The cause and effects of inflation essay

Most people are aware that inflation is a continuing rise in the general level of prices, but it is also important to know the causes and effects of inflation as well. It is also important to understand that inflation is self-sustaining and can act as a snowball effect.

Consumers expecting a rise in prices may increase spending, causing the market prices to rise. In the periods of higher prices, producers may be more inclined to increase wages and other costs, because these higher costs can be passed on to the consumer in the form of increased prices.

These higher prices become the basis for further increases in production costs and higher prices, and the snowball effect begins. Inflation has a huge effect on our economy as it affects the distribution of income, the allocation of resources and the output of resources.

These three effects are the major effects of inflation and are generally referred to as Equity effects, Efficiency Effects, and Output Effects. Equity effects generally refers to the alteration in the distribution of income. This alteration can cause harm or good, depending on the particular individual and their source of income.

An individual on a fixed income may be harmed by inflation as they are losing some of the value of their salary.

Their purchasing power is reduced because their $25, 000 salary will not buy as much as it did previously because the prices of goods and services has increased, while their salary has remained the same. Savings bonds and other fixed money can also be hurt by inflation as well. On the other hand, those who depend on income in the form of profits may benefit. Business owners and owners of stocks may see this if the rate of profits rises faster than the rate of inflation.

Efficiency effects involve the changing of resource allocation. Because inflation increase demands for goods and services the supply for these goods and services are also increased. Also, inflation causes people to make adjustments to their from of money, as income held in the form of money tends to lose value with inflation. The time spent on this adjustment causes a reduction in economic efficiency.

Output effects of inflation are usually seen as increased production and employment due to an increase in real profit income for business owners due to the price increases usually staying ahead of wages.

Because of this, inflation is said to stimulate the economy as business owners increase employment to make up for this increase in production that occurs with inflation. The Federal Reserve Board, which has a certain amount of control over all banks, has several ways with which it can control inflation. The three main policies that the FED uses to influence money growth, which influences inflation are the Required Reserve Ratio, the Discount Rate, and the Open Market Operations.

The Required Reserve Ratio is the ratio of reserve that banks are required to maintain.

When the FED wishes to slow money growth, which tends to slow inflation, it would raise the reserve requirement. This usually tends to have banks lend out less and decrease loans, which causes less spending in the economy as less there is less money being borrowed by consumers. On the other hand a decrease in the Required Reserve Ratio would have the opposite effect as banks would not have to hold as much in reserves, which would lead them to increase loans. This increase in loans would increase money available for consumers, which would increase pending.

The discount rate is another policy implemented by the FED. This is the rate of interest that the Federal Reserve Bank charges when it loans out money to other banks. When this interest rate is increased, banks will tend to borrow less from the FED, which as a result decreases their reserves. Banks in turn raise their interest rates on loans because of this, which leads to less loans being taken out by consumers. Less loans taken out b consumers means less spending, which slows the money growth, which slows inflation.

On the other hand, if the FED was to lower its Discount Rate, banks would increase the amount borrowed, keep a higher reserve and set interest rates for its loans lower. As a result, consumers would spend increase borrowing and increase spending as well, which in turn, would increase money growth and increase inflation. The last major policy of the FED is Open Market Operations. This policy is where the Federal Reserve Open Market Committee buys and sells Federal Securities. When an Open Market purchase is made, the FED is buying Federal Securities from banks or from the public, which causes banks excess reserves to increase.

This increase will cause more loans to be made by the banks, which in turn increases the money supply. The FED can also have an Open Market sale, in which it sells Federal Securities. The result of this is a decrease in excess reserves and results in banks lending less, which reduces the money supply. Overall inflation has a big impact on our economy, and can have great effects, which may be either harmful or helpful. With the Fed’s policies, a certain amount of limited control has been set over inflation and can be adjusted to fit the FED’s goals.

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