2.1.2 Inflation

a) Understanding of:
   - *inflation*
   - *deflation*
   - *disinflation*

b) The process of calculating the rate of inflation in the UK using the Consumer Prices Index (CPI)

c) The limitations of CPI in measuring the rate of inflation

d) The Retail Prices Index (RPI) as an alternative measure of the rate of inflation

e) Causes of inflation:
   - *demand pull*
   - *cost push*
   - *growth of the money supply*

f) The effects of inflation on consumers, firms, the government and workers

- The main four macroeconomics indicators:
  1. Rate of economic growth
  2. Rate of inflation
  3. Unemployment levels
  4. State of the balance of payments
- Inflation: A sustained rise in the general price level which is a weighted average of spending of all households in a country
- Rate of inflation is measured by annual percentage change in consumer prices
- Government has target of 2% for inflation using the CPI
- The Bank of England set monetary policy interest rates so inflationary pressures are controlled and inflation target is reached
- Economists use index numbers to make comparisons over time. All subsequent data points can be compared back to an initial 'base'. The base is always shown with an index of 100- it's 100% of its value- then following data points are adjusted to this value. Index numbers don't have units
- Inflation is measured by changes in the consumer price index (CPI) are used but they don't include housing costs such as rent payments and mortgage interest so changes in retail price index (RPI or headline rate) may be used
- The idea of CPI is to track price changes for a selection, or basket of goods and services which best represents the spending habits of the population as a whole. The items included are updated each year to reflect the introduction of new products and the fading popularity of others.
- There are over 700 goods and services included in the basket. Each item is assigned a weight which best represents expenditure patterns. Each weight can be consider as a fraction or percentage of total spending: the total sum of weights equals 1 (or 100%)
- Price value per year: the price of each good x weighting (and then add them all together)
- Index for year X= $\frac{price\ value\ of\ year\ X}{price\ value\ of\ base\ year}\ X\ 100$

- Percentage change = $\frac{new\ value - old\ value}{old\ value}\ X\ 100$
- Consumer price index: Used for inflation targeting in the UK which doesn't include housing costs such as mortgage interest repayments or rent
- CPI limitations:
  - The CPI is not fully representative - it will be inaccurate for the 'non-typical' household, e.g. 14% of the CPI index is devoted to motoring costs - inapplicable for non-car owners.
  - Spending patterns: e.g. Single people have different spending patterns from households that have one or more children
  - Changing quality of goods and services: Although the price of a good or service may rise, this may also be accompanied by improvements in quality/performance of the product
  - New products: The CPI is slow to respond to new products and services – the CPI basket is changed each year but only a few items fall out / come in
- Retail price index: Aka headline rate which includes housing costs and is used for setting the state pension and for price capping. If housing costs rise faster the RPI will be higher than the CPI
- Deflation: A fall in general price level which is a sign of stagnation
- Disinflation: Prices rise more slowly than they have done in the past
- 'Weights': They show the proportion of income spent on items and are used to ensure that the percentage change in price reflects the impact on the average family in terms of their spending
- Three causes of inflation:
  1. Demand-pull inflation
  2. Cost-push inflation
  3. Growth in the money supply
  4. Administered prices
- Demand-pull inflation: Caused by excessive aggregate demand which means spending is rising above sustainable levels, these changes have a multiplier effect which causes upward pressure on prices. The economy is close to full capacity (inelastic AD) so there is a positive output gap (AD > potential GDP)
- Cost-push inflation: Inflation caused by decreases in aggregate supply which means the costs of production rise, firms are willing to purchase less, exchange rate falls or minimum wage rises
- Administered prices: changes in regulated prices, indirect taxes and subsidies and environmental taxes
- Inflation expectations: once inflation is expected agents in the economy will raise their expectations and build it into their calculations and decisions
- Monetarists argue that inflation is mainly caused by increases in the money supply
- Monetarism: The school of economics based on the belief that inflation tends to be a problem of too much money in the economy
- If inflation rates are too high or too low it is a sign that the economy is experiencing problems
- The government tasks the Monetary Policy Committee with the objective of 2% inflation, within a range of tolerance of plus or minus 1%

- International competitiveness: The degree to which a country's goods and services can be sold on international markets. If inflation is above 3% exports are expensive and imports are cheaper which tends to worsen the balance of payments
- For people with fixed incomes inflation means their wages do not rise in real terms so they get progressively worse off even if they are earning more in real terms
- Fixed incomes: Many people do not enjoy wage increases in line with inflation so they suffer if the cost of living wages rises
- Tight monetary policy: When the interest rates are kept high because of inflationary fears
- If inflation is higher than nominal wage rises workers real incomes is falling.
- Higher inflation makes the MPC decide on a rise in interest rates or tight monetary policy which can have damaging effects for example investment costs more and debt is more expensive to repay
- Inflation makes the government look incapable of controlling the economy but is good if there are high levels of debt as debt doesn't change in its nominal value. Employers and trade unions can use it in wage negotiations. The government uses it to decide on increases in welfare benefits.
- Inflation's significance on the price of goods:
    1. Some will be rising above average
    2. Some prices may be rising more slowly
    3. Some price may even be falling
- Inflation means purchasing power has fallen as a fixed amount buys less than before
- Hyperinflation: When prices are rising extremely quickly and money rapidly loses value
- Limitations of CPI and RPI:
    1. RPI excludes all households in the top 4% of incomes
    2. CPI includes a broader range of the population but doesn't include interest or council tax
    3. Information given by households may be inaccurate
    4. The basket of goods only changes once a year so it might miss short term changes
- Inflation is calculated by:
    1. Weights are assigned to each item bought by the average household
    2. The 'Living Costs and Food Survey' collects information of purchases
    3. The weights show the proportion of income spent on each item
    4. A price survey is done to record changes in prices of the 650 most commonly used goods and services
    5. Price changes are multiplied by the weights to give a price index which can be used to calculate percentage change over consecutive years