

ECONOMICS

for South African students

Macroeconomics

Inflation

Inflation

- Definition
- Measurement
- Costs
- Causes
- Policy

Definition of inflation

- Continuous and considerable rise in prices in general
- *Four important aspects*
 - neutral definition (does not mention causes)
 - continuous rise – process
 - considerable increase
 - general price level – not individual prices

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Measurement of inflation

- Based on CPI, but CPI is index of price of basket, not a rate
- Calculate the rate of change in CPI
- Month on same month of previous year
- Year on year (annual average on annual average)

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Producer price index (PPI)

- Also important price index but differs from CPI
- *Differences between CPI and PPI*
 - cost of living (CPI) vs. cost of production (PPI)
 - consumer goods and services (CPI) vs. goods only (PPI)
 - capital and intermediate goods excluded (CPI) vs. included (PPI)
 - VAT included (CPI) vs. excluded (PPI)

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Costs or effects of inflation

- Is inflation a problem? Why?
- *Distribution effects*
 - some individuals or groups lose while others benefit
 - who lose and who win?
 - debtors tend to gain at the expense of creditors
 - young tend to gain at the expense of elderly
 - government tends to gain at expense of private sector
 - **key concepts:** real interest rate, bracket creep

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- ***Economic effects***
 - impact on employment and growth
 - inflation tends to stimulate speculative activity
 - resources used to try to live with or gain from inflation
 - productive activity neglected
 - saving discouraged
 - exports may suffer
 - imports may be stimulated

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- ***Social and political effects***
 - people unhappy
 - social and political unrest may ensue
- ***Expected inflation***
 - inflation may result in the expectation of further inflation
 - self-fulfilling prophesy
 - may give rise to hyperinflation

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Three important concepts

- **Hyperinflation**
 - very high inflation which tends to escalate out of control
- **Deflation**
 - continuous fall in prices in general
 - falling prices even more damaging than rising prices
- **Disinflation**
 - falling inflation rate
 - prices still increase but at a declining rate

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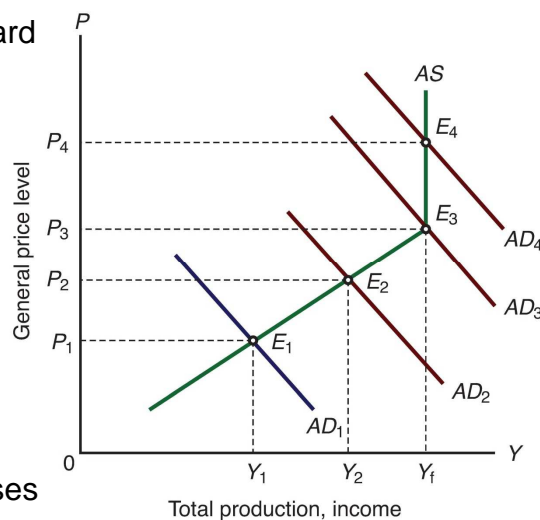
Causes of inflation: demand-pull inflation

- Prices pulled up by increase in aggregate demand
- Could be the result of any or combination of components of *AD*
 - *C, I, G, X*
 - usually accompanied by increase in *M* (money stock)

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- Illustrated by rightward shift of AD curve

Demand-pull inflation



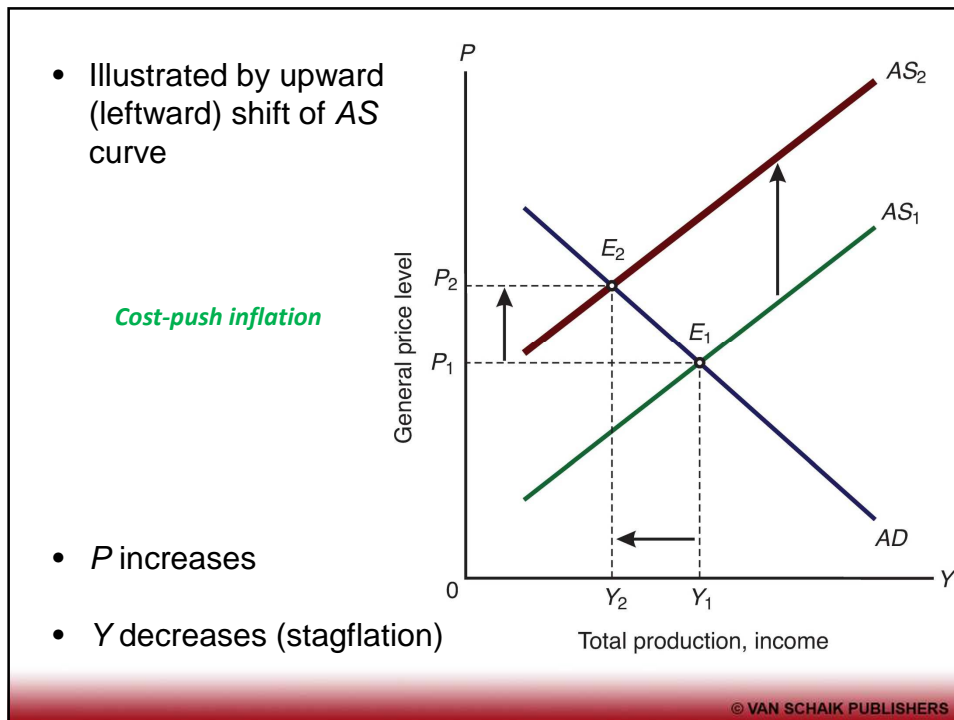
- Price level P increases
- Production and income Y also increases (up to full employment)

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Causes of inflation: cost-push inflation

- Prices pushed up by increase in costs
- *Sources of cost push*
 - increased wages and salaries
 - increased cost of imported capital and intermediate goods
 - increased profit margins
 - decreased productivity
 - natural disasters

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Anti-inflation policy

- *Demand-pull inflation*
 - use restrictive monetary and fiscal policy
 - P decreases but Y also decreases
 - trade-off situation
- *Cost-push inflation*
 - cannot use restrictive monetary and fiscal policy
 - restrictive policy would increase unemployment further
 - ideal is to increase supply
 - difficult in practice
 - cannot use restrictive monetary and fiscal policy

Inflation targeting

- **Elements**

- price stability primary goal of monetary policy
- broad approach to inflation diagnosis
- Transparency
- accountability

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- **Advantages (include):**

- easy to understand (transparent)
- explicit yardstick (helps accountability)
- provides good guide for decision makers
- anchor for inflation expectations
- limits discretion of policymakers

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