INFLATION

- *Inflation:* a sustained increase in an economy's price level.
- *Creeping inflation*: a low rate of inflation.
- *Hyperinflation*: an exceptionally high rate of inflation, which may result in people losing confidence in the currency.

Measurement of Inflation

- *Selecting a base year:* This is usually a relatively standard year in which nothing unusual has occurred. It is given a value of 100. The base year is changed on a regular basis.
- *Carrying out a survey to find people's spending patterns:* A sample of the population's households are asked to keep a record of what they buy. The products purchased are placed into categories such as food and clothing and footwear.
- *Attaching weights to the different categories:* Weights are based on the proportion of total expenditure spent on the different categories. For instance, if on average households spend $500 of their total expenditure of $2,000 on food, the category will be given a weight of ¼ or 25%.
- *Finding out price changes:* Prices in a range of retail outlets and from a number of other sources such as gas companies and train companies are recorded.

The distinction between money values and real values

- *Money values:* values at the prices operating at the time.
- *Real values:* values adjusted for inflation.

To convert money values into real values, the figures are multiplied by the price index in the current year and divided by the price index in the base year.

For example:

A worker's wages may rise from $5,000 in 2015 to $6,000 in 2016. The worker may think he has received a 20% pay rise. He has in money terms but not in real terms if inflation has occurred. If the consumer price index was 100 in 2015 and 125 in 2016, his wages in real terms would have changed to:

$\$6,000 \times 100/125 = \$4,800$.

So in real terms, his income has fallen by 4%.

Category	Weight	% price change	Weighted price change
Food and non-alcoholic beverages	286/1,000	1.5	0.43
Alcoholic beverages and tobacco	92/1,000	10.3	0.95
Clothing and footwear	51/1,000	2.8	0.14
Housing, water, electricity, gas and other fuels	131/1,000	4.7	0.62
Furnishings, household equipment and routine household maintenance	64/1,000	3.7	0.24
Health	30/1,000	5.3	0.16
Transport	147/1,000	−0.4	−0.06
Communications	36/1,000	1.8	0.06
Recreation and culture	48/1,000	1.2	0.06
Education	32/1,000	2.4	0.08
Restaurants and hotels	43/1,000	6.0	0.26
Miscellaneous goods and services	40/1,000	2.7	0.11
All items	1,000		3.05

Table 4.1 Consumer price index, Mauritius

The causes of Inflation

Cost-push inflation: Inflation caused by increases in costs of production. The is occurs when prices are pushed up by increases in the cost of production.

- wages may increase more than labour productivity and so result in a rise in labour costs.
- Increases in real material costs and fuel can also push up prices.
- these increases may be caused by a fall in the exchange rate.

