

# Inflation

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GCE A-LEVEL & IB ECONOMICS

# Lesson Structure

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- Measuring Inflation
- Limitations of CPI
- Causes of Inflation
  - Growth in money supply
  - Demand-pull inflation
  - Cost-push inflation

# Inflation

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Think about a favorite restaurant you tend to go to over the years.

How have the prices of the food there changed?



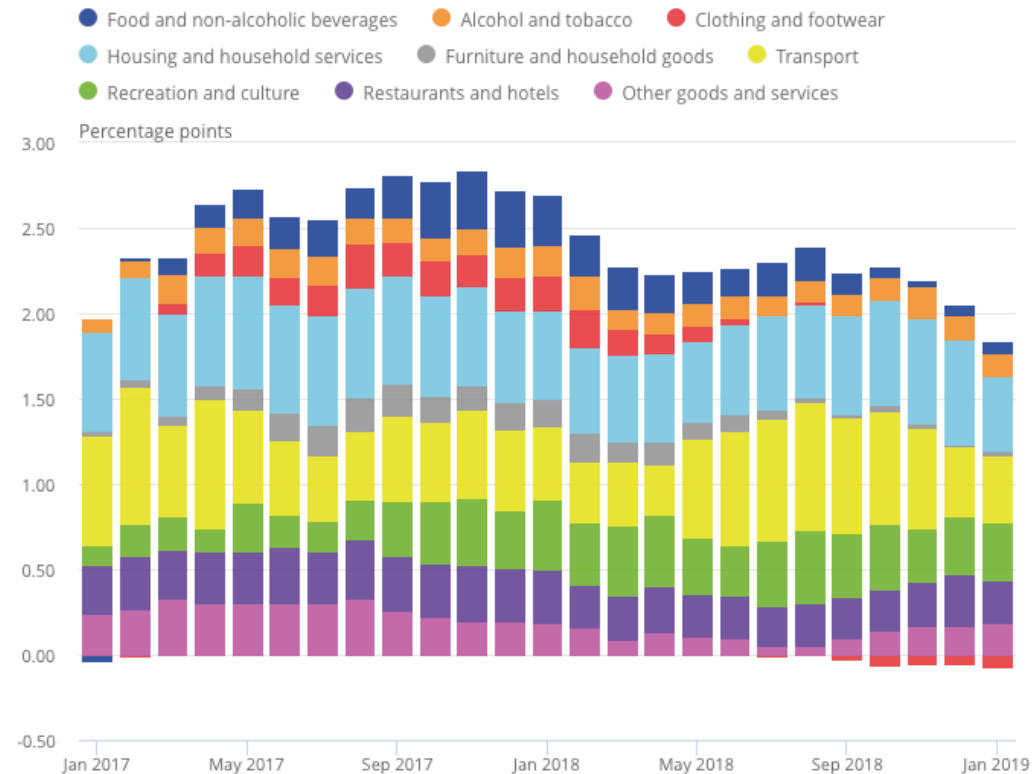
What other items in your daily lives have seen price rises over the years? Discuss with your neighbour and come up with 3 things on your mini whiteboard.

# Inflation

What type of goods/services actually contributed to inflation consistently over the years?

**Figure 3: Contributions to the CPIH 12-month rate: January 2017 to January 2019**

UK



Source: Office for National Statistics – Consumer Prices Index including owner occupiers' housing costs

