ul>

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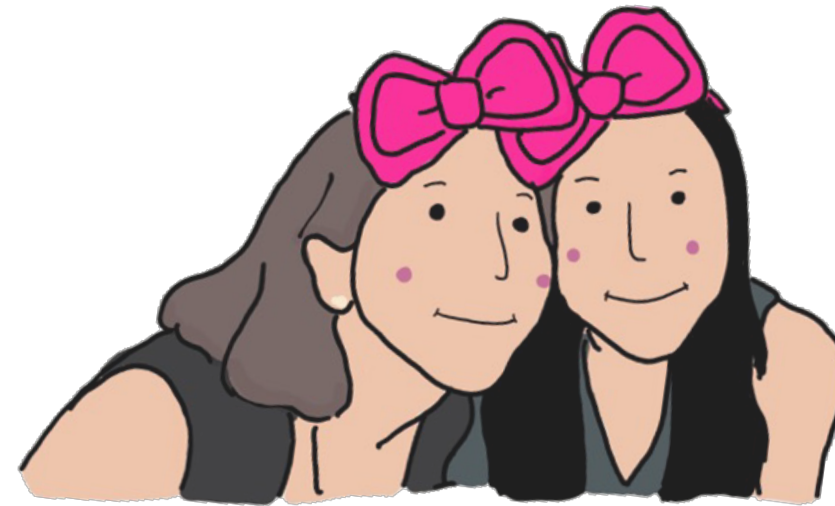
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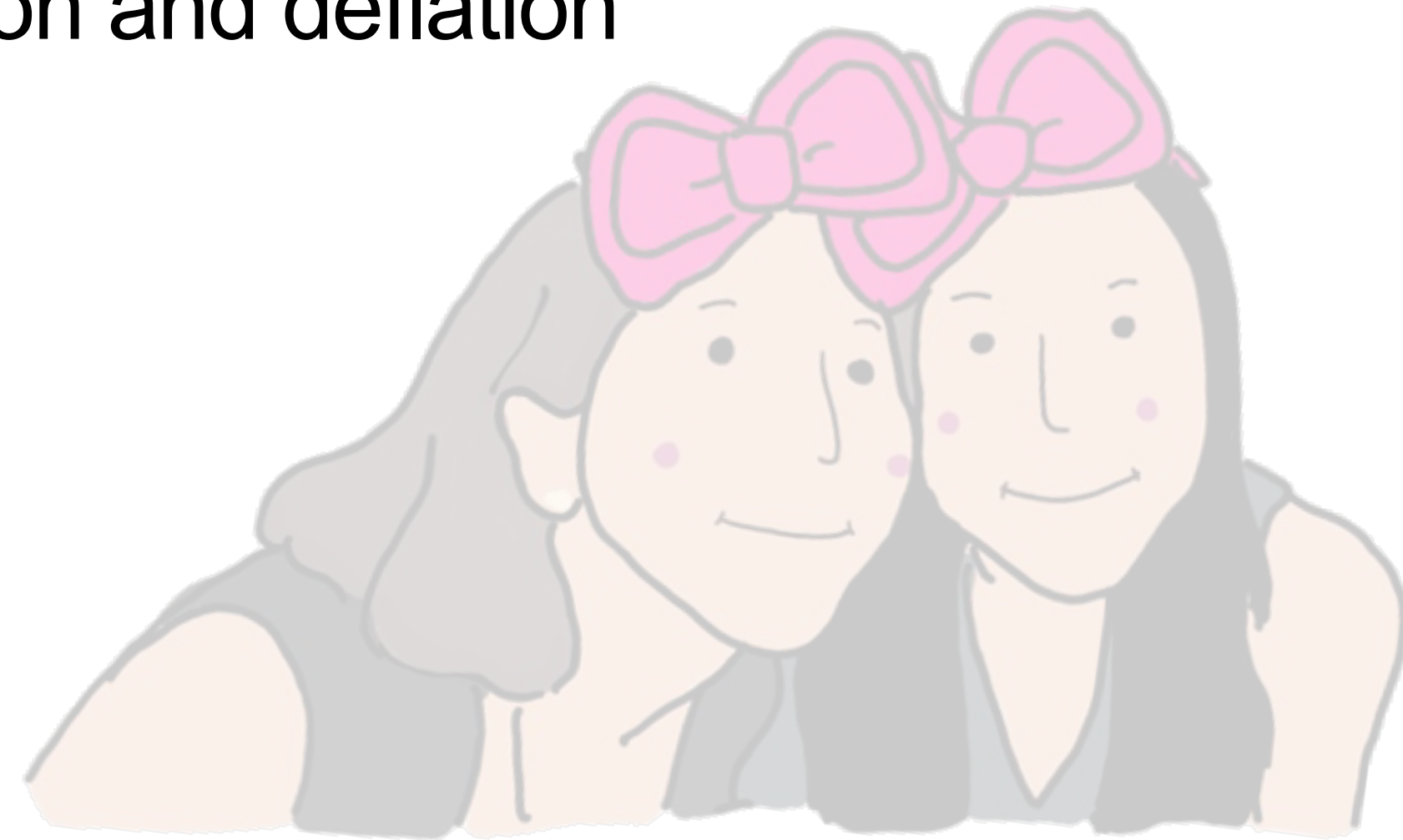
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# **MACROECONOMICS - Consequences of inflation and deflation & Policies to control inflation and deflation**

