Inflation and it's impact on business

Specification requirement—The impact of inflation on businesses.

Currently the United Kingdom is in an extended low inflation period. At time of writing, February 2013 the CPI inflation rate is around 2.7%, and the RPI index at around 3.5%. Inflation has been a little higher than government targets over the last 2 years (actual 3-4%, target 1-2%), but the major problem has been economic growth rather than fighting inflation. Relatively low levels of inflation have been with us for the last 18 years, with CPI inflation varying between 2% and 5%. This low level of inflation contrasts with inflation peaking at 27% in 1977 and an average rate inflation of around 10% during the 1980's.

The government regards achievement of low level of inflation as being good for the economy. This is because low inflation encourages investment by business and spending by consumers. It also has the effect of increasing our competitiveness with overseas producers, so in theory limiting imports and increasing exports.

In an attempt to control the level of inflation the government has handed its main inflationary policy tool, that is the setting of interest rates, to the Monetary Policy Committee of the Bank of England. The government' sets targets for inflation between narrow bands (CPI of 2%, + or - 1%) and requires the Monetary Policy Committee to maintain inflation between these bands by the use of interest rate policy. This use of interest rates as one of the main tools of economic management, has been with us since the mid 1980's. Previous to this time we had long period of economic management through Keynesian policy and in the early 1980's through Monetarist policy.

Measuring Inflation

The government measures inflation through the use of regular pricing of a basket of goods. This basket of goods is meant to reflect the spending habits of the average person within the UK economy. So the basket contains such things as petrol, cars, travel, holidays, consumer electrics, food, medicines, housing, and even lottery tickets. By judging and measuring the difference in the cost of purchasing this basket of goods on a monthly basis we are able to obtain an inflation figure. It is worth noting that there is more than one measure of inflation used in the UK. The target rate of inflation is known as The Consumer Prices Index (CPI), this is measured using the basket of goods as indicated, other measures of inflation include RPI, the RPIX, and a measure of Factory Gate Prices

Causes of inflation.

Inflation is primarily caused by either cost-push factors or demand-pull factors.

Cost-push factors are those related to the costs of production, and cause these costs of production to increase. Examples would be an increase in the cost of raw materials, increasing cost of Labour or increasing interest rates and therefore the cost of capital increasing. We have over the last 2 years seen a sustained

increase in the price of oil, this has the potential to cause cost push inflation.

Demand-pull factors are those factors that enable firms to increase prices because demand is increasing. Higher demand leads to higher prices. We often see this happening when demand outstrips supply, then prices start to increase. The main causes of increased demand are; increased confidence amongst consumers, higher real incomes (incomes allowing for inflation), or higher disposable incomes (incomes after taxation).

When these two sets of factors, cost push and demand pull. come together we can have what is known as of wage price spiral. We see how the inflationary spiral is created below.

Increasing inflationary expectations can lead to demand for higher wages, this situation is often seen during a period of recovery in the economy when a shortage of labour, can give workers the confidence to demand increased pay. These higher wages increase the cost of production and also increase levels of demand.

If firms pass on these increased costs to consumers, prices would increase. Increased prices will need to another round of wage increases, as workers try to protect their spending power (real incomes). Therefore the cycle continues. Inflation becomes self-perpetuating.

The effects of inflation on firms.

The major effect of inflation on firms is to discourage investment. High inflation brings with it less predictable returns on capital purchased and the also the expectation that demand will fall in the future. This discouragement of investment is one of the main reasons why the government wishes to limit inflation. Low inflation will encourage investment and a help businesses develop a long term view. One of the major problems with British Industry (and Governments) in the past is that they have been unable to look beyond the next boom or bust period. Remember that investment is not just capital investment but also investment in labour, such as training schemes, and the incorporation of modern working practices. Firms have in the past taken the view that there is little point in investing in labour if they are going to make redundancies during the next recession.

There are other impacts on firms.

- **Increasing menu costs.** If inflation is at a high level, firms will have to continuously re-price goods. This re-pricing brings with it costs such as reprinting of brochures, sales details etc.

- **Shoe Leather costs.** If inflation forces up the price of raw materials or components, the firm will be forced to shop around for cheaper raw materials or components, again increasing costs to management. The advent of B2B has reduced the impact of shoe leather costs on firms.

- **Increased management time spent negotiating wage increases with employees** If inflation is high then there will be more regular and continuing pressure for increase in wages. Negotiations with employees may be almost permanent and there will be an increased threat of industrial action.

There is one major advantage of inflation, and that is it will reduce the real cost of repaying

loans. But this saving has to be balanced by the high interest rates that go with high levels of inflation.

Effects of deflation

Deflation (a general fall in price levels) can be a real problem if it gets hold in an economy,. For individuals it can lead to falls in wage levels, and increasing real debt burdens (value of debts increase relative to value of assets and income). Both of these factors discourage expenditure.
Deflation also brings major problems to firms. Firstly as a result of the above described impacts on consumers, demand will fall, also consumers will defer purchases, waiting for the price of goods to fall further, so again reducing demand. Firms will also be nervous of investing as the return that investments will produce will be uncertain, as firms do not know how much the goods produced will be sold for. Also real debts of firms increase, pushing up the risk of failure.
These factors severely limit growth in an economy.

Conclusion

We can see then that inflation can be regarded as the enemy of long-term growth and it is true to say that one of the main causes of the decline in international competitiveness of UK industry over the period between 1965 and 1990 has been high inflation, especially in comparison to our major competitors, but perhaps our major concern toward the end of the first decade of he 21st century is the threat of deflation..

Notes