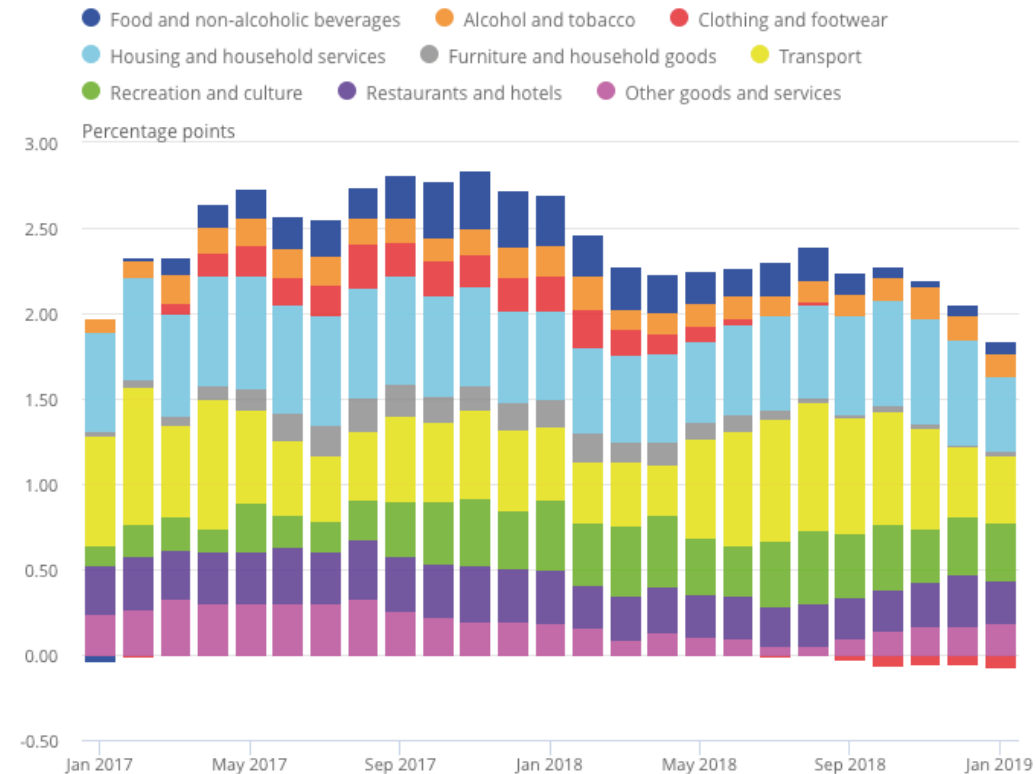
# Inflation

Within housing and household services, the largest contributions were from owner occupiers' housing costs (a 0.19 percentage point contribution to the CPIH 12-month rate); and council tax and rates (a contribution of 0.12 percentage points). Electricity, gas and other fuels and actual rentals for housing each contributed 0.05 percentage points.

Other large upward contributions came from transport, recreation and culture, and from restaurants and hotels. Further reductions in fuel prices continued the downward trend in contributions from transport that began in September 2018. Within these categories, the most notable contributions were from package holidays, catering services and the operation of personal transport equipment.

**Figure 3: Contributions to the CPIH 12-month rate: January 2017 to January 2019**

UK



Source: Office for National Statistics – Consumer Prices Index including owner occupiers' housing costs

# Basket of Goods

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One way to measure inflation is by using the \_\_\_\_\_ (CPI).  
It's the graph you just saw!

The index takes in a basket of goods an \_\_\_\_\_ household would buy, and calculate the price difference year on year to capture inflation.

Note that the measure is weighted according to the proportions of each product. This means it accounts for the quantity and value of goods as well. E.g. if an average household buys 10 eggs for \$0.5 each, it will include  $\$0.5 \times 10 = \$5$  cost of eggs in the grocery category.

# Basket of Goods

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But how do they determine what is an average household's basket of goods?

A household expenditure \_\_\_\_\_ is completed to decide on the basket of goods and attach \_\_\_\_\_ based on the proportion of goods they spend their incomes on.

Curious on what goods are included/removed?

<https://webarchive.nationalarchives.gov.uk/20160109130531/http://www.ons.gov.uk/ons/infographics/basket-of-goods-2014/index.html>



# Limitations of CPI

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Look up some limitations of the Consumer Price Index and fill in the blanks below!

