ENGLISH FOR STUDENTS OF ECONOMICS

Lecture 02: Inflation

Read the Text carefully. Meanwhile, underline the New Words.

Lenin is said to have declared that the best way to destroy the capitalist system was to debauch the currency.

By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens.

Keynes

Economics, as a social science, studies individuals and organizations engaged in the production, distributions, and consumption process of goods and services. It is subdivided into microeconomics, that focuses only on the consumer, firms or industry, and macroeconomics, that focuses on the issues of the economy as a whole such as unemployment; economic growth, financial crises, and so on. Amid all the economic problems nowadays, the inflation issue is considered as key issue. Therefore, keeping prices stable (or keeping the inflation rate low) is one of the most important economic goals facing economic policy makers.

I. Meaning of Inflation:

In the late 1970s, when the U.S. inflation rate reached about 10 percent per year, inflation dominated debates over economic policy. And even though inflation has been low over the past decade, it remains a closely watched macroeconomic variable. One study found that inflation is the economic term mentioned most often in U.S. newspapers (far ahead of second-place-unemployment, and third-place-productivity). Inflation is closely watched and widely discussed because it is thought to be a serious economic problem.

Inflation is a rise in the general level of prices. When inflation occurs, each dollar of income will buy fewer goods and services than before. Inflation reduces the "purchasing power" of money. Nevertheless, inflation does not mean that all prices are

rising. Even during periods of rapid inflation, some prices may be relatively constant and others may even fall. For example, although the United States experienced high rates of inflation in the 1970s and early 1980s, the prices of video recorders, digital watches, and personal computers declined.

After World War II, a 12-ounce bottle of Pepsi sold for 5 cents. Today, a 12-ounce of Pepsi sells for more than 20 times that much. This is not inflation. Inflation is an increase in the general (average) price level of goods and services in the economy. Inflation's opposite is deflation. Deflation is a decrease in the general (average) price level of goods and services in the economy. Note that inflation does not mean that all prices of all products in the economy rise during a given period of time. For example, the annual percentage change in the average overall price level during the 1970s reached double digits, but the prices of pocket calculators and digital watches actually declined. The reason that the average price level rose in the 1970s was that the rising prices of Pepsi, houses, and other goods outweighed the falling prices of pocket calculators, digital watches, and other goods.

II. Measurement of Inflation:

To track prices, government statisticians construct price indexes, or measures of the overall price level. An important example is the consumer price index (CPI), which measures the trend in the average price of goods and services bought by consumers.

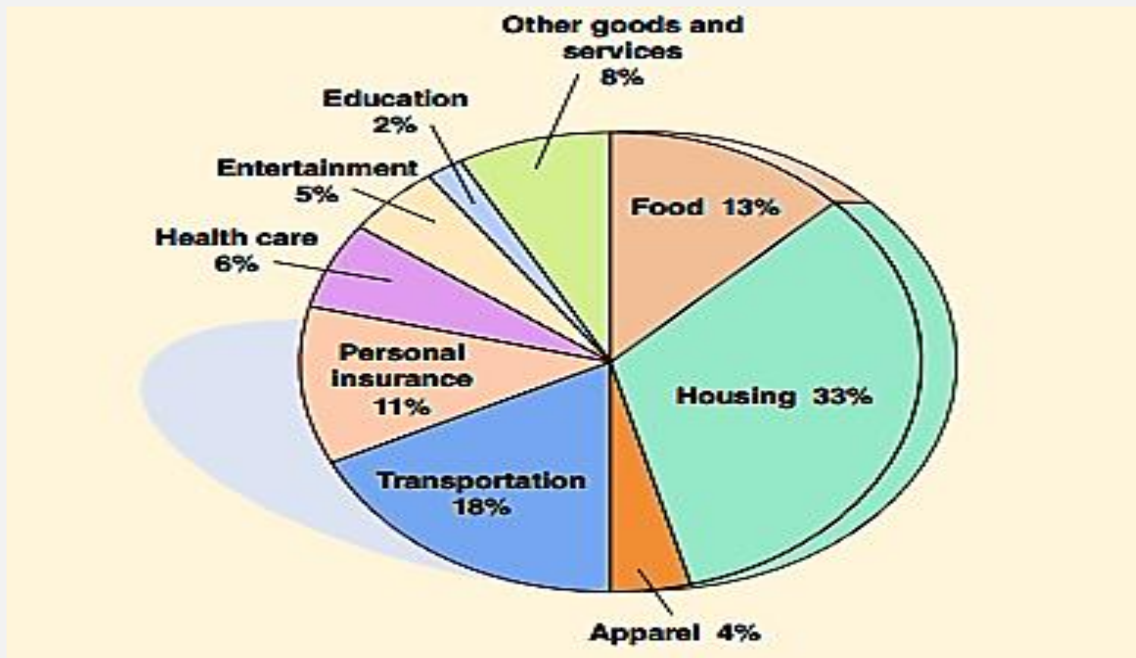
CPI is the main measure of inflation in most countries is the Consumer Price Index. The government uses this index to report inflation rates each month and each year. It also uses the CPI to adjust Social Security benefits and income tax brackets for inflation. In the United States, the CPI reports the price of a "market basket" of some 300 consumer goods and services that are purchased by a typical urban consumer.

The composition of the market basket for the CPI is based on spending patterns of urban consumers in a specific period. The BLS (the Bureau of Labor Statistics in the USA) updates the composition of the market basket every 2 years so that it reflects the most recent patterns of consumer purchases and captures the inflation that consumers are currently experiencing.