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# Overviews

1. Consequences of inflation and deflation
2. Policies to control inflation and deflation



# 1. Consequences of inflation

## • Harmful effects of inflation

1.Consumer, worker // producer,MNCS  
2.Government // tax payer  
3.Saver, lender // borrower  
4.Exporter // Importer ***KNOCKOUT 2***

1. **Consumers** have lower purchasing power & living standards.

2. **Fixed income earners** have lower real income (income adjusted for inflation).

3. **Producers** face higher cost of production and gain lower profit. Menu cost is cost of changing catalog and shoe-leather costs is search cost.

4. **MNCs** are discouraged to invest in the country with high inflation as it creates uncertainty.

5. **Tax payers** pay higher indirect tax as price of products rises.

6. **Savers** gain lower real interest rate or real return on saving.  
(real interest rate = nominal interest rate - inflation rate)

7. **Current account** can be worsen, when inflation rate in the country is relatively higher than its rivals. Exports become less competitive, while imports are cheaper than domestic goods. It leads to lower export revenue and higher import expense.

# 1. Consequences of inflation

## • Beneficial effects of inflation

- 1.Consumer, worker // producer,MNCS
- 2.Government // tax payer
- 3.Saver, lender // borrower
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1. **Good inflation** is caused by demand pull inflation, because it results in increasing in national output and employment.

2. **Producers** can gain higher revenue if Inflation is caused by higher spending or demand pull inflation.

3. **Government and borrowers** have lower real debt or real cost of borrowing when prices rise.  
(real interest rate = nominal interest rate - inflation)

4. **Current account** may not be worsen, if inflation rate in the country is still lower than rival countries. Inflation will not negatively affect international competitiveness.

# 1. Consequences of deflation

- Harmful effects of deflation

- 1.Consumer, worker // producer,MNCS
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1. **Bad deflation** is caused by a fall in aggregate demand. It can cause a fall in domestic production, employment and economic growth.

2. Deflation may cause **economic recession**. **Consumers** expect that price level continuously falls, then they pass on consumption to the future. It results in lower spending and production.

3. **Producers and MNCs** are discouraged to invest, if deflation is caused by a fall in aggregate demand or total spending in an economy.

4. **Borrowers and government** may have higher real debt.  
(real interest rate = nominal interest rate + deflation)

# 1. Consequences of deflation

## • Beneficial effects of deflation

- 1.Consumer, worker // producer,MNCS
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1. **Good deflation** is caused by an increase in aggregate supply (such as technological advance), leading to higher national income and employment.

2. **Consumers** have higher purchasing power resulting in better standard of living.

3. **Saver, lenders** gain higher real interest rate.  
(real interest rate = nominal interest rate + deflation rate).

4. **Current account improved** as deflation makes exports become cheaper in foreigners' view and imports become more expensive than domestic goods. It leads to higher demand for exports and lower demand for imported goods.

