Inflation

IGCSE

Inflation

Inflation refers to sustained increase in general price level. When prices of most goods and services are increasing in an economy it is known as inflation.

Inflation reduces consumers' purchasing power since goods and services become expensive. But exact reduction in consumers' purchasing power depends upon rate of inflation.

How to calculate Inflation?

Inflation is calculated using different price indices.

Price Index refers to calculation used to estimate changes in prices of goods and services over time.

Some common price indices are as follow:

Consumer Price Index (CPI): it estimates inflation from the perspective of consumers.

Producer Price Index (PPI): it estimates inflation from the perspective of producer.

Uses of Price Indices

Price Index is used as reliable indicator for economy's inflation. Inflation adjusted variable like interest rates, wages, pension fund all require accurate measure of economy's inflation rate. CPI is useful in all such cases. This process of adjusting economic variables with regards to economy's inflation is known as Indexation.

Uses of Price Indices

Price Indices are used to convert nominal variables into real variables. Hence indices are used as deflator.

Complications Involved in CPI Estimation

Continuous changes in consumers' preferences require alteration in basked of goods and services used to estimate economy's inflation.

Presence of arbitrage (different prices of similar products in different parts of the country) is expected to make price estimation difficult.

Causes of Inflation

Over time economists have identified following three causes of inflation:

1. Demand-Pull Inflation
2. Cost-Push Inflation
3. Inflation as Monetary Phenomenon

Demand Pull Inflation

Any economy having limited production potential is unable to expand its output beyond its maximum production potential. Rapidly increasing demand for goods and services that is not matched by proportionate increase in supply of goods and services result in higher prices of products.

Demand Pull Inflation

Increase in economy's aggregate demand that is not matched by increase in aggregate supply results in demand pull inflation.

Cost Push Inflation

Rising production costs reduce producers' profits if prices of products are not increased proportionately to increase in cost of production. Hence to keep their profits constant producers are very likely to increase prices of products in-line with rise in inputs costs.

Cost Push Inflation

Rise in wages, salaries, electricity expense etc are all likely to result in Cost Push Inflation.

Provision of cheaper utilities like electricity, gas etc to businesses is important to curb cost push inflation.

Inflation as Monetary Phenomenon

Money is used as medium of exchange and therefore helps consumers to purchase desired goods and services.

At any point in time the available stock of money is used to purchase available stock of goods and services.

Inflation as Monetary Phenomenon

All other factors being constant value (price) of products depends upon existing stock of goods and services. If for given stock of goods/services economy's money supply increases then products' prices will bid up.

Hence Central Bank currency notes printing should be in accordance with increase in economy's stock of goods and services.

Imported Inflation

Economies relying on foreign products are expected to suffer from imported inflation if foreign products prices are increasing for some reason.

Depreciating exchange rate, high inflation rates in foreign economies etc are expected to be reason behind Imported Inflation.

Imported Inflation

Reliance on imported raw materials is expected to have more adverse effects on local economy during times of rising prices of imported goods.

High Rate of Inflation

- What are the costs associated with inflation?

1. The unemployed people will have lower purchasing power which means they will be able to afford less and therefore their living standards will decrease due to decrease in purchasing power.
2. Some people with very low income levels might be unable to afford the basic necessities of life resulting in absolute poverty.

High Rate of Inflation

4. When the rate of inflation is very high people are afraid that in future the prices will increase even more and therefore they save more of their incomes than spend and therefore consumption will decrease.

High Rate of Inflation

4. When prices of domestic goods is increasing at the faster rate then exports will decrease and imports will increase resulting in deficit on the balance of payments.

5. Menu Cost: is the cost associated with constantly updating the information about the product prices which is known as menu cost.

Why is low and stable rate of inflation is healthy for the economy?

- When inflation is low and stable producers can charge a little higher than the rate of inflation which helps them earn higher profit margin.
- Low rate of inflation encourages investment and therefore should be healthy for the economy.

Why is low and stable rate of inflation is healthy for the economy?

- Due to higher investment it also increases employment.
- Government will collect more taxes due to increased economic activity.

How to calculate Inflation

- Inflation is calculated using Consumer Price Index (CPI).
- Steps of Calculating CPI

1. Identifying the basket goods / services
2. Recording the 2 set of prices (at the start of the period and at the end of the period).

How to calculate Inflation

3. Assigning weights to all the products

4. Do the calculations to find the index values and calculate the rate of inflation.