Inflation: Measurement & Causes

AS Economics Presentation

2005

Key Issues

- The meaning of inflation
- Measuring the general price level
- Deflation and hyperinflation
- Causes of inflation (demand pull and cost push)
- Controlling inflation – demand and supply-side policies
- Recent trends in UK inflation
- Why has inflation in the UK remained so low?

Key Concepts

- The Consumer Price Index (CPI)
  - Measures changes in the cost of living of a typical household
- The Cost of Living
  - Is the quantity of goods and services that a given amount of money (e.g. £1000 a month) will buy for a typical household
- Family Expenditure Survey (FES)
  - This is the data used to calculate the weights used in the consumer price index.
- The Inflation Rate
  - The annual percentage in the consumer price index. This is calculated relative to some arbitrary *base year* set equal to 100

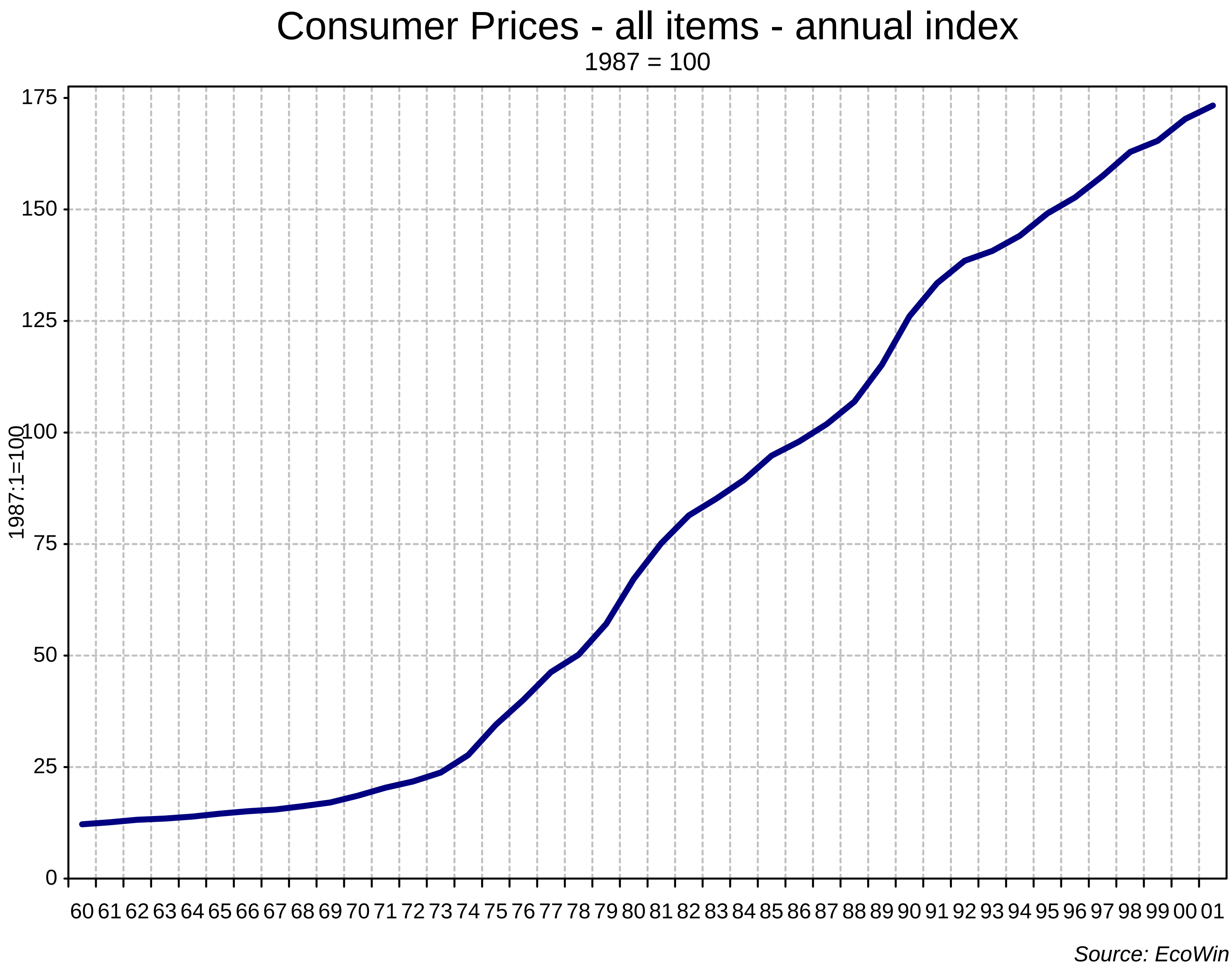
Defining inflation

- Inflation is a <u>sustained</u> increase in the average price level of a country
- The rate of inflation is measured by the <u>annual percentage change in the level of prices</u> as measured by the consumer price index
- A sustained fall in the general price level is called <u>deflation</u> – in this situation, the rate of inflation becomes negative

