7. INFLATION

Investopedia[19] inflation as a sustained increase in the general level of prices for goods and services in a county, and is measured as an annual percentage change. Under conditions of inflation, the prices of things rise over time. Put differently, as inflation rises, every dollar you own buys a smaller percentage of a good or service. When prices rise, and alternatively when the value of money falls you have inflation. Inflation is defined as a sustained increase in the general level of prices for goods and services in a county, and is measured as an annual percentage change. Under conditions of inflation, the prices of things rise over time. Put differently, as inflation rises, every dollar you own buys a smaller percentage of a good or service. When prices rise, and alternatively when the value of money falls you have inflation. The value of a dollar (or any unit of money) is expressed in terms of its purchasing power, which is the amount of real, tangible goods or actual services that money can buy at a moment in time. When inflation goes up, there is a decline in the purchasing power of money. For example, if the inflation rate is 2% annually, then theoretically a $1 pack of gum will cost $1.02 in a year. After inflation, your dollar does not go as far as it did in the past. This why a pack of gum cost just $0.05 in the 1940's – the price has risen, or from a different perspective, the value of the dollar has declined. In recent years, most developed countries have attempted to sustain an inflation rate of 2–3% by using monetary policy tools put to use by central banks. This general form of monetary policy is known as inflation targeting.

There is no single theory for the cause of inflation that is universally agreed upon by economists and academics, but there are a few hypotheses that are commonly held:

Demand-Pulled Inflation – Inflation is caused by the overall increase in demand for goods and services, which bids up their prices. This theory can be summarized as "too much money chasing too few goods". In other words, if demand is growing faster than supply, prices will increase. This usually occurs in rapidly growing economies. This theory is often promoted by the Keynesian school of economics. Cost-Pushed Inflation – Inflation is caused when companies' costs of production go up. When this happens, they need to increase prices to maintain their profit margins. Increased costs can in-

[19] http://www.investopedia.com/university/inflation/inflation1.asp

clude things such as wages, taxes, or increased costs of natural resources or imports.

Monetary Inflation – Inflation is caused by an oversupply of money in the economy. Just like any other commodity, the prices of things are determined by their supply and demand. If there is too much supply, the price of that thing goes down. If that thing is money, and too much supply of money makes its value go down, the result is that the prices of everything else priced in dollars must go up! This theory is often promoted by the "Monetarist" school of economics.

Reading

Part 1

What is inflation[20]

In a market economy, prices for goods and services can always change. Some prices rise; some prices fall. One speaks of inflation if there is a broad increase in the prices of goods and services, not just of individual items. As a result, you can buy less for €1. Expressed the other way around, a euro is worth less than it was before. When calculating the average increase in prices, the prices of products we spend more on – such as electricity – are given a greater weight than the prices of products we spend less on – for example, sugar or postage stamps. Every household has different spending habits: some have a car and eat meat, others travel solely by public transport or are vegetarian. The average spending habits of all households together determine how much weight the different products and services have in the measurement of inflation. For measuring inflation, all goods and services that households consume are taken into account, including everyday items (such as food, newspapers and petrol), durable goods (such as clothing, PCs and washing machines), services (such as hairdressing, insurance and rented housing). All the goods and services consumed by households during the year are represented by a "basket" of items. Every product in this basket has a price, which can change over time. The annual rate of inflation is the price of the total basket in a given month compared with its price in the same month one year previously.

[20] https://www.ecb.europa.eu/ecb/educational/hicp/html/index.en.html

Perceived inflation

Consumer surveys often show that people "feel" inflation to be higher than the actual price indices indicate. So what forms people's perceptions of inflation? A number of academic studies have found the following:

1. Price rises catch our attention more than stable or declining prices – Increases in prices also stay in our memory for longer. We tend to notice stable or declining prices less, although these prices also count when calculating the average inflation rate.
2. We notice frequent, out-of-pocket purchases more – In recent years, the prices of some goods and services we buy frequently have increased above average. Examples of these are petrol, bread and bus tickets. We often pay too much attention to changes in the prices of these items when thinking about inflation. This may mean we end up overestimating the actual rate of inflation.
3. We notice infrequent purchases and direct debits less – A substantial amount of our household budget is spent on goods and services that we buy less frequently. Examples are cars and holidays. There are also items we often pay for by automatic bank transfer (direct debits and standing orders), such as rented housing and telephone bills. We tend to notice these expenditures and changes in their prices less when thinking about inflation.

The Harmonised Index of Consumer Prices (HICP) is based on an average basket of goods and services. This average basket is representative for all households. However, households that experience an above-average inflation may be more acutely aware of this than those that benefit from a below-average inflation.