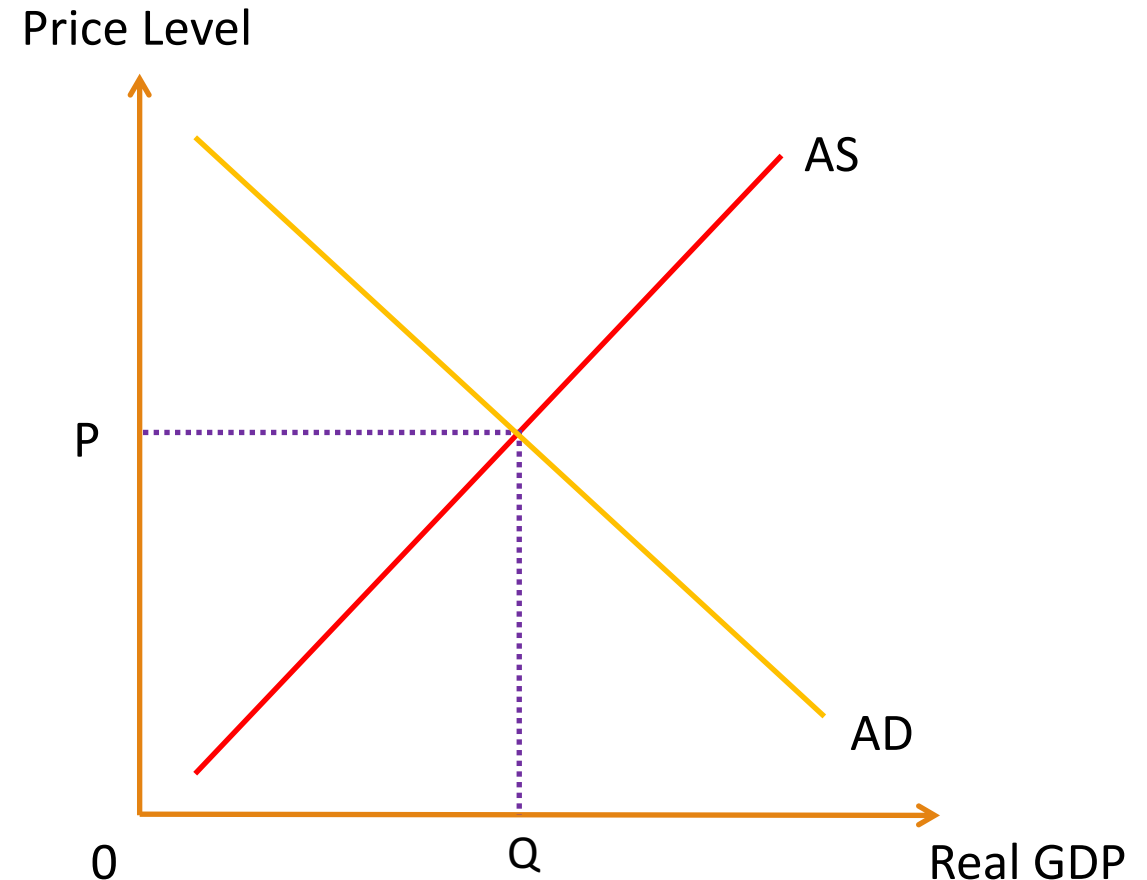
- \_\_\_\_\_ are not included in the CPI, but is included in the RPI  
(\_\_\_\_\_)
- Because it is based on spending of an average household, actual inflation may not apply to families with higher or lower \_\_\_\_\_
- CPI does not include improvements in the \_\_\_\_\_ of goods and services over time, despite their prices may have increased



# Equilibrium Price Level and Output

Would anyone like to remind me of how to find the equilibrium price level and real GDP of an economy?

What type of diagram will we use?



# Welcome to the GRAZE Economy!

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Let us assume that this economy only produces 3 Graze mini-bites each year. Each student is a household hoping to buy these mini-bites. The buyer who pays the highest price will get the mini-bite. Let's start bidding!

# Welcome to the GRAZE Economy!

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	Avg. price of a GRAZE mini-bite
Year 1	
Year 2 (Growth in Money Supply)	



In the second year, the government decides to print out more banknotes. As a result, this increases the money supply circulating the economy. Everyone gets \$100 more. Let's bid again – what will happen to the price of GRAZE mini-bites?

# Growth of Money Supply

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The money supply is the amount of money circulating the economy in a given period of time. It normally includes cash, bank deposits etc.

