2.1.2 Inflation

Definition

- Inflation is a sustained increase in the general price level for goods and services
- Deflation is a sustained decrease in the general price level for goods and services
- Disinflation is a fall in the rate of inflation. Prices are still rising but by a smaller rate than before

CPI

- Consumer price index is a measure of inflation used for inflation targeting in the UK.
- CPI is an index number, values are percentages relative to the base year (100)
- CPI is calculated via a weighted basket of goods and services

- The Living Costs and Food Survey collect information from a sample of approx 7000 households using self-reported purchases
- Civil servants survey monthly prices of 700 most commonly used g+s in variety of stores
- Items are weighted with regards to the proportion of income spent on the item

Limitations of CPI

- Does not include housing costs (mortgage payments and rent)
- Basket isn't representative of all consumers and non-typical consumers may experience different changes in cost of living to government figure
- Attempts in capturing changes in weight and quality of goods may be imprecise
- 700 common items changes yearly so rapid changes in spending patterns may

not be reflected
- There may be sampling issues with surveyed household. This may be understated spending on certain items (e.g. alchohol) or biases

CPIH

- ONS preferred measure
- CPI + Housing costs and council tax

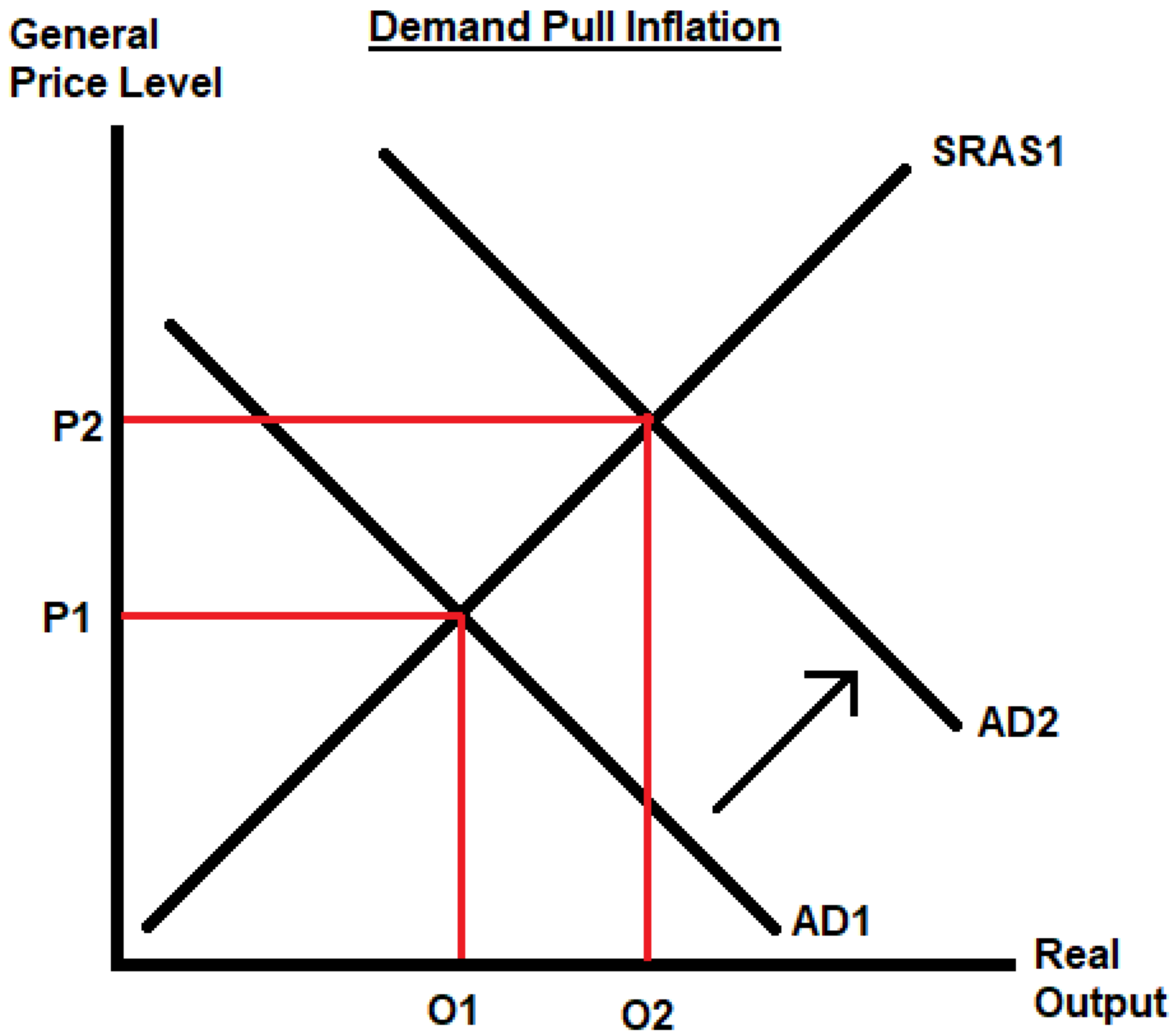
RPI

- Retail price index is similar to CPI but takes into account mortgage payments
- It is an older measure of inflation
- It is less relaiable than CPI and CPIH for international comparisons
- RPI is used in long-term contracts and index-linked gilts

