AP MACROECONOMICS • EXERCISE SHEET

2.5 Costs of Inflation

Name: ______________ Class: __________ Date: ____________ **Total: 9 marks**

Objective

Build the skills to answer exam questions on **the costs of inflation**.

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

1 Worked examples

Study these first. Each one shows the method for a question type used later.

■ Anticipated vs unanticipated

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

■ Borrowers vs lenders

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

■ 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.

2 Practice

2.1 State who gains from unanticipated inflation: borrowers or lenders. [1]

2.2 Define menu costs. [1]

2.3 Explain how inflation hurts people living on a fixed income. [2]

3 Exam-style questions

3.1 Unanticipated inflation benefits [1]

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

3.2 Shoe-leather costs arise because people [1]

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

3.3 Inflation turns out much higher than expected.

(a) State whether a borrower with a fixed-rate loan gains or loses. [1]

(b) Explain why. [2]

4 Go further

- work through the **2.5 Costs of Inflation** lesson on the **Learn** page;
- read the **Economic Indicators and the Business Cycle** section of the AP Macroeconomics handout on the **Know** page.

Solutions

2.1 borrowers.

2.2 the cost to firms of changing their listed prices.

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

3.1 B.

3.2 B.

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