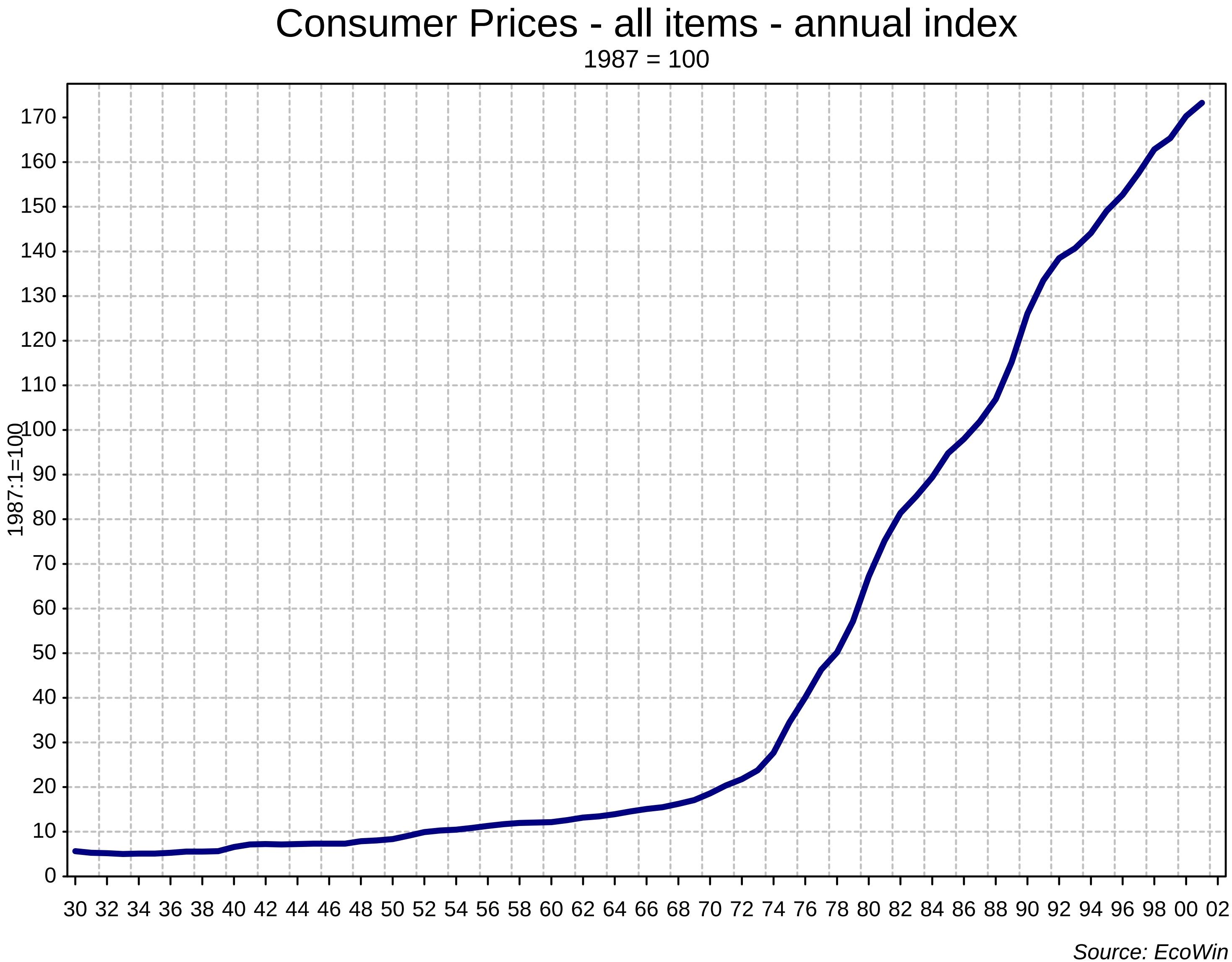
The consumer price index

- The consumer price index is the main measure of inflation for the UK
- The government has set the Bank of England a target for inflation (using the CPI) of 2%
- The aim of this target is to achieve a sustained period of low and stable inflation

