

7.3: Benefits of Low Inflation

Learning Objectives

- Explain the possible economic benefits of inflation

Potential Benefits of Low Inflation

Although the economic effects of inflation are primarily negative, two countervailing points are worth noting. First, the impact of inflation will differ considerably according to whether it is creeping up slowly at 0% to 2% per year, galloping along at 10% to 20% per year, or racing to the point of hyperinflation at, say, 40% per month. Hyperinflation can rip an economy and a society apart. An annual inflation rate of 2%, 3%, or 4%, however, is a long way from a national crisis. If variability in inflation rates is a problem, then moderate and high inflations are more likely to have significant variability than are low inflations.

Low inflation is also better than deflation which occurs with severe recessions. More precisely, targeting a zero rate of inflation risks undershooting which is deflation. Deflation has similar problems as inflation but working in reverse. For example, debtors end up paying more for loans as a result of unexpected deflation.

Second, an argument is sometimes made that moderate inflation may help the economy by making wages in labor markets more flexible. The earlier discussion on unemployment pointed out that wages tend to be sticky in their downward movements and that unemployment can result. A little inflation could nibble away at real wages, and thus help real wages to decline if necessary. In this way, even if a moderate or high rate of inflation may act as sand in the gears of the economy, perhaps a low rate of inflation serves as oil for the gears of the labor market. This argument is controversial. A full analysis would have to take all the effects of inflation into account. It does, however, offer another reason to believe that, all things considered, very low rates of inflation may not be especially harmful.

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