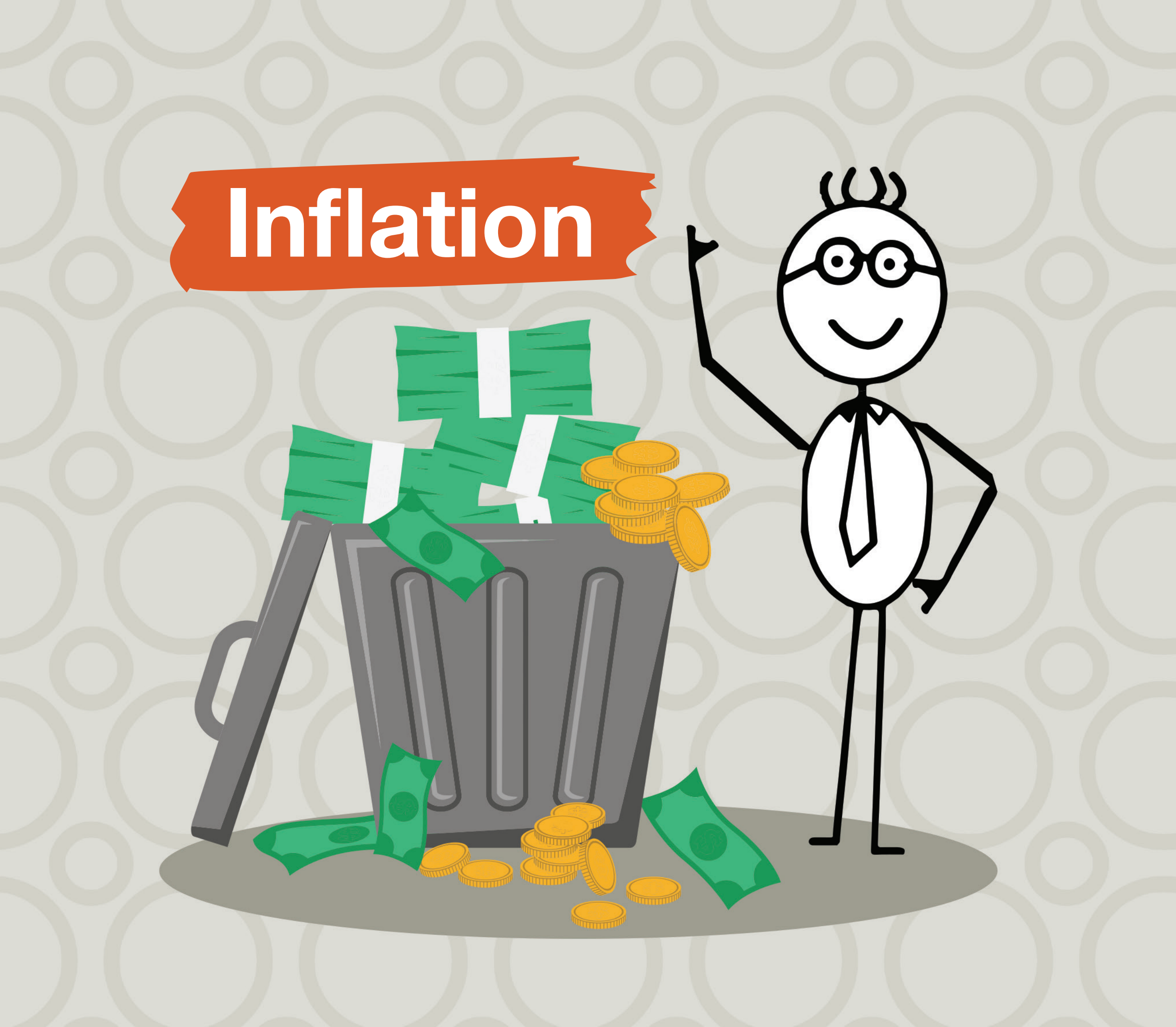
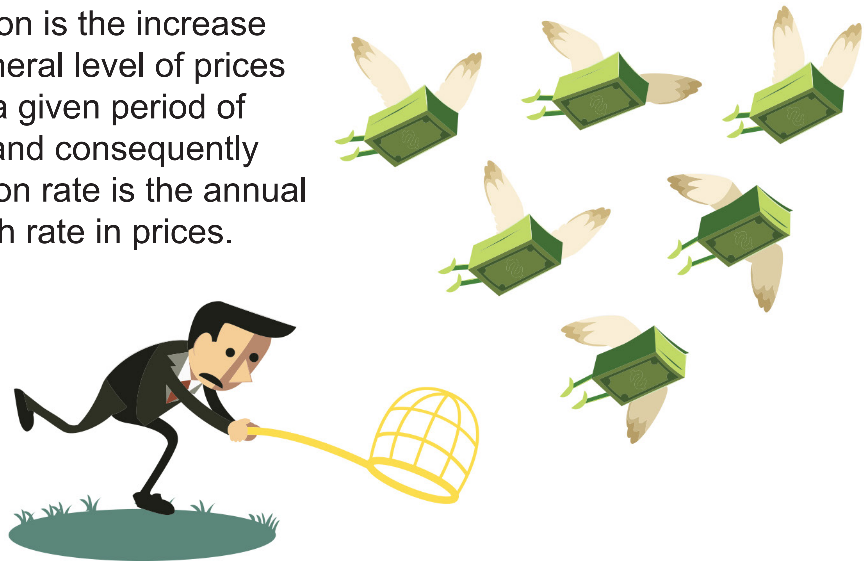