## 2. Policies to control inflation

### Policies to reduce demand pull inflation

#### 1. Contractionary fiscal policy

- **A cut in government spending** decreases AD. It reduces demand pull inflation.
- **A rise in income tax** reduces consumption and AD. It reduces demand pull inflation.

#### 2. Contractionary monetary policy

- **Increasing interest rate** encourages people to save rather than spend, resulting in lower consumption and AD. It reduces demand pull inflation.

### Limitation of contractionary fiscal and monetary policies to reduce demand pull inflation

1. It depends on **consumer and business confidence**. e.g. even interest rate increases, people may spend more when they have high confidence.
2. It depends on **size of policies**. A small increase in interest may have limited impact in reducing AD; as a result, inflation rate may not decrease.

## 2. Policies to control inflation

### Policies to reduce cost push inflation

#### 1. Supply-side policy

- **Providing education and training** can improve labour productivity resulting in lower cost of production and prices of products.
- **Deregulation** decreases cost to firms. They can supply more outputs at lower prices.

### Limitation of supply-side policies to reduce cost push inflation

1. **Poor quality of education** cannot improve labour productivity.
2. Supply side policy has **time lag**. For example, the effects of education will be seen in the long run.
3. **Some policies**, such as government spending on education, will increase aggregate demand as well, **causing demand-pull inflation**.

## 2. Policies to control deflation

### Policies to reduce deflation caused by falling in AD

#### 1. Expansionary fiscal policy

- **A cut in income tax** increases consumers' disposable income and spending, resulting in higher consumption and demand pull inflation.
- **Government** increases spending leading to higher AD and demand pull inflation.

#### 2. Expansionary monetary policy

- **Lower interest rate** encourages people to spend rather than save. It causes higher consumption and AD. While lower interest rate encourages firms to borrow money to invest resulting in rising in AD.

### Limitation of policies

1. The effectiveness of reducing income tax on rising AD depends on **consumer confidence**. e.g. people might save more and spend less if they lack of confidence.
2. It depends on **size of policies**. E.g. small cut in interest has limited impacts in increasing AD.

## 2. Policies to control deflation

### Policies to reduce deflation caused by rising in AS

**Government does not need to intervene for good deflation.** Good deflation is when prices of goods and services fall by a reason of a fall in cost of production.

### Limitation of policies

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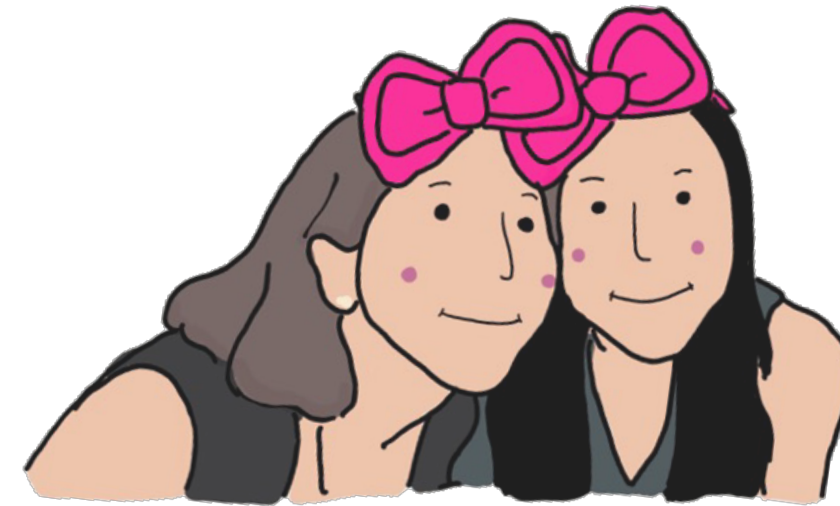
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# **MACROECONOMICS - Exercise**

