Exercise walk-through

Costs of Inflation ▪ 2.5

eXercise

You must be able to

- distinguish **anticipated 预期** from **unanticipated 未预期** inflation
- explain how unanticipated inflation redistributes purchasing power between **borrowers** and **lenders**
- describe **menu costs 菜单成本** and **shoe-leather costs 皮鞋成本**
- explain how inflation erodes savings and fixed nominal incomes

Method — Anticipated vs unanticipated

If inflation is fully **anticipated**, contracts adjust and little harm is done.
Unanticipated inflation redistributes wealth by surprise.

Method — Borrowers vs lenders

Surprise inflation lets **borrowers** repay in cheaper money — they **gain**; **lenders** and savers **lose**.

Method — Menu and shoe-leather costs

Menu costs = the effort of re-pricing goods. **Shoe-leather costs** = the bother of holding less cash and visiting the bank more often. Inflation also erodes the real value of savings and fixed incomes.

Practice 2.1 ▪ 1 mark

State who gains from unanticipated inflation: borrowers or lenders.

Solution 2.1

Method: Borrowers vs lenders

Worked steps

borrowers **B1**.

Practice 2.2 ▪ 1 mark

Define menu costs.

Solution 2.2

Method: Menu and shoe-leather costs

Worked steps

the cost to firms of changing their listed prices **B1**.

Practice 2.3 ▪ 2 marks

Explain how inflation hurts people living on a fixed income.

Solution 2.3

Method: Menu and shoe-leather costs

Worked steps

their nominal income is fixed while prices rise **B1**, so its real value (what it can buy) falls **B1**.

Exam-style 3.1 ▪ 1 mark

Unanticipated inflation benefits

- **A** lenders
- **B** borrowers
- **C** savers
- **D** everyone equally

Solution 3.1

Method: Anticipated vs unanticipated

A lenders

B borrowers ✓

C savers

D everyone equally

Worked steps

B.

Exam-style 3.2 ▪ 1 mark

Shoe-leather costs arise because people

- **A** re-print price tags
- **B** hold less cash and visit the bank more
- **C** save more
- **D** borrow less

Solution 3.2

Method: Menu and shoe-leather costs

A re-print price tags

B hold less cash and visit the bank more ✓

C save more

D borrow less

Worked steps

B.

Exam-style 3.3 ▪ 1 mark

Inflation turns out much higher than expected.
(a) State whether a borrower with a fixed-rate loan gains or loses.
(b) Explain why.

Solution 3.3

Method: Menu and shoe-leather costs

Worked steps

(a) the borrower gains **B1**. (b) they repay a fixed nominal amount with money that is now worth less, so the real value repaid is lower than expected **B1** **B1**.