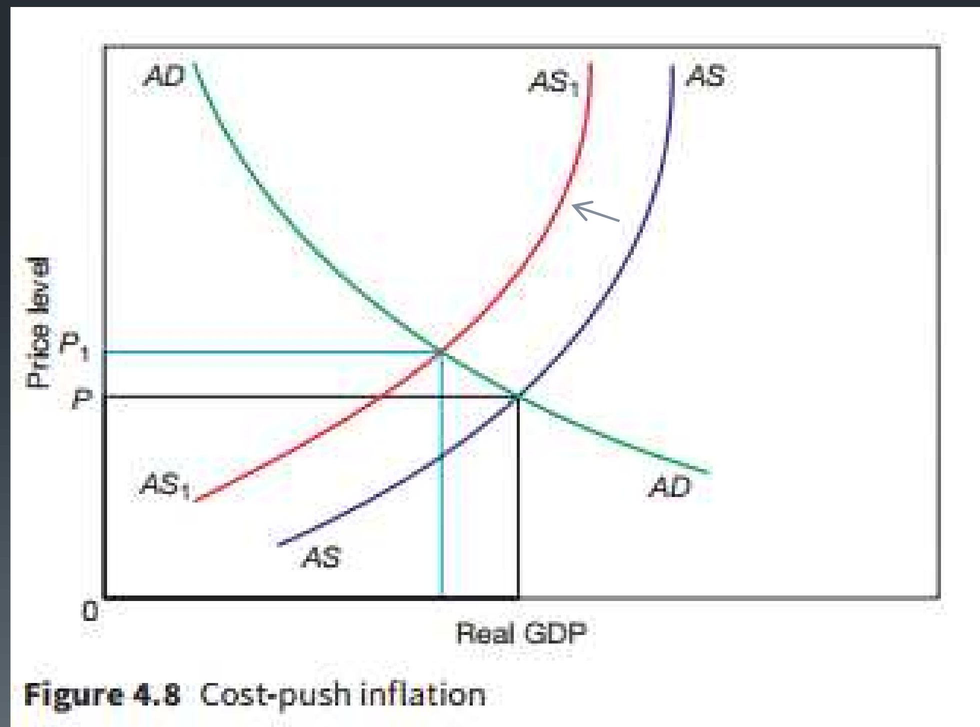
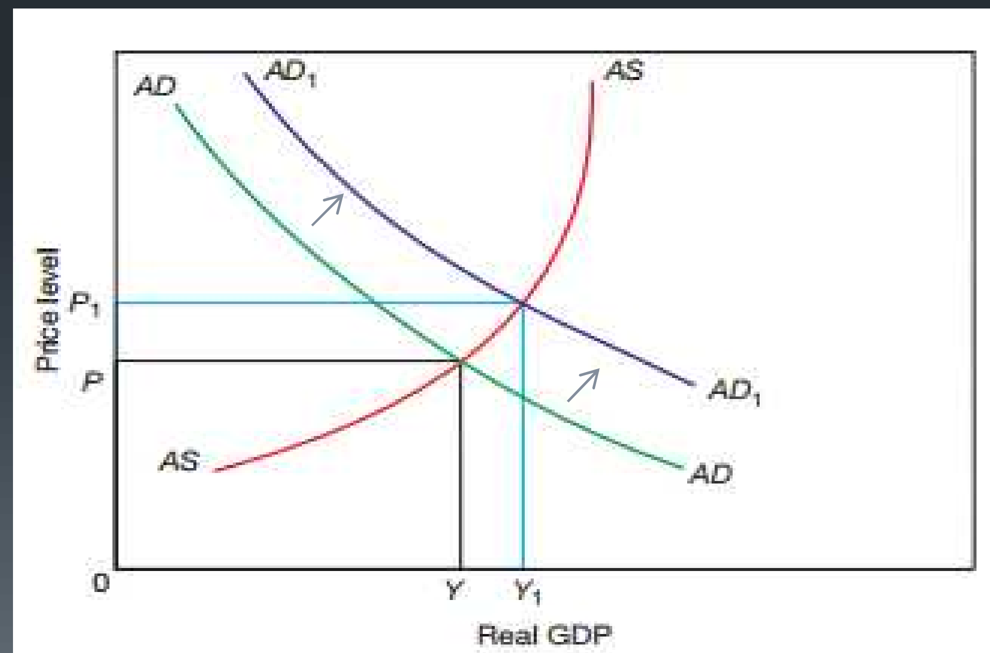


Figure 4.8 Cost-push inflation

Demand-pull inflation: inflation caused by increases in aggregate demand not matched by equivalent increases in aggregate supply.

- a consumer boom
- a rise in government spending
- higher business confidence resulting in an increase in investment or an increase in net exports.
- if the money supply grows more rapidly than output, the greater supply of money will drive up the price level.



The potential costs include:

- A reduction in net exports
- An unplanned redistribution of income
- Menu costs
- Shoe leather costs
- Fiscal drag
- Discouragement of investment
- Inflationary noise
- Inflation causing inflation

The potential benefits include:

- Stimulating output
- Reduce the burden of debt
- Prevent some unemployment

Factors affecting the consequences of inflation

The effects of inflation depend on:

- the cause of inflation
- its rate
- whether the rate is accelerating or stable
- whether the rate is the one that has been expected
- how the rate compares with that of other countries.

TOP TIP

Remember that inflation does not always reduce households' purchasing power. It does *ceteris paribus*, but if wages rise by more than prices, households will be able to purchase more goods and services.