Inflation critical analysis

Finance, Financial Analysis

The cost of inflation depends on two cases; perfectly anticipated inflation and unanticipated inflation. Anticipated inflation is defined when individuals are able to make accurate predictions of inflation, they can take steps to protect themselves from its effects. Also, trade unions might use their bargaining power to negotiate for increases inmoneywages to protect the real wages of union members. Households may want to switch savings into accounts offering a higher rate of interest or into other financial assets where capital gains might exceed price inflation.

Businesses can adjust their prices and lenders can adjust interest rates. However, businesses may also seek to hedge against future price movements by transacting in " forward markets". For example, many airlines such as Bahamas-Air may buy their fuel months in advance as a protection or 'hedge' against fluctuations in world oil prices. In Contrast, When inflation is unanticipated, individuals do not realize that they should protect their real purchasing power against a rising price level until the price level has already risen and their real purchasing power has already fallen.

In this instance, there will be gainers and losers, in terms of purchasing power, from the inflation. In general, unanticipated inflation causes a misallocation of resources. Firms, unions, banks, will push prices and wages up. Those who can do it best will cause a misallocation of resources. For example suppose workers at manufacturing companies in the Bahamas wage increases, and public employees don't. Then, resources (labor) will be reallocated due to the relative market power of the different workers.

But more importantly, lenders such as Banks will lose withrespectto borrowers, giving individuals an incentive to borrow. For instance, when Bahamian people take out mortgages in order to buy houses at fixed interest rates, they end up aying back less in real terms than they had contracted for, wealth is then redistributed from banks and other financial institutions to homeowners with mortgages. In relative terms, borrowing becomes cheaper than paying in cash.

Another example would be if individuals who retire on pensions that are fixed in nominal amount will find the values of those pensions in terms of the goods they buy eroded as years pass, in this case the redistribution is from pensioners to the owners of insurance companies and other financial institutions that have contracted to pay them fixed dollar amounts. Alternatively, individuals have the incentive to spend now before the price level rises further.

This however, will push prices up even faster, and may cause the inflation rate to accelerate and if uncertainty continue to increase, consumers and investors become less certain about the future, as prices rise in an unanticipated fashion. They may change their pattern of spending, and be less willing to undertake projects that take a long time to payoff. The Costs of Hyperinflation. Hyperinflation is define when the prices of most goods and services skyrocket, usually more than 50% a month. It usually starts when a country's Federal government begins printing money to pay for fiscal spending.

As the money supply increases, prices creep up as in regular inflation. However, instead of tightening the money supply to lower inflation, the government keeps printing more money to pay for spending. Once consumers realize what is happening, they expect intlation. T causes them to buy more now to avoid paying a higher price later. This boosts demand, causing inflation to spiral out of control. The only winners in hyperinflation are those who borrowed before the hyperinflation. Fortunately, the Bahamas have ever experienced hyperinflation but other countries such as Germany and Zimbabwe has.

But if the Bahamas was to experience hyperinflation like Germany, the consumers can expect 1 . Inflation Expectations and Wage Demands: Price increases lead to higher wage demands as people try to maintain their real living standards. This process is known as a Wage-price spiral'. 2. Arbitrary Re-Distributions of Income: Inflation tends to hurt people in Jobs with poor bargaining positions in the labour market - for example people in low paid Jobs with little or no trade union protection may see the real value of their pay fall.

Inflation can also favour borrowers at the expense of savers as inflation erodes the real value of existing debts. 3. Business Planning and Investment: Inflation can disrupt business planning. Budgeting becomes difficult because of the uncertainty created by rising inflation of both prices and costs - and this may reduce planned investment spending. 4. Competitiveness and Unemployment: Inflation is a possible cause of higher unemployment in the medium term if one country experiences a much higher rate of inflation than

another, leading to a loss of international competitiveness and a subsequent worsening of their trade performance.