Inflation

Inflation is one of the most familiar commonly used terms in economics. It is a phenomenon signalizing imbalance of economy.

Definition:

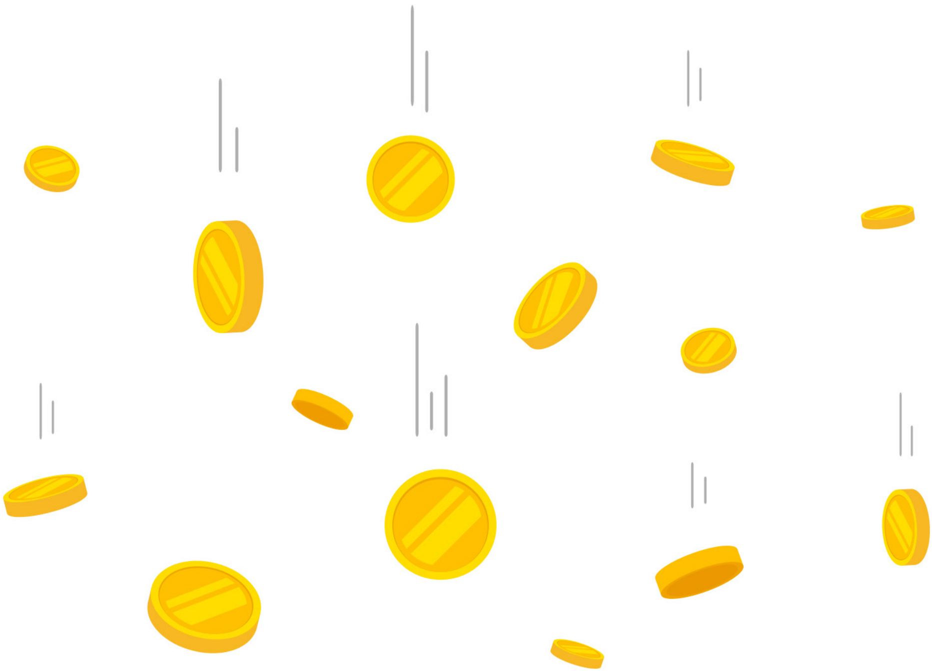
Inflation is the increase in general level of prices over a given period of time and consequently inflation rate is the annual growth rate in prices.



Different Key concepts: Inflation, Deflation, Hyperinflation, Stagflation and Disinflation.

