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

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)
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)

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
• **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

• **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
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

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)
• Illustrated by rightward shift of AD curve

• 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
Illustrated by upward (leftward) shift of AS curve

Cost-push inflation

- $P$ increases
- $Y$ decreases (stagflation)

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

• **Advantages (include)**:
  – easy to understand (transparent)
  – explicit yardstick (helps accountability)
  – provides good guide for decision makers
  – anchor for inflation expectations
  – limits discretion of policymakers