E.g. If petrol prices increase much more than the prices of other goods and services, people who use a car frequently may "feel" a rate of inflation that exceeds the HICP because their personal expenditure on petrol is higher than average. By contrast, those who use a car rarely or not at all will experience a lower "personal" rate of inflation. The HICP is usually reported as an annual growth rate. This means that the general price level for a particular period of time – say, January 2009 – is compared with the same period one year earlier – namely January 2008. When forming their perceptions, people may think back to prices several years ago. Over a long period of time prices tend to rise substantially, even with a low annual rate of inflation. For example, if the annual rate of change of the HICP is 2%, after 10 years the general price level will have increased by over 20%. We often consider changes in a product's price tag as inflation. But sometimes the quality of the product changes at the same time. The HICP deals with this by subtracting the change that is due to quality.

E.g. Car prices may have gone up but new models often include, as standard, features that were previously sold as optional extras (for example, satellite navigation systems, air conditioning and airbags). In such cases, the price increase is due partly to an increase in quality and not only to inflation. If car prices went up, say, 5% on average but quality increases accounted for 1%, then the HICP would reflect a 4% increase for this product.

Questions to answer:

1. What is HICP and how is it constructed?
2. Can you think of any pros and cons of the way inflation is measured?
3. Why is the change in some prices more important than in others?
4. What is perceived inflation?

Part 2

More information on inflation, how to understand it or how to calculate it can be found in many various sources. The following questions are based on A "HOW-TO" GUIDE: UNDERSTANDING AND MEASURING INFLATION by Jim Stanford:[21]

Questions to answer:

1. What is price level?
2. What is inflation?
3. What is deflation?
4. What is hyper-inflation?
5. What is the Consumer Price Index (CPI)?
6. What is the difference between nominal and real prices and why is it important to distinguish between the two?
7. What is the difference between nominal and real wages and why is it important to distinguish between the two?

[21] http://economicsforeveryone.ca/files/uploads/How_To_Inflation.pdf

Speaking

Read How an Economy Grows and Why it Doesn't by Irwin A. Schiff[22] and discuss the following:

1. Can credit be expanded? What are the limitations of it?
2. How are consumption loans connected with savings?
3. How are investment or capital loans connected with savings?
4. Who is Max Goodbank and what is his view on risk ventures?
5. How is Max Goodbank connected with the water works project and why does the project work?
6. What or who does the author believe causes inflation?
7. Can you explain what the author means by the statement that: "Off shore banking of real fish became popular among fish-wise citizens".
8. How do you understand the following statement: "Since fish deposited in the bank were losing value so quickly, Islanders were encouraged to save less, while many simply discontinued saving completely. Fish had to be spent quickly to avoid losses to increasing prices".
9. What was senator Dee Dipped's solution for the unemployment problem?
10. Who is society's biggest debtor?

Listening

Part 1

Inflation and Bubbles and Tulips: Crash Course Economics #7[23]

Adriene Hill and Jacob Clifford teach you about how and why prices rise. Sometimes prices rise as a result of inflation, which is a pretty normal thing for economies to do. We'll talk about how across the board prices rise over time, and how economists track inflation. Bubbles are a pretty normal thing for humans to do. One item, like tulips or beanie babies or houses or tech start-ups experience a rapid rise in prices. This is often accompanied by speculation, a bunch of outrageous profits, and then a nasty crash when the bubble bursts. People get excited about rising prices, and next thing you know, people are trading their life savings for a tulip bulb.

[22] https://freedom-school.com/money/how-an-economygrows.pdf
[23] https://www.youtube.com/watch?v=T8-85cZRI9o

Questions to answer:

1. What is purchasing power?
2. How much was it to go to the cinema to watch "Gone with the wind"?
3. What is the consumer's basket?
4. What is the CPI and how is it measured?
5. What is the difference between nominal and real prices?
6. What is the disadvantage of the CPI?
7. What causes inflation?
8. What was the tulip bubble?

Part 2

Watch the following link on price stability[24] and read the booklet on price stability.[25]

Questions to answer:

1. What is price stability?
2. Why do we have money?
3. Who suffers the most in times of high inflation and why?
4. Who keeps an eye on inflation nowadays in:
   a. The Czech Republic
   b. Your own country if it's not the Czech Republic
   c. The Euro area
   d. Canada
   e. The U.S.A
   f. The U.K
   g. Australia
5. What are the two factors mentioned that need monitoring because they could push up prices in the short-run?
6. What can push up prices in the medium to long-run?
7. What happens when there is too much money chasing too few goods?
8. What is an interest rate?
9. How is the interest rate connected with the amount of money in circulation and with inflation?
10. How can deflation damage the economy?
11. What are the functions and forms of money?
12. What is "Fisher effect"?

[24] https://www.ecb.europa.eu/ecb/educational/pricestab/html/index.en.html
[25] https://youtu.be/F6PvX625JCs