Economists measure price stability by looking at inflation, or the rate of inflation. The inflation rate is the percentage change in the overall level of prices from one year to the next. For example, the CPI was 201.6 in 2006 and 207.3 in 2007. The inflation-rate calculation is just like the growth-rate calculation. We will generally denote the overall price level by the letter P. We thus calculate the inflation rate for 2007 as follows:

$$\text{Rate of inflation in year } t = 100 \times \frac{P_t - P_{t-1}}{P_{t-1}} \qquad \text{Rate of inflation in 2007} = 100 \times \frac{207.3 - 201.6}{201.6} = 2.8\% \text{ per year}$$

The composition of CPI in the USA.



You Need to Know ✔

Inflation refers to an increase in the general price level, not the price of a specific good or service.

III. *Three Strains of Inflation*

Like diseases, inflations exhibit different levels of severity. It is useful to classify them into three categories: low inflation, galloping inflation, and hyperinflation.

1 .*Low Inflation*: Low inflation is characterized by prices that rise slowly and predictably. We might define this as single-digit annual inflation rates. When prices are relatively stable, people trust money because it retains its value from month to month and year to year. People are willing to write long-term contracts in money terms because they are confident that the relative prices of goods they buy and sell will not get too far out of line. Most countries have experienced low inflation over the last decade.

2. *Galloping Inflation:* Inflation in the double-digit or triple-digit range of 20, 100, or 200 percent per year is called galloping inflation or “very high inflation.” Galloping inflation is relatively common, particularly in countries suffering from weak governments, war, or revolution. Many Latin American countries, such as

Argentina, Chile, and Brazil, had inflation rates of 50 to 700 percent per year in the 1970s and 1980s.

Once galloping inflation becomes entrenched, serious economic distortions arise. Generally, most contracts get indexed to a price index or to a foreign currency like the dollar. In these conditions, money loses its value very quickly, so people hold only the bare-minimum amount of money needed for daily transactions. Financial markets wither away, as capital flees abroad. People hoard goods, buy houses, and never, ever lend money at low nominal interest rates.

3. *Hyperinflation:* While economies seem to survive under galloping inflation, a third and deadly strain takes hold when the cancer of hyperinflation strikes. Nothing good can be said about an economy in which prices are rising a million or even a trillion percent per year.

Hyperinflations are particularly interesting to students of inflation because they highlight its disastrous impacts. Consider this description of hyperinflation in the Confederacy during the Civil War:

"We used to go to the stores with money in our pockets and come back with food in our baskets. Now we go with money in baskets and return with food in our pockets. Everything is scarce except money! A partial return to barter inconvenience is the result."

IV. Sources of Inflation:

Economists identify two distinct causes of inflation; demand-pull inflation and cost-push inflation. Demand-pull inflation is inflation that occurs when aggregate spending exceeds the economy's normal full-employment level of output, i.e., when aggregate demand is pushed too far to the right along a given aggregate supply curve. Demand-pull inflation is normally characterized by both a rising price and output level. It often results in an unemployment rate lower than the natural rate.

Cost-push inflation originates from increases in the cost of producing goods and services, such as wages or the prices of raw materials. Aggregate supply is pushed to the left, which is referred to as stagflation. It is associated with increases in the price level, decreases in aggregate output, and an increase in the unemployment rate above the natural rate.

V. The impact of Inflation:

Inflation can slow economic growth, redistribute income and wealth, and cause economic activity to contract. Inflation impairs decision-making since it creates uncertainty about future prices and/or costs and distorts economic values. For example,

a business may postpone the purchase of equipment because of increasing uncertainty about the purchasing power of future money streams. Such postponed capital outlays slow capital formation and economic growth.

- *Inflation and Wealth*: Income is one measure of economic well-being, and wealth is another. Income is a flow of money earned by selling factors of production. Wealth is the value of the stock of assets owned at some point in time. Wealth includes real estate, stocks, bonds, bank accounts, life insurance policies, cash, and automobiles. A person can have a high income and little wealth, or great wealth and little income.

  Inflation can benefit holders of wealth because the value of assets tends to increase as prices rise. Consider a home purchased in 2000 for $200,000. By 2009, this home might sell for $300,000. This 50 percent increase is largely a result of inflation. In addition, people who own forms of wealth that increase in value faster than the inflation rate, such as real estate, are winners.

  On the other hand, the impact of inflation on wealth penalizes people without it. Consider younger couples wishing to purchase a home. As prices rise, it becomes more difficult for them to buy a home or acquire other assets.

Key concepts:

- ***Inflation*** is an increase in the general (average) price level of goods and services in the economy.
- ***Deflation*** is a decrease in the general level of prices. During the early years of the Great Depression, there was deflation, and the CPI declined at about a double-digit rate. ***The consumer price index (CPI)*** is the most widely known price-level index. It measures the cost of purchasing a market basket of goods and services by a typical household during a time period relative to the cost of the same bundle during a base year. The annual rate of inflation is computed using the following formula:

$$\text{Annual rate of inflation} = \frac{\text{CPI in given year} - \text{CPI in previous year}}{\text{CPI in previous year}} \times 100$$

- ***Disinflation*** is a reduction in the infl ation rate. This does not mean that prices were falling, only that the infl ation rate fell.
- ***The inflation rate*** determined by the CPI is criticized because (1) it is not representative, (2) it has diff culty adjusting for quality changes, and (3) it ignores the relationship between price changes and the importance of items in the market basket.

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