FACULTY OF JURIDICAL SCIENCES

Lecture-12

INFLATION

Inflation is an increase in the level of prices of the goods and services that households buy. It is measured as the rate of change of those prices. Typically, prices rise over time.

The most well-known indicator of inflation is the Consumer Price Index (CPI), which measures the percentage change in the price of a basket of goods and services consumed by households. Inflation is the decline of purchasing power of a given currency over time. A quantitative estimate of the rate at which the decline in purchasing power occurs can be reflected in the increase of an average price level of a basket of selected goods and services in an economy over some period of time. The rise in the general level of prices, often expressed as a percentage, means that a unit of currency effectively buys less than it did in prior periods.

- Inflation is the rate at which the value of a currency is falling and, consequently, the general level of prices for goods and services is rising.
- Inflation is sometimes classified into three types: Demand-Pull inflation, Cost-Push inflation, and Built-In inflation.
- The most commonly used inflation indexes are the Consumer Price Index (CPI) and the Wholesale Price Index (WPI).
- Inflation can be viewed positively or negatively depending on the individual viewpoint and rate of change.
- Those with tangible assets, like property or stocked commodities, may like to see some inflation as that raises the value of their assets.

CAUSES OF INFLATION

1. Demand-pull inflation

Demand-pull inflation happens when the demand for certain goods and services is greater than the economy's ability to meet those demands. When this demand outpaces supply, there's an upward pressure on prices — causing inflation.

A practical example of this would be tickets to see Hamilton live on Broadway. Because there were a limited number of seats and the demand for the live show was far greater than capacity, the price of tickets skyrocketed approaching $2,000 on third party sites, well above the standard ticket price of $139 and premium ticket price of $549 at the time.

2. Cost-push inflation

Cost-push inflation is the increase of prices when the cost of wages and materials goes up. These costs are often passed down to consumers in the form of higher prices for those goods and services. An example of this would be lumber, as lumber is an input good for houses. When the cost of lumber spiked as much as 400% earlier in 2021 it had an impact on the increase in housing prices resulting in inflation.

3. Increased money supply

Increased money supply is defined as the total amount of money in circulation, which includes cash, coins, and balances and bank accounts according to the Federal Reserve. If the money supply increases faster than the rate of production, this could result in inflation, particularly demand-pull inflation because there will be too many dollars chasing too few products. An increase in money supply is usually created by the Federal Reserve through a process called Open Market Operations (OMO).

4. Devaluation

Devaluation is downward adjustment in a country's exchange rate, resulting in lower values for a country's currency.

The devaluation of a currency makes a country's exports less expensive, encouraging foreign nations to buy more of the devalued goods. Devaluation also makes foreign products for the devaluing country more expensive which encourages citizens of the devaluing country to buy domestic products over foreign imports.

China is perhaps most known for this tactic as the United States and other nations have frequently accused China of working to devalue the Yuan over the years.

5. Rising wages

Rising wages is exactly what it sounds like — an increase in what's being paid to workers. "Wages are a cost of production," adds Baker. "If wages rise a large amount, businesses will either have to pass the cost on, or live with lower margins. The exception is if they can offset wage growth with higher productivity."

However, economists remain mixed on the impact of gradual increases in wages, like raising the minimum wage, compared to faster, more sudden wage growth seen in places like Silicon Valley. Some believe that an increase in wages could result in cost-push inflation due to the higher cost to businesses, while others believe that higher wages across the board (not just concentrated in certain sectors) will also increase demand enough to offset a spike in prices.

"Rising wages should allow consumers to combat inflation, especially if the wages are rising at the same or a faster rate than the inflation rate," "The rising wages allow consumers to pay higher prices without impacting their purchasing power."

6. Policies and regulations

Certain policies can also result in either a cost-push or demand-pull inflation. When the government issues tax subsidies for certain products, it can increase demand. If that demand is higher than supply, costs could rise. Additionally, stringent building regulations and even rent stabilization policies could inadvertently increase costs and create an inflationary environment by passing those costs to residents or artificially reduce the supply of housing.

DEFLATION

Deflation is when consumer and asset prices decrease over time, and purchasing power increases. Essentially, you can buy more goods or services tomorrow with the same amount of money you have today. This is the mirror image of inflation, which is the gradual increase in prices across the economy.
While deflation may seem like a good thing, it can signal an impending recession and hard economic times. When people feel prices are headed down, they delay purchases in the hopes that they can buy things for less at a later date. But lower spending leads to less income for producers, which can lead to unemployment and higher interest rates.

This negative feedback loop generates higher unemployment, even lower prices and even less spending. In short, deflation leads to more deflation.

Deflation is measured using economic indicators like the Consumer Price Index (CPI). The CPI tracks the prices of a group of commonly purchased goods and services and publishes the changes every month.

CAUSES OF DEFLATION

There are two big causes of deflation: a decrease in demand or growth in supply. Each is tied back to the fundamental economic relationship between supply and demand. A decline in aggregate demand leads to a fall in the price of goods and services if supply does not change.

A drop in aggregate demand may be triggered by:

- **Monetary policy:** Rising interest rates may lead people to save their cash instead of spending it and may discourage borrowing. Less spending means less demand for goods and services.
- **Declining confidence:** Adverse economic events—such as a global pandemic—may lead to a decrease in overall demand. If people are worried about the economy or unemployment, they may spend less so they can save more.

Higher aggregate supply means that producers may have to lower their prices due to increased competition. This boost in aggregate supply may stem from a drop in production costs: If it costs less to produce goods, companies can make more of them for the same price. This can result in more supply than demand and lower prices.

CONSEQUENCES OF DEFLATION

Although it may seem helpful for the price of goods and services to fall, it can have very negative effects on the economy.

- **Unemployment.** As prices drop, company profits decrease, and some companies may cut costs by laying off workers.
- **Debt.** Interest rates tend to go up in periods of deflation, which makes debt more expensive. Consumers and businesses often decrease spending as a result.
- **Deflationary spiral.** This is a domino effect caused by each overlapping piece of deflation. Falling prices may result in less production. Less production may lead to lower pay. Lower pay may result in a drop in demand. And a drop in demand may cause increasingly lower prices. And on and on. This can make a bad economic situation worse.