An increase in the \_\_\_\_\_ tends to lead to \_\_\_\_\_. There are a few reasons why there is a larger amount of money circulating the economy such as:

- Bank of England printing more bank notes
- Decrease in interest rates
- Banks lending more money via quantitative easing

# Welcome to the GRAZE Economy!

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	Avg. price of a GRAZE mini-bite
Year 1	
Year 2 (Growth in Money Supply)	
Year 3 (Increase in consumption)	

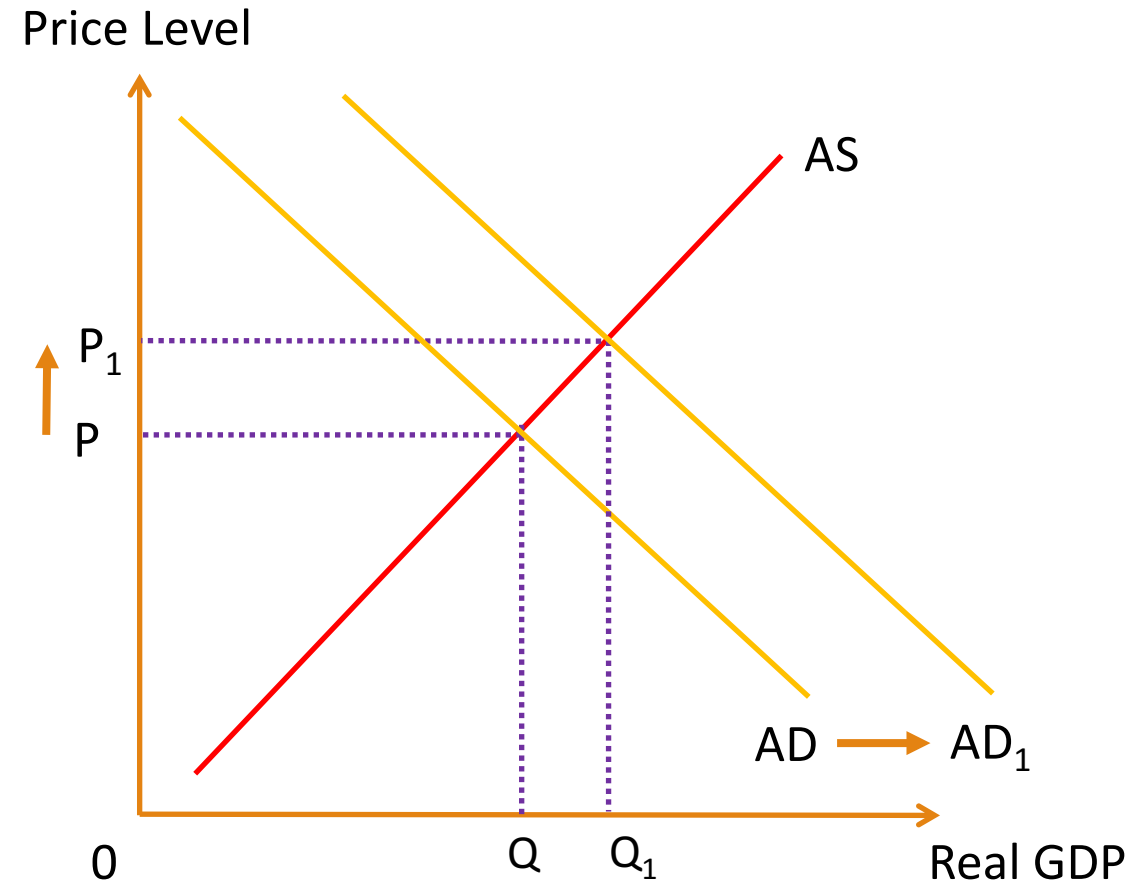


In the third year, the economy is doing well. Household has rising incomes and started demanding more goods and services. As a result, most households are looking to buy 2 Graze mini-bites. Let's bid again – what will happen to the price of GRAZE mini-bites?

# Demand-Pull Inflation

An increase in incomes in the economy will increase consumption and aggregate demand as people become richer.

When AD increases, prices of goods and services will become more expensive as people are willing to pay more for it, despite there is not an increase in the number of goods. This is what we call



# Demand-Pull Inflation

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Can you think of two situations when there will be demand-pull inflation apart from an increase in incomes? Discuss with your neighbour.

Hint: Think about when will factors of AD increase.