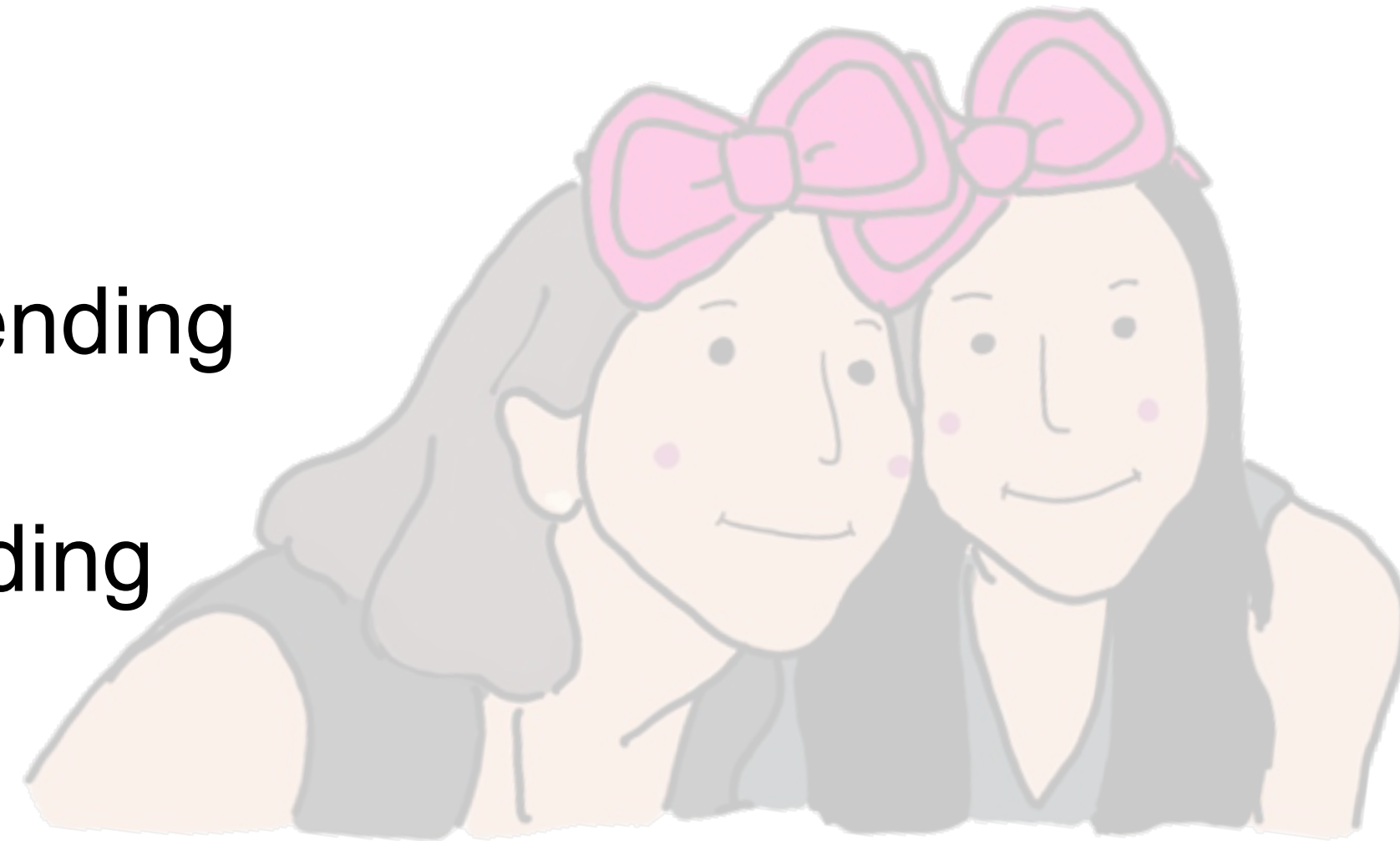
## **Inflation and Deflation**

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## Exercise: MCQ

1.) Which choice increased will help a government to reduce inflation rate?