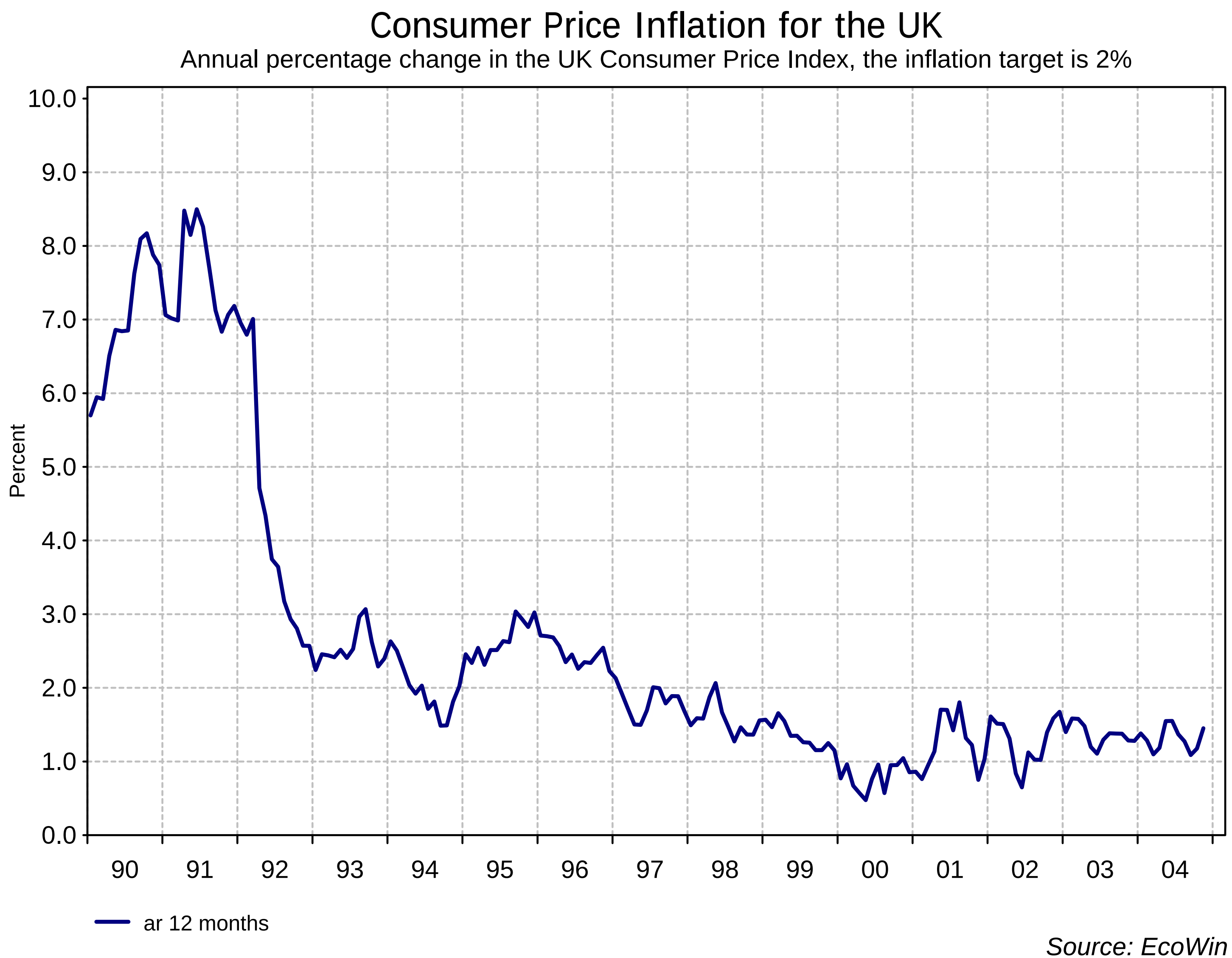
The Consumer Price Index



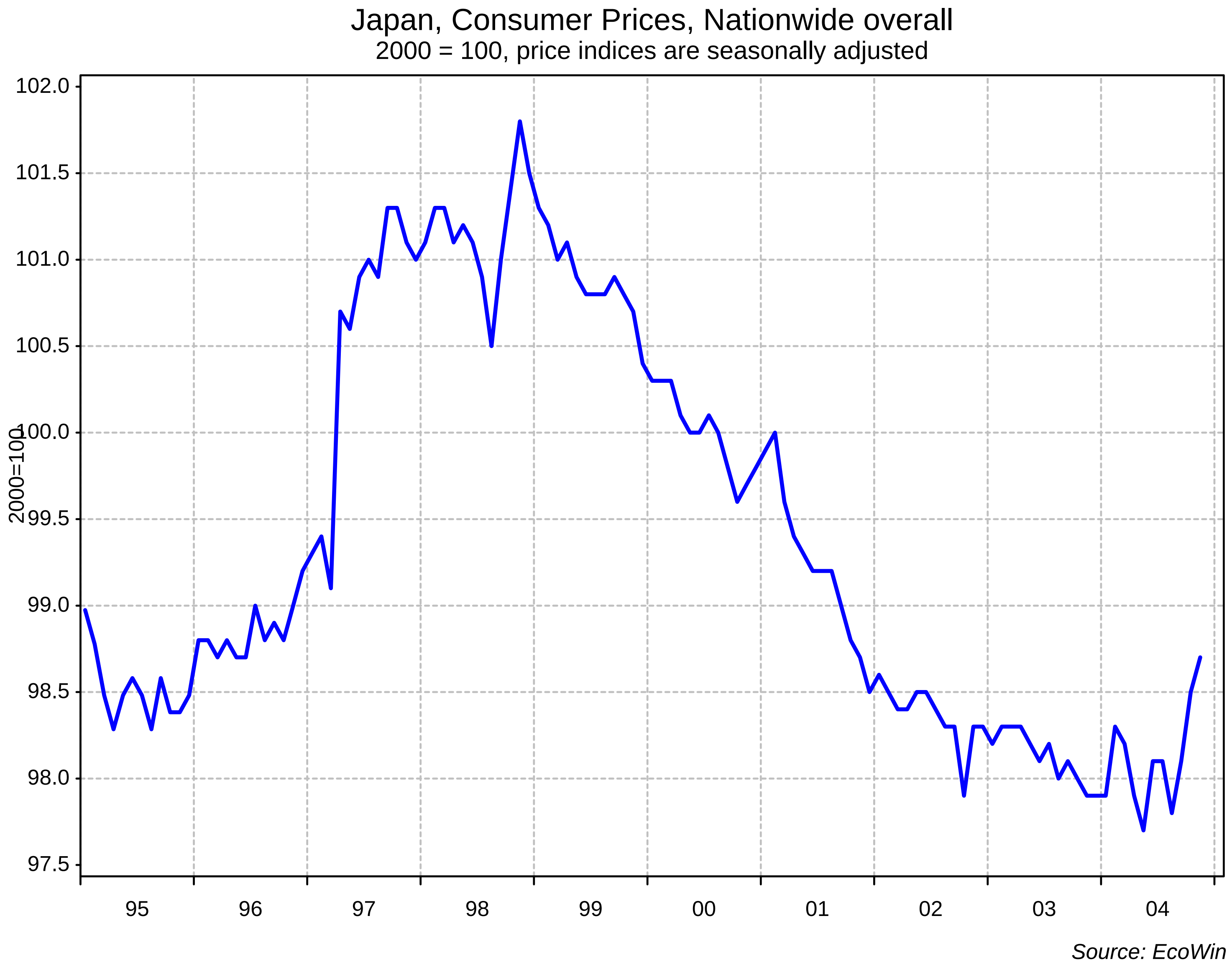
A long run view of UK inflation



UK Consumer Price Inflation



Deflation in Japan in recent times



Hyper inflation

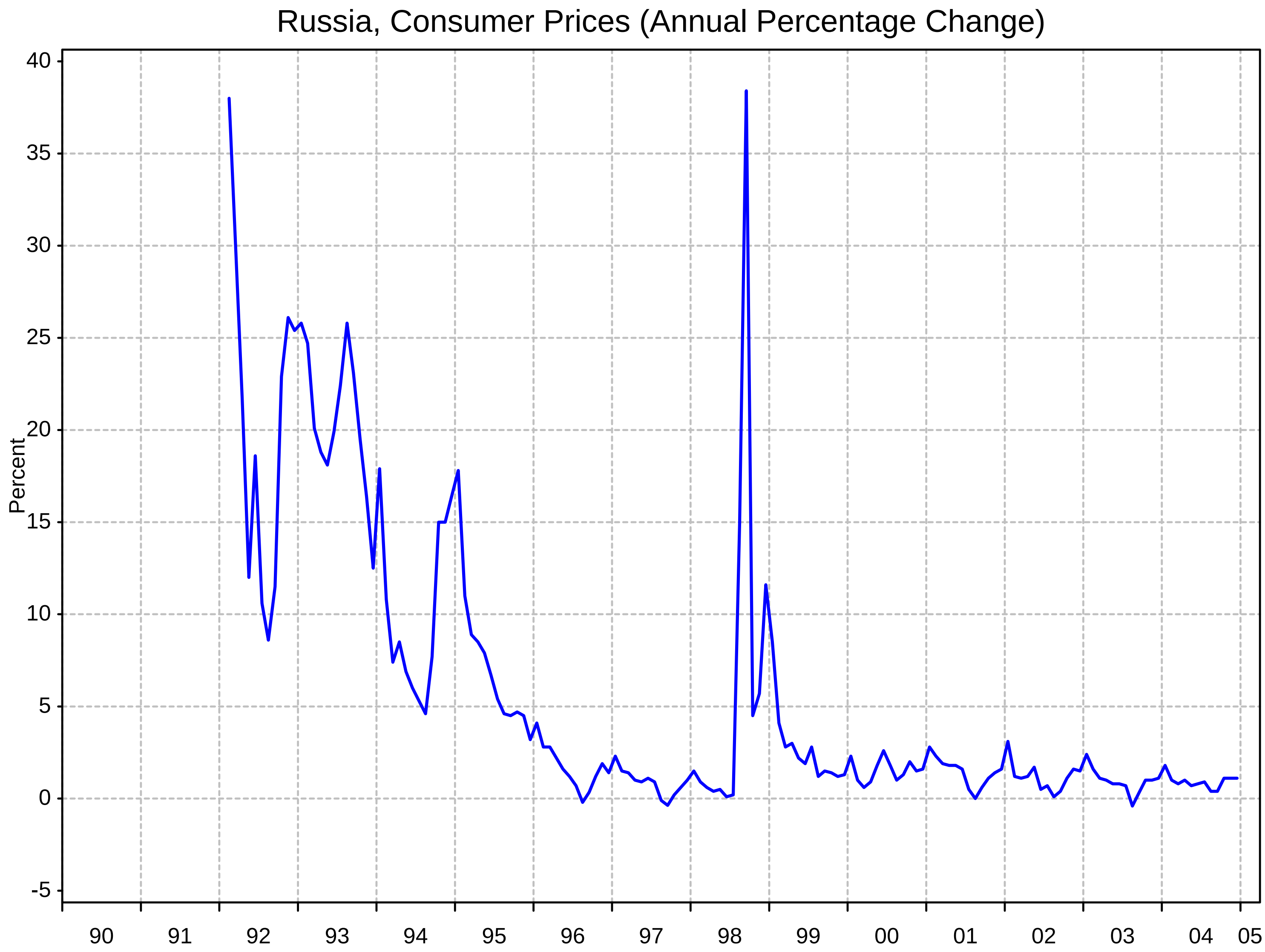
A Bank of England employee pictured in the 1920s with a 20 million deutschmark note – whose purchasing power equated to a box of matches

