Discuss whether inflation always harms an economy

Inflation is a sustained raise in the price level over a given time period. The government has a target inflation of 2% but the bank of England is allowed to go 1% either side of this target (1-3%). The bank of England set interest rates to try and influence inflation rates. In January 2015 inflation rates fell (disinflation) to 0.5% and in Europe there was deflation.

There are harmful effects associated with inflation. Menu costs are one consequence of inflation. Menu costs are the cost of changing prices due to inflation. This term is applied in general to the cost in both time, money and effort that a business incurs as a result of continually having to update prices in line with inflation. Restaurants have to constantly update food and drinks menus and this cost of reprinting menus regularly is expensive. Also it affects companies who work largely out of catalogues whose printing and distrusting costs are high. Other companies that are affected include big shopping chains to have to update bar codes and price stickers costs a great deal of extra money time and labour, Tesco is one company who incurs larges menu costs.

Another harm effect on inflation one an economy is shoe leather costs. These are the costs in terms of the extra time and effort involved in reducing money holdings. Savers are constantly required to search the market for the highest interest rates so that their money does not lose value when stored in a bank, especially in current accounts. Therefore time and effort is wasted in the constant search for the most rewarding interest rates which is damaging to an economy and if the saver fails to find the good interest rate then their money will lose value this is bad for an economy because it reduces a person's purchasing power in the future.

Inflationary noise is anther harmful effect on an economy as a result of inflation. Inflationary noise is the distortion of price signals caused by inflation. This is a problem because the constantly increasing prices means that consumers and businesses are constantly having to research the market taking up time and effect and money to find the best deals in the market, they may make the wrong purchasing decision. For an economy to work efficiently consumers need to buy the best quality for the lowest price to send signals to producers to increase supply or decrease it so as to allow the correct allocation of resources for allocative efficiency, with inflationary noise this may not happen and this is bad for an economy.

However they type of inflation is very important for determining whether inflation is always bad for an economy. There are two types of inflation; cost push and demand pull inflation. Demand pull is associated with being better for the economy than cost push. Diagram 1 shows how with demand push inflation, D shifts right from D to D1 moving P* to P1 (inflation) and increasing real GDP (economic growth) form Y* to Y1, this increase employment which is good for an economy. However as you can see in diagram 2 with cost push inflation caused by a shift left in S to S1 the increase in P1 from P* also causes a decrease in real GDP from Y* to Y1 this is negative economic growth, which causes unemployment which is bad for economy. In addition if inflation is low and steady and demand pull then a higher AD and a steady rise in the price level may encourage firms