- A. Budget surplus\*
- B. Government spending
- C. Consumer spending
- D. Export



## Exercise: MCQ

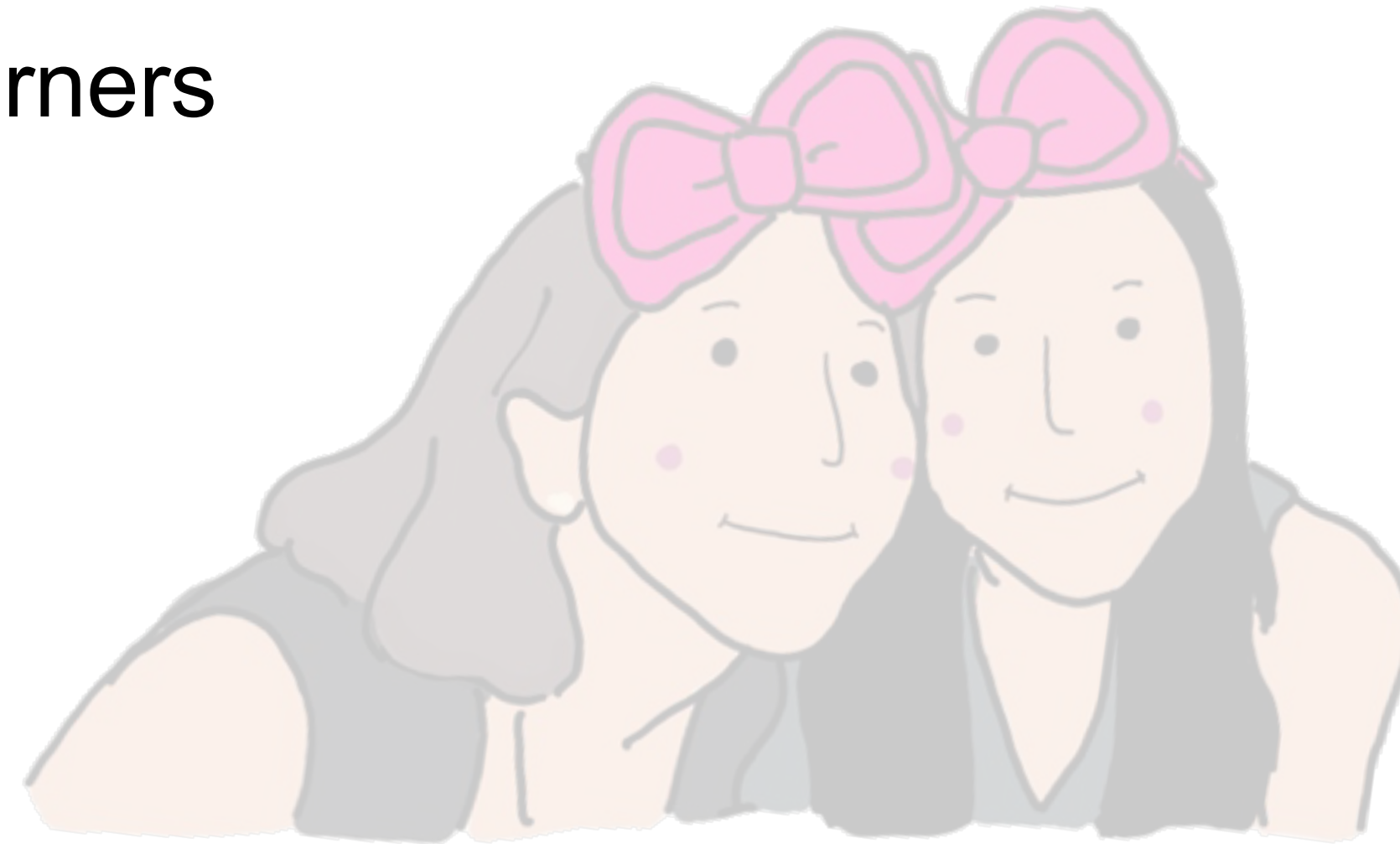
2. ) Who is the most likely to benefit during the period of inflation?