The hyperinflation in Weimar Germany led to employees taking their wages home in larger wicker baskets

Hyperinflation

- With hyperinflation - inflation goes out of control
  - Huge amounts of money has to be printed to meet people's demand for cash
  - Money effectively becomes worthless
  - The effect is nearly always to lead to a collapse in business and consumer confidence and a recession
  - In most cases a new monetary system may have to be created
- Several countries are experiencing high rates of inflation today – including Zimbabwe, where prices surged by over 600% in 2003

Consumer Price Inflation in Russia

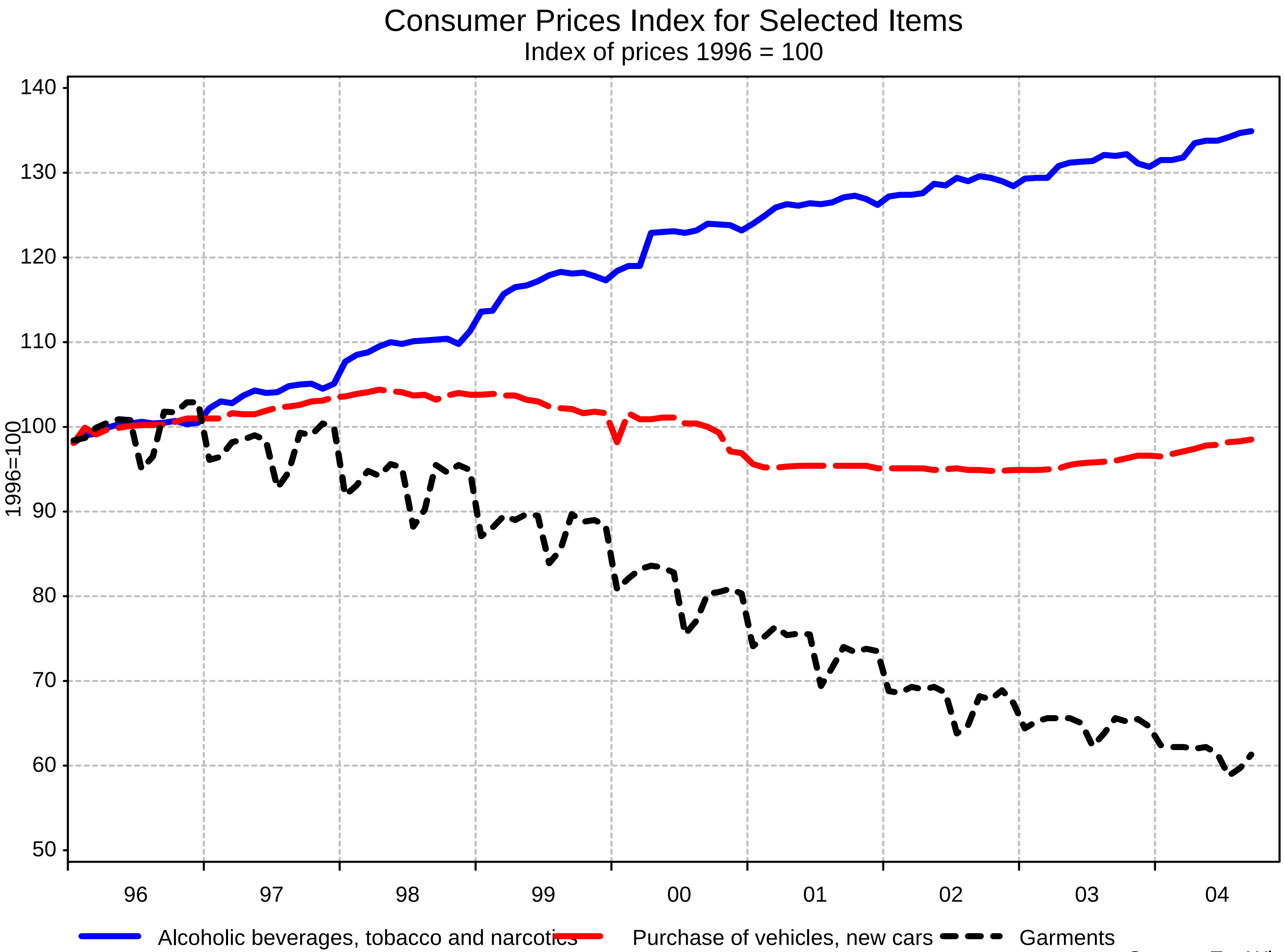


Source: EcoWin

UK inflation – recent trends

- "If the point of (economic) policy is low and stable inflation and low and stable unemployment, then Britain's record puts it in the forefront of the three main economic areas [Britain, the US and the Eurozone]."
- Dr de Anne Julius, former member of the Monetary Policy Committee, June 2004

