

**What is inflation,
what are its causes,
and
why is an understanding of it
important?**

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What is inflation?

- Inflation refers to the *ongoing* rate of increase in prices over a specified period of time – it does not refer to a one-off price increase
- There are different types of inflation:
 - General price level inflation (Consumer Price Index or CPI), which applies to the prices of a basket of newly produced final goods and services (i.e., the stuff of which GDP is comprised)
 - Asset-price inflation, which applies to the prices of various assets (e.g., property, other durable real assets, shares, and bonds; the latter two being financial assets)
 - Commodity price inflation, which applies to the prices of natural resources and agricultural output
 - Wage inflation, which applies to the wages and salaries of workers
- The last two forms of inflation often lead to general price level inflation – 1973 oil price rises led to general price level inflation and wage-price spiral in 1974 (Aust: GPLI was 17%; WI was 25%)
- See Figure 1. (The *bathtub model* requires an A3 colour printing and is not provided here.)
- Because GPLI (the CPI) refers to new final goods and services (with a couple of exceptions), GPLI refers to the stuff (GDP) in the bathtub
- GPLI (the CPI) doesn't apply to most stuff sold outside the bathtub, yet the prices of stuff outside of the bathtub can have significant implications for the cost of living for many people
- Prices of the stuff outside the bathtub invariably reflect economic rents
 - They can have large distributional effects
 - This is where some of the great fortunes are made – unearned income in many instances; reshuffling of financial assets
 - Prices are driven up by increased demand often financed by loans (advances)
 - Prices backed by huge private sector debts (financial liabilities)
- Inflation is a macroeconomic price-level signal – there is a need to recognise it and understand its causes to ensure right policy response

What are the main forms of general price level (CPI) inflation?

- Demand-pull inflation (demand-side of economy)
 - Occurs when total spending on new final goods & services exceeds the productive capacity of the economy (bath-tub overflows with water)
 - Quite rare – unlikely to have occurred in Australia since at least the early- 1970s
- Cost-push inflation (supply-side of economy)
 - Occurs when the cost of producing new final goods & services rises rapidly, usually due to rapid rises in cost of inputs (e.g., labour or raw materials/energy)
 - More common form of CPI inflation
- Note: Because there are demand-side and supply-side forces at play with regard to all prices, there are elements of one form of CPI inflation in the other
- Wage-price inflation spirals – increased cost of production drives up the prices of new goods & services; wages rise to catch up; prices rise, and so on

Demand-pull inflation

- Because demand-pull inflation occurs when total spending exceeds productive capacity of the economy, quelling requires reducing total spending.

Policy responses?

- Reduced government spending (fiscal policy)
 - Easy to do, although more difficult to manage the response (i.e., cut spending where?)
 - Easy to achieve desired spending reduction (total spending cut = cut in government spending, although has multiplier effects)
 - Eradicates CPI inflation fairly quickly
- Reduced private-sector spending
 - Increase taxes (fiscal policy) – reduces private-sector after-tax incomes and therefore private-sector spending
 - Increase interest rates (monetary policy) – supposedly reduces private-sector spending by increasing the cost of borrowing (?)
 - Impact on total spending less certain because impact is 'indirect'
 - Question mark over impact of interest rates on spending – one person's interest payment = another person's interest income (distributional impact only)
 - Rising interest rates to reduce spending often has greatest impact on the most vulnerable (low-income people with mortgages)
 - Slower eradication of CPI inflation

Cost-push inflation

- Reflects structural weaknesses and deficiencies in the economy

For example:

- Rising labour costs that increase the cost of production may be due to poor educational/training arrangements – surpluses of some occupations and shortages of other occupations
- Rising raw materials/energy costs that increase the cost of production may be due to poor resource management; poor energy delivery systems; excessive reliance on too few energy sources (e.g., oil in the early-1970s and still; coal)
- Policy response?
 - Usual response in recent decades is to raise interest rates to reduce private-sector spending.
 - Wrong response! – doesn't deal with structural deficiencies.
 - Involves treating cost-push inflation as if a case of demand-pull inflation – led to 1970s stagflation (high inflation and high unemployment).
 - Proper response is to overcome structural weakness
 - This takes time – CPI inflation is prolonged; Inflation is bad but not end of the world; prolonged spell of inflation is the price paid for poor policies of the past.
 - One of biggest obstacles to environmental policy is fear of inflation if we deal with weakness (e.g., emissions targets & pollution taxes)

Why is an understanding of inflation important?

- Treating cost-push inflation as if demand-pull inflation
 - Since the 1970s, policy response to cost-push inflation is one that is more applicable to demand-pull inflation – that is, reducing private-sector spending by hiking interest rates.
 - We have no Job Guarantee and governments have abandoned the full employment objective.
 - Reduced total spending in the belief that this will quell cost-push inflation has meant:
 - Unnecessarily high labour underutilisation rates since 1970s – the NAIRU approach to quelling inflation
 - Has quelled inflation, but in time-consuming manner, and only by gradually lowering people's inflationary expectations (which reduces wage rise demands and price hikes by businesses)
- As mentioned before, since cost-push inflation is the reflection of structural weaknesses in the economy, best to deal with by overcoming the weaknesses – will solve other pressing issues.