Causes of Inflation

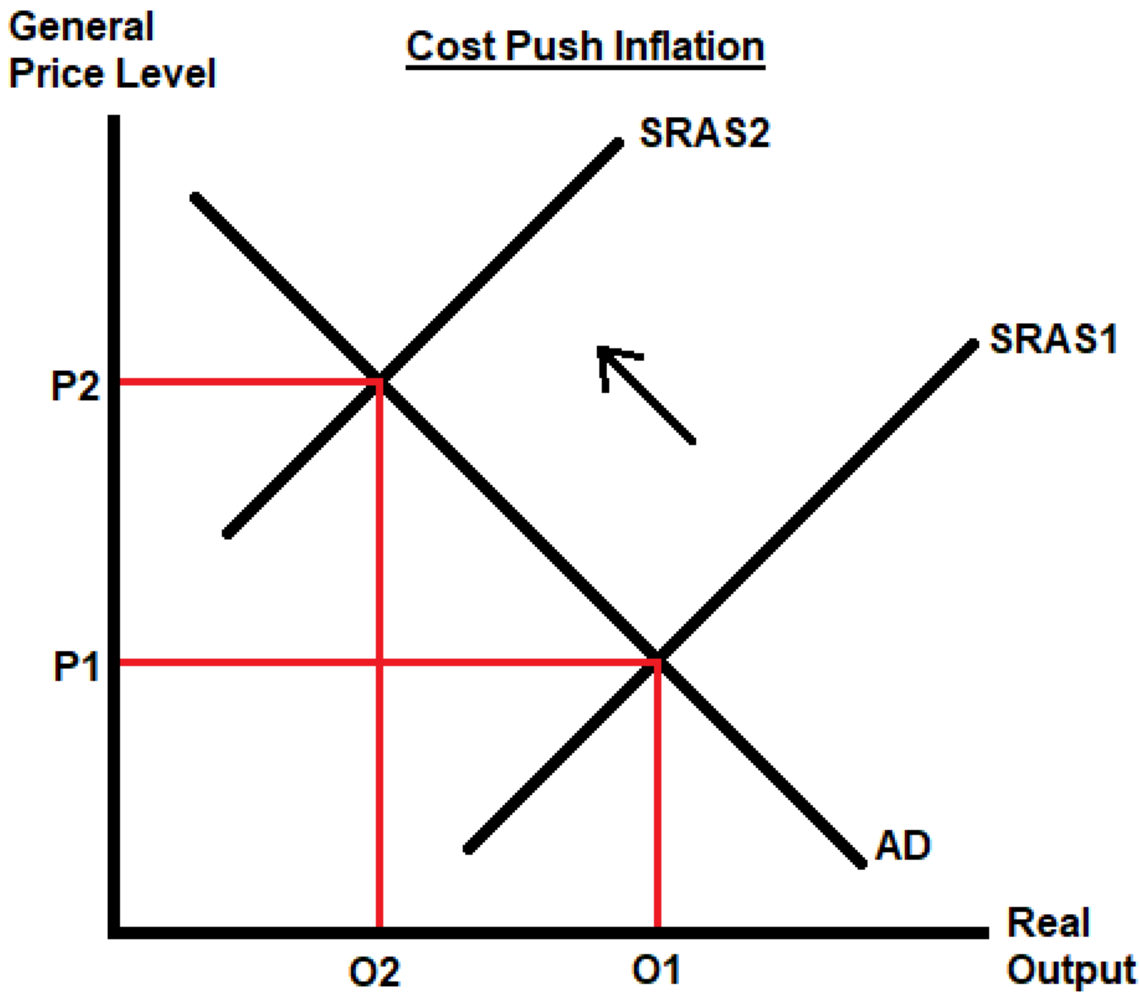
- Demand-pull inflation is when AD increases at a faster rate than AS. It is caused by:
  - Decrease in interest rates
  - A rise in business + consumer confidence
  - An increase in government spending
  - An increase in net trade (exports increasing relative to imports)
  - Depreciation of exchange rate (increases demand for exports relative to

imports)



- Cost-push inflation is when AS decreases (due to an increase in costs of production). It is caused by:
  - Rise in business taxes
  - Rise in oil + raw material prices
  - Fall in exchange rate
  - An increase in minimum wage/wages

- Increased red tape (increases costs)



- Growth of Money Supply
    - Increasing money leads to an increase in AD (AD shift while AS remains the same) for goods leading producers to increase prices

Effects of Inflation

- On Consumers:

  - Fixed incomes (especially Students, Pensioners) result in a fall in real income when prices rise since they do not enjoy wage increases
  - Real value of savings will decrease if inflation is higher than interest
  - If inflation is higher than mortgage loan interest rate, real value of loans will fall (a positive)
- On Firms:
  - If inflation is higher than trading partners, exports and international competitiveness will fall. This worsens the balance of trade
  - High rates can make it difficult for firms to set budgets, resulting in lack of confidence and investment
  - Cost push inflation can cause decrease in profits, leading to lower investment
  - Some inflation (especially demand pull) can be useful for firms to

    - increase revenues, leading to increased investment
    - MPC may increase interest rates, reducing investment due to increased loan costs
- On Government:
    - Inflation reduces real value of national debt
    - Inflation can lead to increased inequality (due to poorer people being on less-changeable incomes)
    - Deterioration in balance of trade
- On Workers:
    - Reduction in real wages if they have weak bargaining position
    - According to the Phillips curve there is a trade off between inflation and unemployment. A low rate of inflation may be due to low level of demand in the economy hence a low level of employment (since less employees are required to produce the goods)