Behind the inflation figures



Source: *EcoWin*

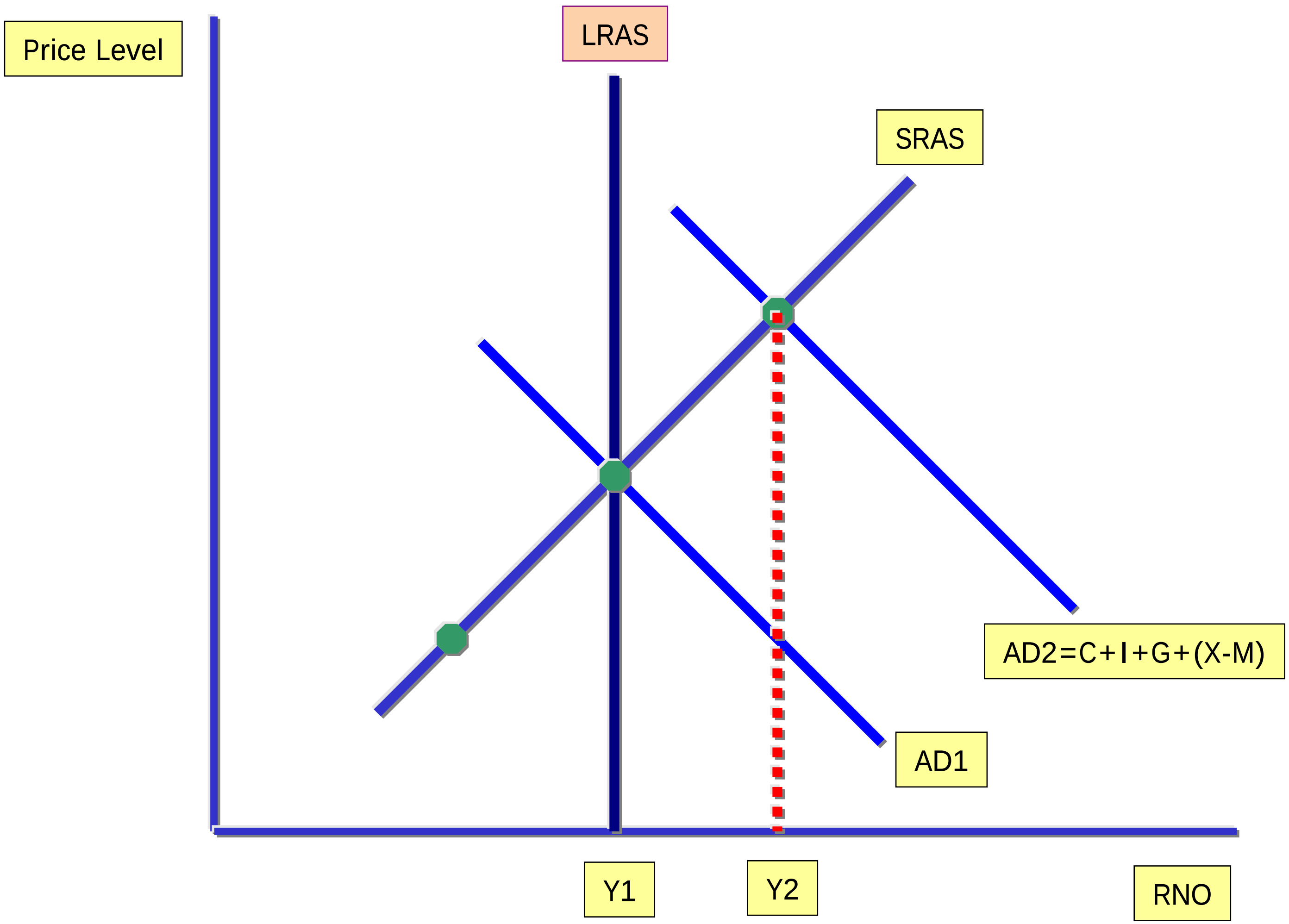
Demand-pull inflation

- Demand–pull inflation
- Occurs when there is excess AD – i.e. when there is a positive output gap (actual GDP > Potential GDP)
- Businesses respond to high demand by raising prices to increase their profit margins
- Demand-pull inflation is associated with the boom phase of the cycle (when SRAS becomes inelastic)
- The main causes of demand pull inflation
  - Very fast growth of demand for credit / borrowing
  - High levels of consumer spending

