Inflation + Deflation

Inflation

- Sustained increase in APL
- Fall in purchasing power
- Disinflation = decrease rate of inflation
- **Demand side** AD shift right: lower tax, increase C + I; increase G, increase net X
- **Supply side** LRAS shift up but Y_{fe} constant: higher CoP (tax, wages, raw materials); WPIDEC (imported cost-push inflation)
- Measured by Consumer Price Index (CPI) $= \frac{\sum price \times weight}{\sum weight}$: 2% (±1%) target
- Retail Price Index: main indicator until 2013 ('headline rate') – broader measure
- RPIX: underlying rate = RPI – mortgage interest costs
- RPIY: change of indirect taxes
- Limitations of measures:
    - RPI/CPI doesn't account to change of quality of goods
    - Do not show regional variations in price
    - CPI doesn't include mortgage cost which are important part of inflation (UK high level of home ownership)
    - Does not represent spending patterns (current basket of goods underestimate true rate as not change quick enough to match tastes)
    - Does not show individual consumer preference
- Problems of inflation:
    - Lower standard of living
    - Wages don't rise as fast as inflation
    - Savings eroded
    - Purchasing power of wages + savings fall
    - Price competitiveness of exports eroded (↓BoP)
    - Redistribution (lenders worse off borrows better off)
        - Inflating incomes push tax-payers into higher tax brackets, ie. Taxpayers worse off (fiscal drag)
        - Pensioners' (fixed incomes) purchasing power + standard of living eroded
    - 'Menu costs': menus and price tags reprint
    - 'Shoe leather costs': consumer confidence (in that they roughly estimate sensible prices) gone, thus time & money spent to shop around

Deflation

- Sustained decrease in cost of living/APL
- Rise in purchasing power
- **BAD** Malign deflation (demand side) AD shift left
    - ↓AD w/o spending (save more spend less)
    - Negative output gap
- **GOOD** Benign deflation
    - ↓CoP: cheaper raw materials, advances in R+D, ↓wages
    - ↑output
    - ↑ standard of living