# Welcome to the GRAZE Economy!

	Avg. price of a GRAZE mini-bite
Year 1	
Year 2 (Growth in Money Supply)	
Year 3 (Increase in consumption)	
Year 4 (Production costs increase)	



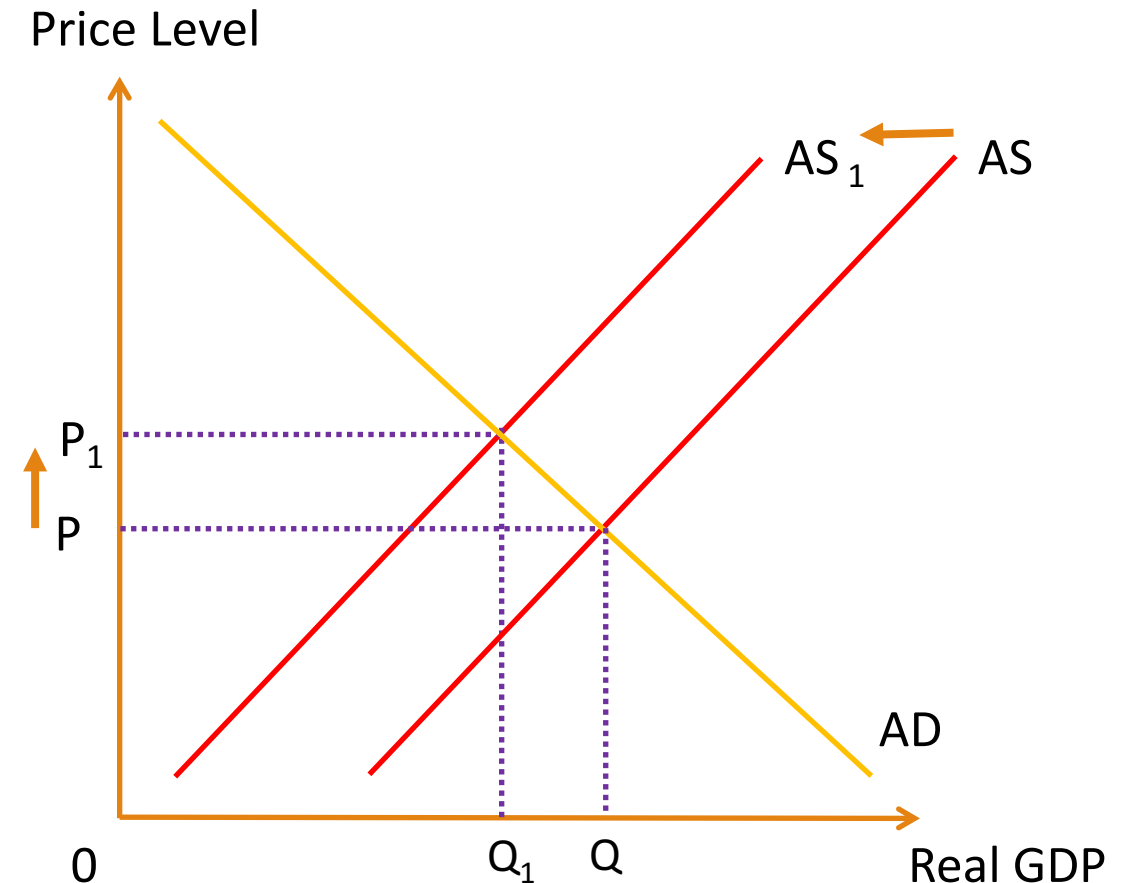
In the forth year, world price of oats increased significantly. As a result, cost of production increased significantly and Graze has decided to charge at least \$300 for each mini-bite and can only produce 2. What will happen to the final price? Let's bid.



# Cost-Push Inflation

An increase in costs in the economy will increase price of goods and services. Not only there are less goods/services available in the economy making them most costly, but also firms increase their prices to protect their profits.

This is known as \_\_\_\_\_



# Cost-Push Inflation

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Can you think of two situations when there will be cost-push inflation apart from an increase in the cost of raw materials? Discuss with your neighbour.

Hint: Think about when will AS decrease.