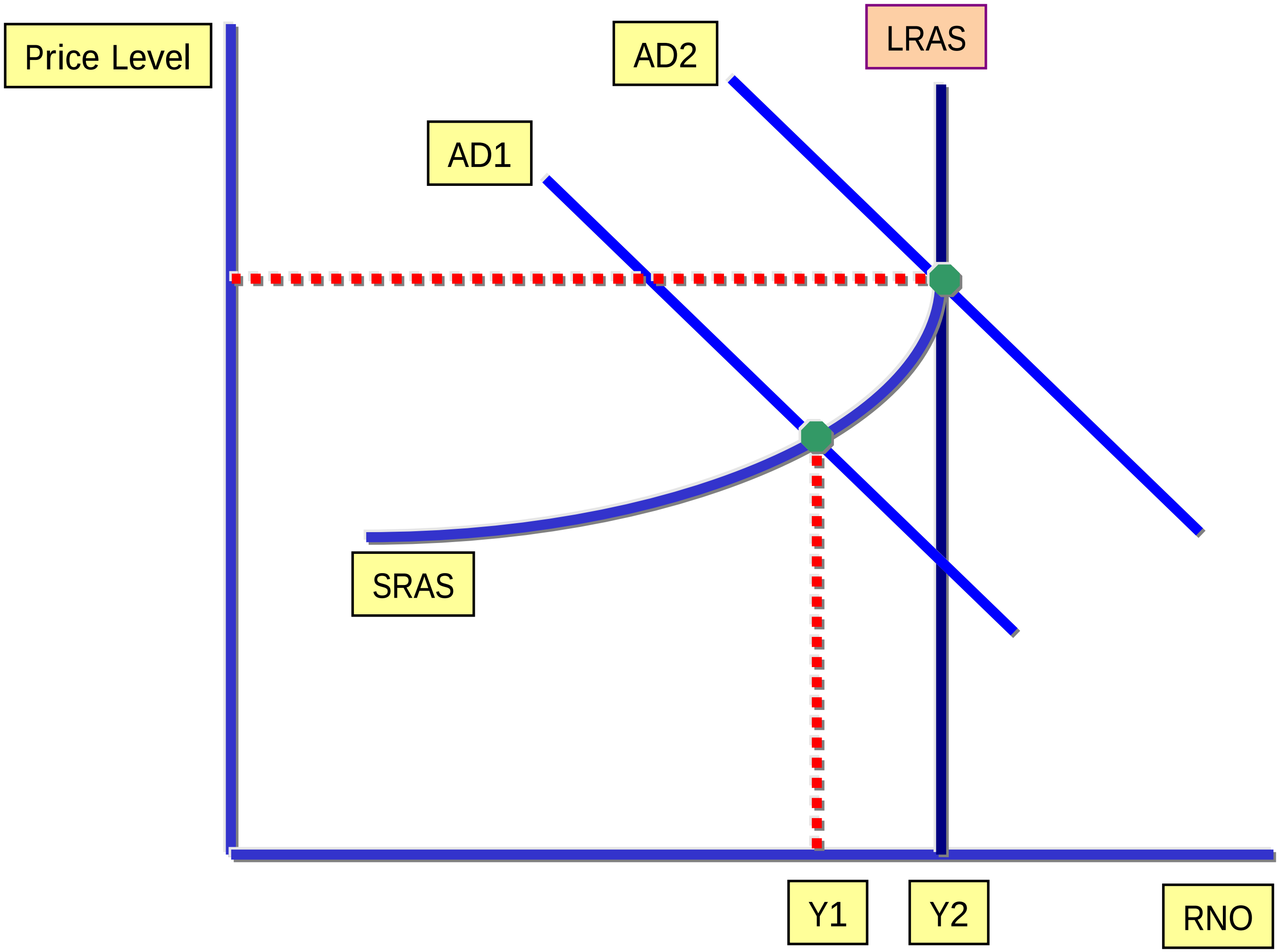
Main causes of demand pull inflation

- A depreciation of the exchange rate increases the price of imports and reduces the foreign price of UK exports
- A reduction in direct or indirect taxation - consumers will have more disposable income causing demand to rise
- Rapid growth of the money supply as a consequence of increased bank and building society borrowing
- Rising consumer confidence and an increase in the rate of growth of house prices
- Faster rates of economic growth in other countries – providing a boost to UK exports overseas (an injection of AD)

Illustrating demand-pull inflation



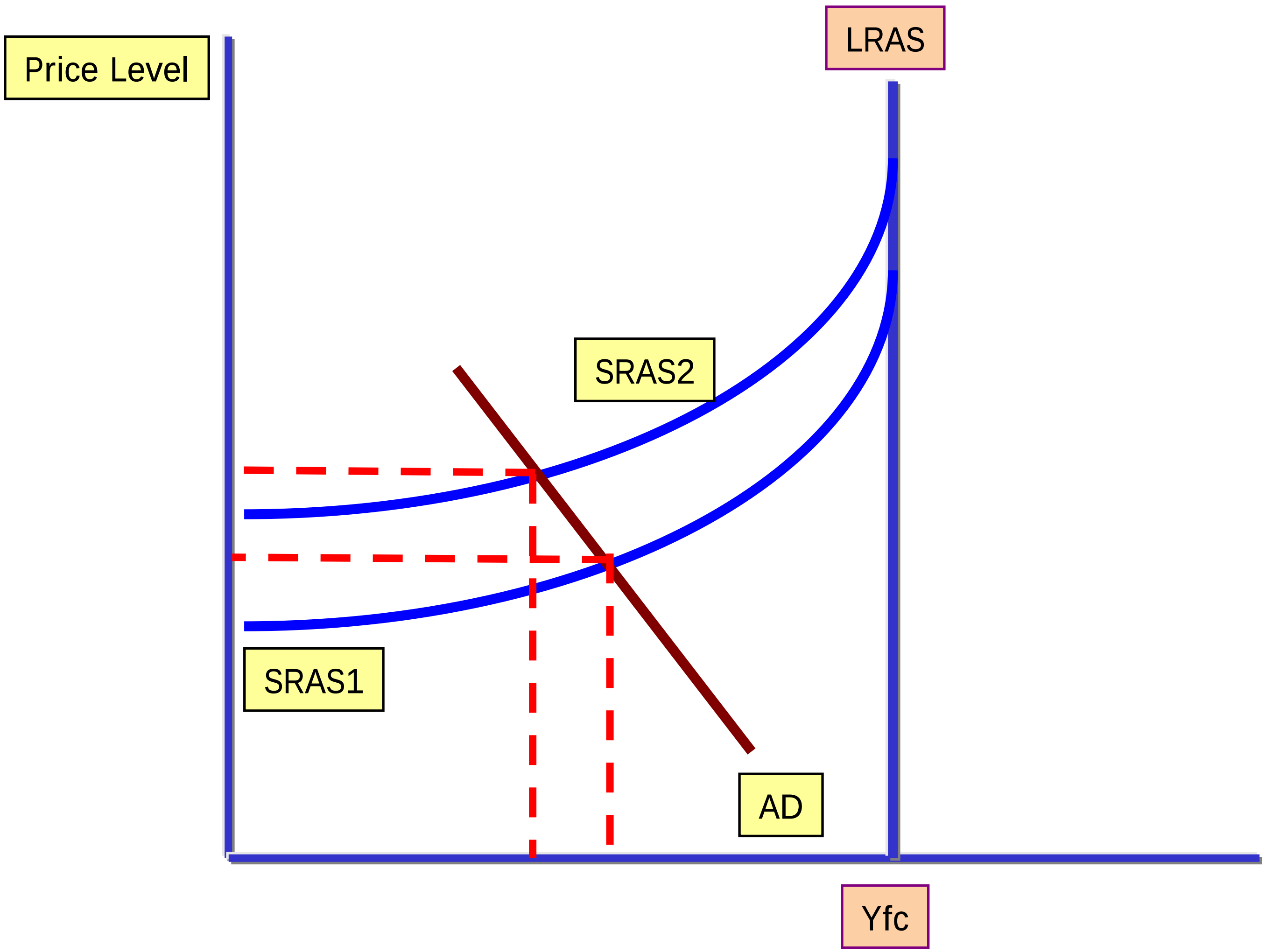
Demand-pull inflation



Cost Push Inflation

- Occurs when costs of production are increasing
- Causes:
  - External shocks (commodity price fluctuations)
  - A depreciation in the exchange rate
  - Acceleration in wages
- Leads to inward shift in SRAS curve
  - Firms raise prices to protect their profit margins – better able to do this when market demand is price inelastic
  - “Wages often follow prices”
  - A rise in inflation can lead to rising inflationary expectations

Illustrating cost-push inflation



Costs and Consequences of Inflation (2)

- Money loses its value and people lose confidence in money as the value of savings is reduced
- Inflation can get out of control - price increases lead to higher wage demands as people try to maintain their living standards. This is known as a wage-price spiral.
- Consumers and businesses on fixed incomes lose out because the their real incomes falls - employees in poor bargaining positions lose out

Costs and Consequences of Inflation (1)

- Inflation can favour borrowers at the expense of savers – because inflation erodes the real value of existing debts
- Inflation can disrupt business planning and lead to lower capital investment
- Inflation is a possible cause of higher unemployment in the long term – because of a lack of competitiveness
- Rising inflation is associated with higher interest rates - this reduces economic growth and can lead to a recession