- Inflation is a general increase in all prices across an economy usually in one year.
- Deflation is the opposite of inflation and it means fall in the prices of goods and services in the economy.
- Hyperinflation is characterized by very rapid increases in the price level across the economy.
- Stagflation is high inflation coupled with low growth and a steadily high rate of unemployment.

- Disinflation is a middle ground where prices are generally rising but at a decreasing rate. For example, Prices that were rising at 2 percent are now rising at 1 percent.



Measuring inflation

Inflation could be measured by either Gross Domestic Product Deflator (GDP Deflator) or Consumer Price Index (CPI) indicator but the most widely and commonly used is the Consumer Price index.

- The GDP deflator reflects the prices of all goods and services produced domestically.
- The consumer price index reflects the prices of all goods and services bought by consumers

The Bureau of Labor Statistics reports the CPI monthly.CPI could be defined as the measure of the overall cost of the goods and services bought by the consumers and it is used to monitor changes in the cost of living over period of time. So we can say that when the CPI rises, consumers have to spend more money to keep the same standard of living. To measure the average consumer's cost of living, government agencies conduct household surveys to identify a basket of commonly purchased items and then tracked and recorded the cost of purchasing this basket over time.

Example of the items that are included in the basket could be housing expenses including rent, transportation, food and medical care. Therefore, this basket differs from one country to another based on the most purchased goods by each country.

Steps to calculate the Consumer Price Index:

(1) Determine the basket and prices that are most purchased by the typical consumer.

(2) Find the prices of each of the goods and services in the basket for each point of time.

(3) Use the data of prices to calculate the cost of the basket of goods and services at different periods of time.

(4) Choose a base year and compute the index.

- Designate one year as the base year, making it the benchmark to be compared with other years.
- Compute the index by dividing the price of the basket in one year by the price in the base year and multiplying by 100.

$$\text{Consumer price index} = \frac{\text{price of basket of goods and services}}{\text{price of basket in base year}} \times 100$$

(5) Compute the inflation rate. The inflation rate is the percentage change in the price index from the preceding period.

$$\text{Inflation Rate in Year 2} = \frac{\text{CPI in year 2-CPI in year 1}}{\text{CPI in year 1}} \times 100$$

The CPI basket is mostly kept constant over time for consistency, but is tweaked occasionally to reflect changing consumption patterns—for example, to include new hi-tech goods and to replace items no longer widely purchased.

What causes inflation?

Economists distinguish between two types of inflation in which both types cause a rise in the overall price level.

1. Demand-Pull Inflation
2. Cost-Push Inflation

First: Demand-Pull Inflation.

This phenomenon occurs when the aggregate demand for goods and services in an economy increases more rapidly than an economy's production. There are 4 reasons that cause demand-pull Inflation.

First, growing economy, in which people get more confident and spend more and invest more, creating gradual and steady price increases. The second is the expectation of inflation. Once people expect inflation, they will buy things now to avoid higher future prices. That increases demand, which then creates demand-pull inflation. The third cause is over- expansion of the money supply. That occurs when the government prints too much money. The fourth is the discretionary fiscal policy[1]. Government spending drives up demand. For example, military spending raises prices for military equipment. When the government lowers taxes, it also increases demand. Consumers have more discretionary income to spend on goods and services.

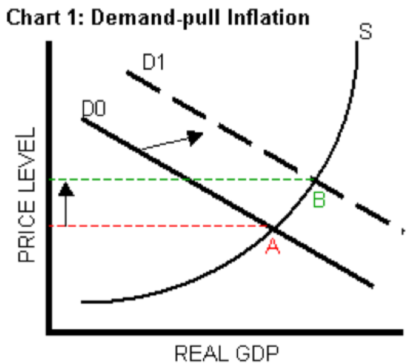


Chart (1) illustrates the Demand-Pull inflation; when the demand increases due to any of the above reasons, the demand curve shifts from D0 to D1.However, suppliers cannot increase production in the short run. Therefore, the supply curve remains constant and consequently the economy’s equilibrium point moves from point A to point B, leading to price increase and resulting in inflation.

1- Non-mandatory changes in taxation, spending, or other fiscal activities by a government in response to economic events or changes in economic conditions.

