

## **Do Now:**

- What are the aspects of full employment?
  - Anyone that wants a job has a job.

# Inflation

- Inflation is an increase in the overall level of prices.
- Inflation is not an increase in the price of a specific good or service relative to the prices of other goods and services.

# Inflation

- Is a problem because it reduces a consumer's ability to purchase goods and services
- The government monitors the inflation rate
- Inflation particularly hurts people on fixed incomes: retired people do not get wage raises

# Deflation

- Deflation is a fall in the overall level of prices.
- Harmful to the economy

# Measuring the Price Level

- Use a price index that measures the cost of a fixed market basket of goods relative to the cost of the same basket in a base year
- Examples
  - Consumer Price Index (CPI) – BLS
  - GDP Deflator – BEA
  - Personal Consumption Expenditures Price Index – BEA

# Nominal vs. Real Variables

- Nominal variables are measured using current prices
- Real variables have been adjusted for inflation by using prices from a base year
- Examples
  - Real wages
  - Real GDP
  - Real interest rate

# Box Office Winners (and Losers)

Revenue (in millions)	Movie Title	Year Released	CPI 1983=100	Real Revenue 1983=100	Rank
\$260	Jaws	1975	54.0	\$481.5	1
\$400	E.T. The Extra-Terrestrial	1982	97.5	\$410.3	2
\$162	Close Encounters of the Third Kind	1977	61.0	\$265.6	3
\$242	Raiders of the Lost Ark	1981	91.6	\$264.2	4
\$357	Jurassic Park	1993	144.4	\$247.2	5
\$77	The Terminal	2004	188.9	\$40.8	17
\$44	Always	1990	130.7	\$33.7	18
\$44	Amistad	1998	163.2	\$27.0	19
\$47	Munich	2005	195.3	\$24.1	20
\$22	Empire of the Sun	1987	113.6	\$19.4	21

# Rate of Inflation

- Shows the rate of change of prices over time
- Rate of inflation is the percentage rate of change in a price index
- Rate of inflation =  $(PI2 - PI1) / PI1$



# Costs of Unexpected Inflation

- Redistributions of wealth
  - Creditors / Debtors and Employees (on contract) / Employers
- Interference with long-term planning
  - Future purchasing power is uncertain
- “Noise” in the price system
  - Information conveyed by prices becomes difficult to interpret

# Costs of Unexpected Inflation

- Shoe leather costs
  - Time and effort spent to minimize the effect of inflation
- Distortions of the tax system
  - “Bracket creep” and future value of depreciation allowances

# Hyperinflation

- Excessive monetary growth → hyperinflation
- Examples
  - Nicaragua (1988) – 33,000% inflation
  - Germany (1923) – 102 million% inflation
  - Hungary (1945) –  $3.8 * 10^{27}$ % inflation
- Harm of inflation is magnified.

# Causes of Inflation

- Long-run
  - Too much money chasing too few goods
  - “Inflation is always and everywhere a monetary phenomenon...” (Milton Friedman)
- Short-run
  - Expectations
  - Excess demand
  - Supply shocks