Long Term Trends in UK Inflation

Inflation rates for the UK economy Annual average % change in retail prices			
Period	Minimum Rate	Maximum Rate	Average Rate
1958-62	0.6	4.3	2.5
1963-67	2.0	4.8	3.3
1968-72	4.7	9.4	6.6
1973-77	9.2	24.2	16.4
1978-82	8.3	18.0	12.0
1983-87	3.4	6.1	4.7
1988-92	3.7	9.5	6.3
1993-97	1.6	3.5	2.6
1998-02	1.5	3.4	2.3

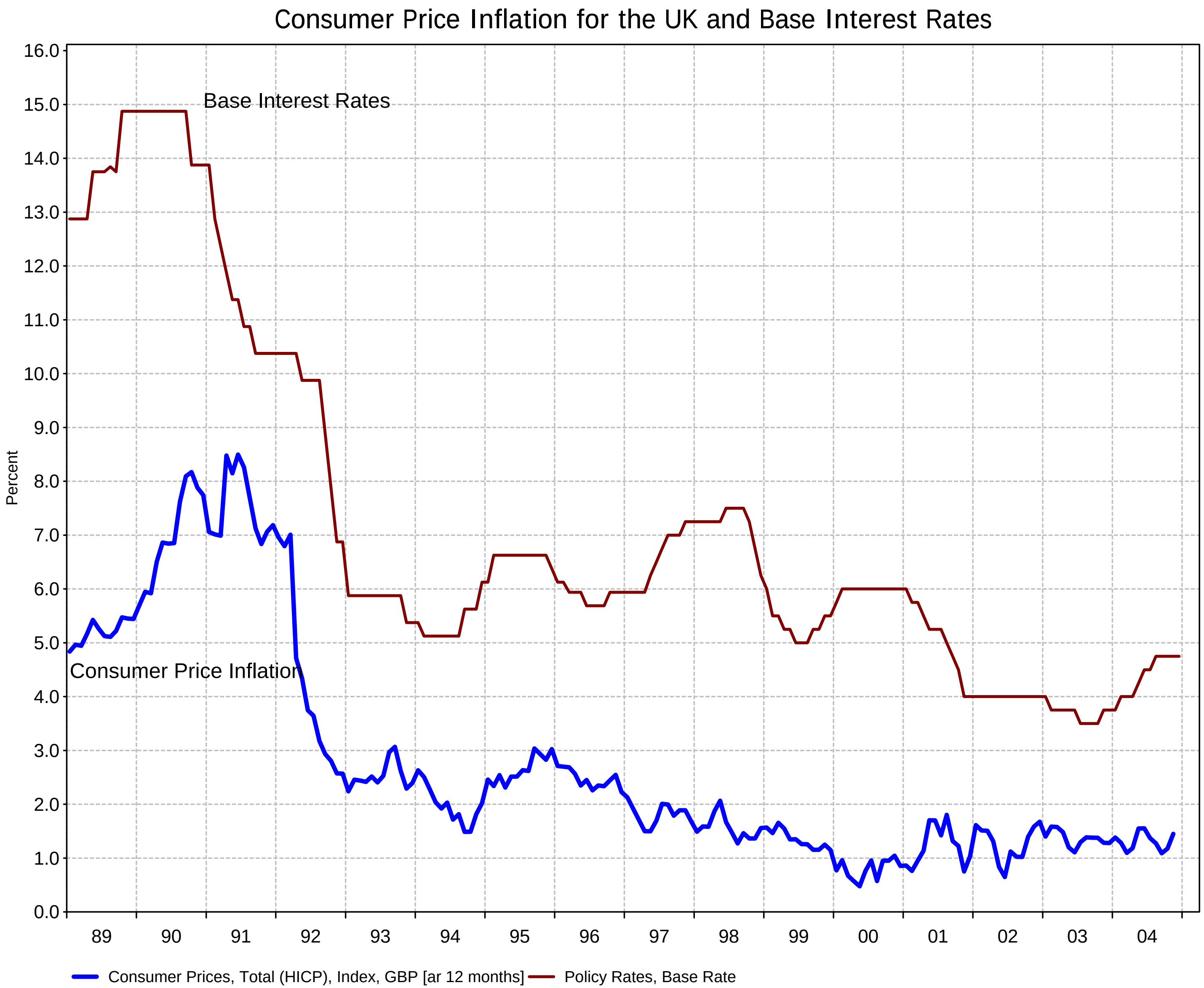
Explaining low inflation in the UK

- Several factors explain the absence of inflation
  - Subdued growth of wages and earnings (below 5%)
  - Absence of major inflationary shocks such as a sharp jump in international commodity prices
  - Success of the Bank of England in keeping aggregate demand under control through interest rate changes
  - Much greater competitive pressure in many industries
  - Strong pound has helped to keep inflation under control
  - Expansion of technology has helped to reduce costs
  - Cuts in the prices charged by many of the privatized utilities
  - Expectations of inflation have fallen!

The “NICE-1990s”!