Second: Cost-Push Inflation

on the other hand occurs under five special circumstances. In all of these circumstances, demand is inelastic. First, Monopoly. Companies that achieves a monopoly over an inelastic demand creates cost-push inflation. A monopoly reduces supply to meet its profit goal. Second, natural disasters which cause inflation by disrupting supply. A third driver is government regulation and taxation. These rules can reduce supplies of

many other products. The fourth reason is a shift in exchange rates. Any country that allows the value of its currency to fall will experience higher import prices. The foreign supplier does not want the value of its product to drop along with that of the currency. If demand is inelastic then prices will increase.

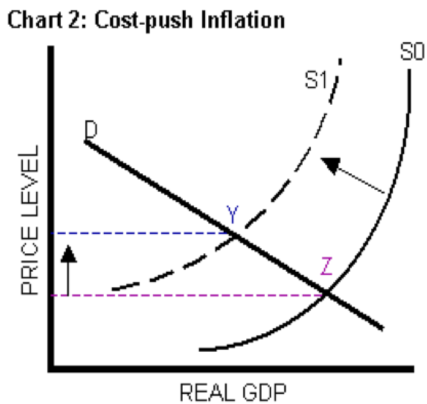


Chart (2) illustrates that when production costs increase, aggregate supply will decrease (from S0 to S1) and an increase in the overall price level because the equilibrium point moved from point Z to point Y.

What methods can the government use to control inflation?

(1) Contractionary Monetary Policy

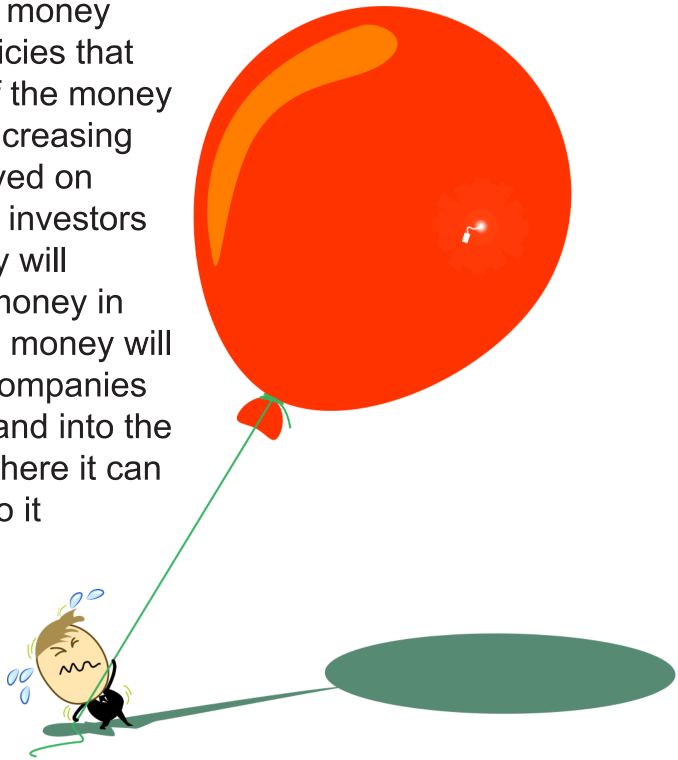
Contractionary policy aims to reduce the money supply within an economy by increasing interest rates. This helps people reduce spending as those who have money will keep it and save it instead of spending it (spending decrease) and therefore prices decrease.

(2) Reserve Requirements

The second method is by increasing reserve requirements on the amount of money banks are legally required to cover withdrawals. The more money banks are required to hold back, the less they have to lend to consumers. If they have less to lend, consumers will borrow less, which will decrease spending.

(3) Reducing the Money Supply

The third method is to directly or indirectly reduce the money supply by imposing policies that encourage reduction of the money supply. For example, increasing the interest rates received on bonds encouraging the investors to buy them. This policy will reduce the amount of money in circulation because the money will be going from banks, companies and investors pockets and into the government's pocket where it can control what happens to it



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