A. Fixed income earners

B. Savers

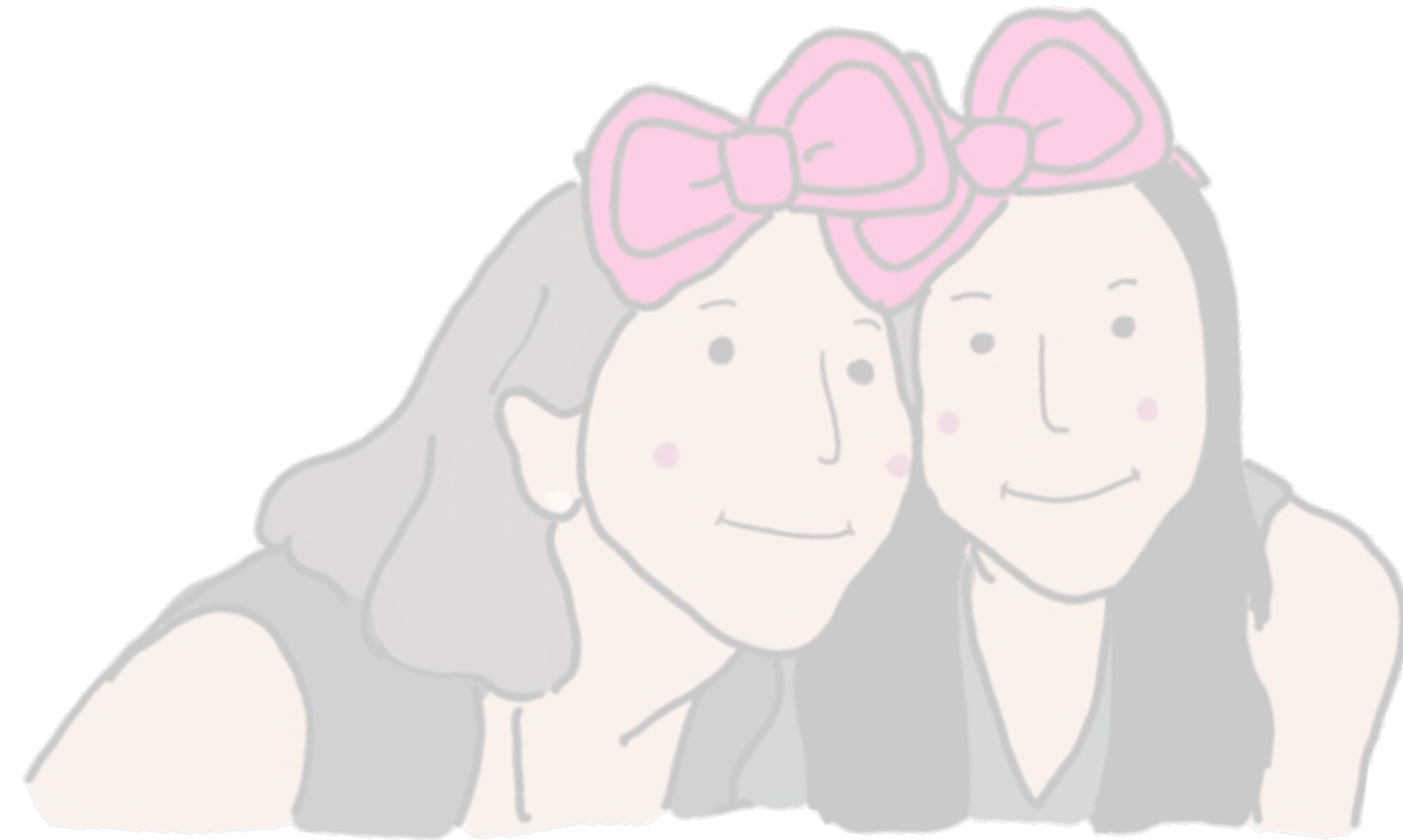
C. Borrowers

D. Exporters



# Exercise: Essay

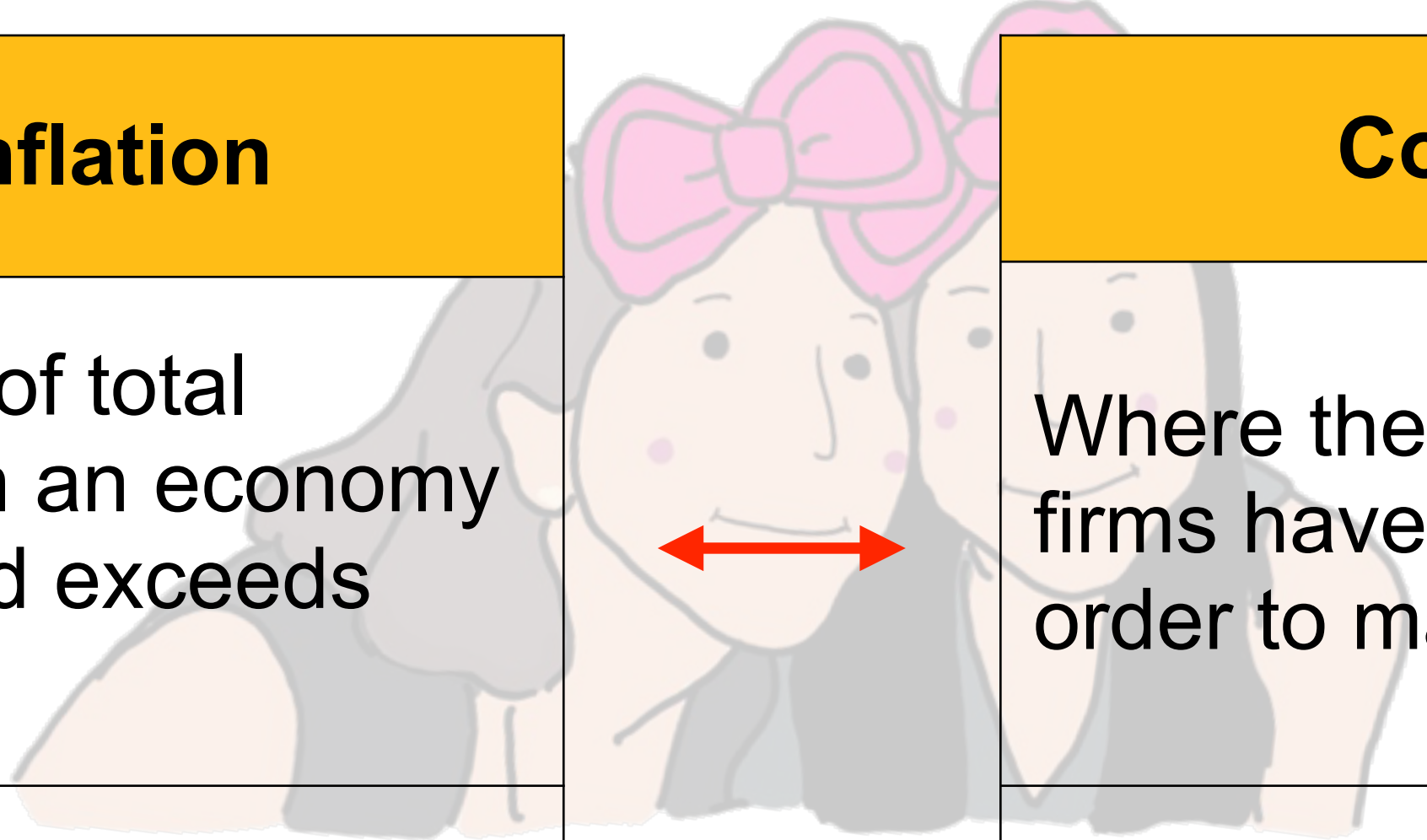
1.) Distinguish between demand-pull and cost-push inflation. [4]



# Exercise: Essay

1.) Distinguish between demand-pull and cost-push inflation. [4]

Demand pull inflation	Cost-push inflation
Where the rising level of total (aggregate) demand in an economy and aggregate demand exceeds aggregate supply.	Where the costs of production rise firms have to increase prices in order to maintain their profit.
e.g. higher consumption, higher investment, higher government spending, higher net export.	e.g. higher wages and raw materials
higher national output or GDP	Lower national output or GDP



# Exercise: Essay

2.) Explain three reasons why high inflation rate is regarded as a serious problem. [6]

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4. **Lender** do not want to lend money due to lower real return leading to lower investment.
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