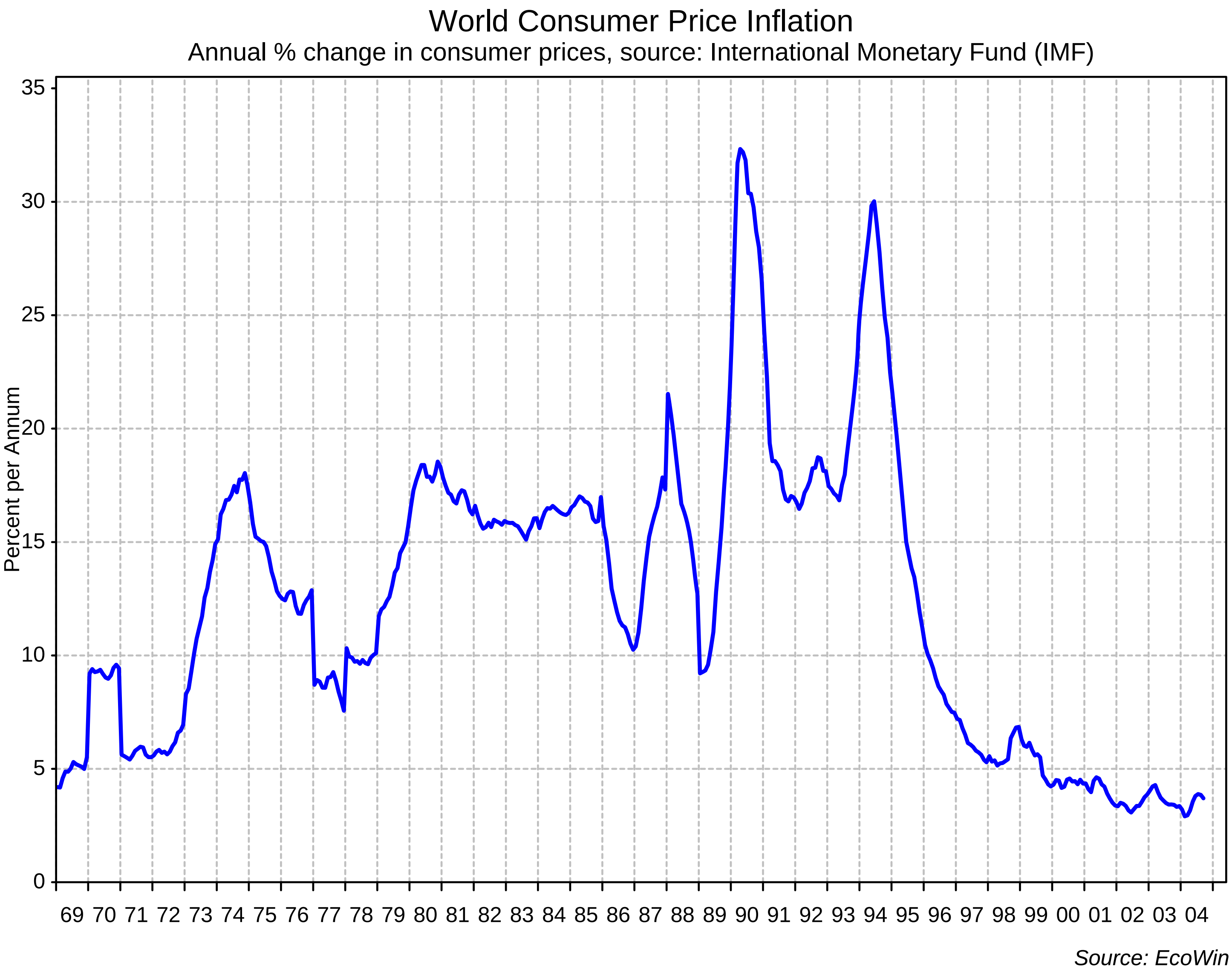
- “In the 1990s, the UK experienced a non-inflationary consistently expansionary - or "nice" - decade; a decade in which growth was a little above trend, unemployment fell steadily, and cheaper imports allowed consumers to enjoy rising living standards without the need to ask for inflationary pay claims”
- Mervyn King, Governor of the Bank of England

Interest rates and inflation

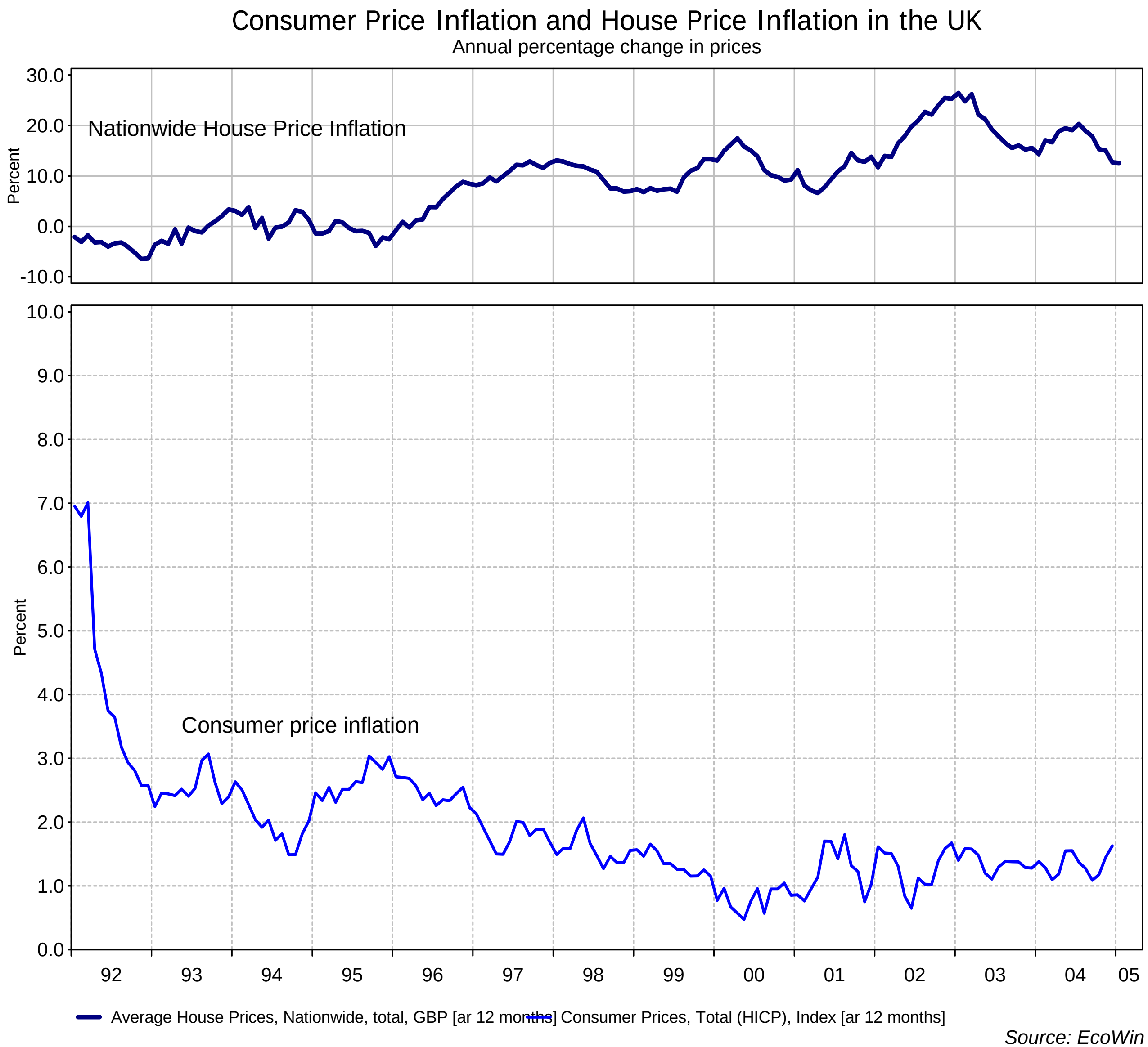


Source: EcoWin

A decline in global inflation pressures



House prices and CPI inflation



Reasons for continued low inflation