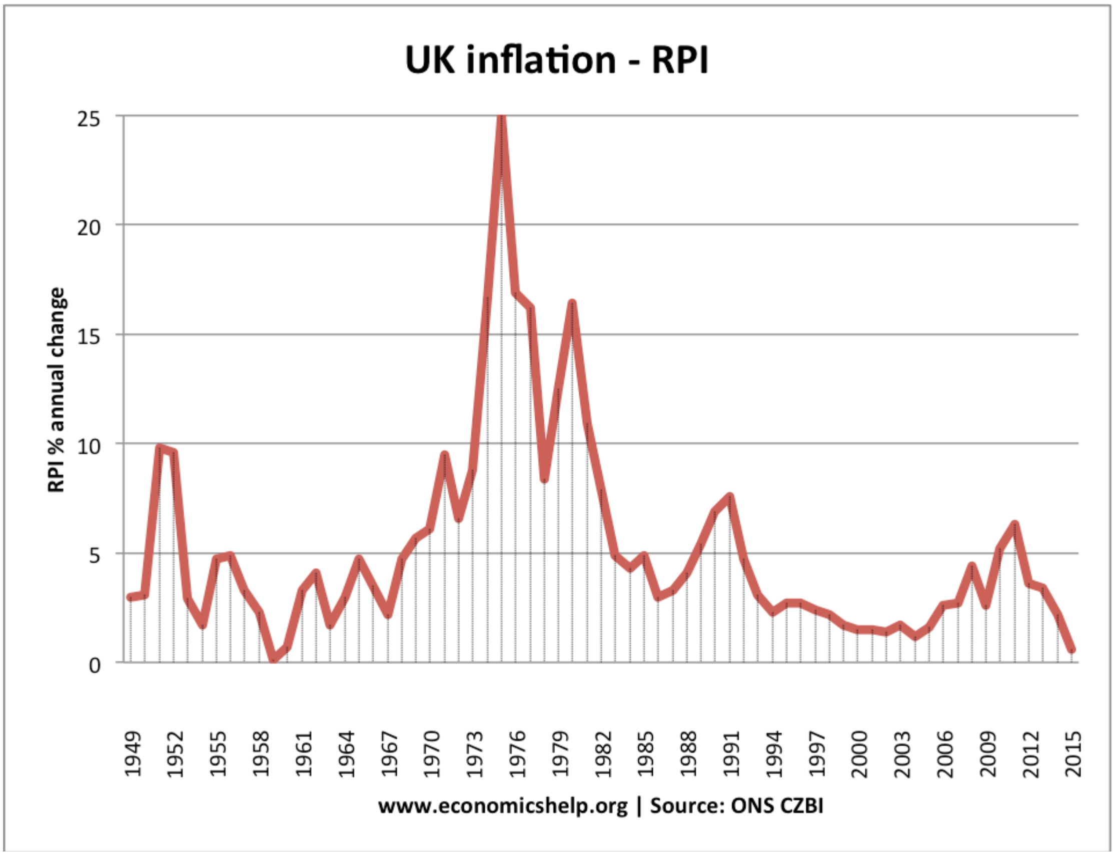
2.2.4 Inflation and Price stability

- Inflation means a sustained increase in the general price level.
- If there is inflation, the value of money declines and there is an increase in the cost of living.
- Price stability means we have a low rate of inflation. It means prices only change by a small amount. (e.g. an inflation rate close to 2% a year)
- Deflation is when prices fall.

Real and nominal values

- Real value = adjusted for inflation
- For example. If wages increase 5% in monetary terms, we say this is a nominal wage increase.
- However, if during this period inflation is 3%, then the real increase in wages is 5-3 = 2%



- Inflation in the UK since 1949. For many years, inflation was less than 5%. But, we also see spikes in the inflation rate in 1974, 1980, 1991 and 2011.
- From 2012 to 2015, we see a fall in the inflation rate. This means prices are still increasing – but at a slower rate

How inflation affects prices

- Suppose inflation is 5%. And a good costs initially £60.
- To adjust for inflation, the firm would put up prices by 105/100 * 60 = £63
- If inflation increased to 8%, the price of the good would now rise by 108/100 * 63 = £68.04

Measuring Inflation

There are different ways to measure inflation.

- Consumer Price Index (CPI)
- Retail Price Index (RPI)

They are similar, but CPI ignores mortgage interest payments. It tends to be lower than RPI. CPI is the official measure of inflation.

How to Measure Inflation - Consumer Price Index (CPI)

Steps to measuring inflation:

1. Household expenditure survey - this seeks to measure what people spend their money on. From this we get a typical basket of goods which is used to measure typical prices.
2. This basket of goods gives a relative importance to each different item, e.g. if the price of petrol increased this would have more effect than an increase in the price of radios because petrol has a higher weighting.
3. The basket of goods is updated each year to take into account changes in expenditure
4. Every month changes in the price of goods and services are monitored and combined into a single figure with using the weights in the basket.

Example of calculating inflation

Good	Weight	Price 1999	Price 2000	Total Weight x Price 2000
Bread	0.10	100	200	20
Tea	0.25	100	120	20
Cloth	0.25	100	100	25
Coal	0.4	100	150	60
Total	1	100		**125**
				inflation = 25%

This shows how inflation is measured using the weight of the good and the price change.

Problems with Calculating Inflation

1. Family expenditure survey does not include everybody, e.g. pensioners are excluded, but pensioners have different spending habits e.g. heating is more important for old people.
2. Changes in quality: Computers have many more features than 10 years ago, so it is difficult to compare prices because they are different goods. If the price of computers increase, is it inflation or a reflection of better quality?
3. Spending habits are always changing. We have to keep updating the basket of goods because we start buying new items.