University of OEB **Academic Year: 2024/2025**

Department of Economic Sciences

Third Year Licence Monetary and Banking Economics

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Lecture 04: Inflation

Introduction

Inflation is a fundamental economic concept that holds immense importance for anyone interested in understanding the dynamics of a modern economy. Inflation can be seen as the relentless rise in the general level of prices for goods and services over time. This rise in prices can significantly impact various economic factors and individuals' lives.

Causes of Inflation

Inflation is often the result of multiple factors, but the two primary drivers are:

a. *Demand-Pull Inflation:* This occurs when the demand for goods and services exceeds their supply. In such cases, businesses can raise prices, creating a cycle of increasing costs.

b. *Cost-Push Inflation:* When the costs of production increase (e.g., due to higher raw material prices or labor costs), businesses may pass these costs onto consumers in the form of higher prices.

Measuring Inflation

Economists commonly use various indices to measure inflation. The most well-known is the Consumer Price Index (CPI), which tracks the changes in the prices of a basket of goods and

services that a typical household might consume. Another key index is the Producer Price Index (PPI), which focuses on changes in the prices of goods at the wholesale level. Understanding these indices is crucial for economists to make informed decisions.

Consequences of Inflation

Inflation can have significant consequences on an economy, including:

a. Purchasing Power Erosion: As prices rise, the purchasing power of a currency decreases. This means that the same amount of money can buy fewer goods and services, which can adversely affect people's standard of living.

b. Interest Rates: Central banks often use interest rates to control inflation. When inflation is high, central banks may raise interest rates to reduce spending and slow down the economy. On the other hand, they may lower interest rates to encourage borrowing and spending when inflation is too low.

c. *Uncertainty:* High inflation can create economic uncertainty, making it challenging for businesses to plan for the future. It can also lead to wage-price spirals, where workers demand higher wages to keep up with rising prices, further fueling inflation.

Hyperinflation

While moderate inflation is generally considered a normal part of a healthy economy, extreme inflation, known as hyperinflation, is a catastrophic scenario. Hyperinflation can result from a variety of factors, such as excessive money printing and a loss of confidence in the currency. It can lead to the devaluation of a nation's currency and cause severe economic and social upheaval.

1- **Reading Comprehension**

- What is inflation, and why is it a significant economic concept?
- Explain the two primary drivers of inflation: demand-pull and cost-push.
- What are the main indices used to measure inflation, and why are they important for economists?
- Discuss the consequences of inflation, with a focus on purchasing power erosion and interest rates.
- What is hyperinflation, and how does it differ from moderate inflation in terms of its impact on an economy?

2- **Vocabulary**

Activity One: Match the terms with their appropriate definition.

Inflation – Demand Pull Inflation – Cost Push Inflation - Consumer Price Index (CPI) - Purchasing Power - Interest Rates – Hyperinflation

A. The rates at which central banks lend money to commercial banks, used to control inflation.
B. An index that tracks changes in the prices of a basket of goods and services typically consumed by households.
C. Extreme and catastrophic inflation that leads to a loss of currency value and severe economic turmoil.
D. The general rise in prices for goods and services over time.
E. The diminishing ability of a currency to buy goods and services as a result of inflation.
F. When demand for goods and services exceeds their supply, leading to rising prices.

G. When production costs increase, causing businesses to raise prices.

Activity Two: Fill in the Blanks with the appropriate term.

1. ________ occurs when the prices for goods and services increase over time.

2. When demand exceeds supply, businesses may raise prices, leading to ________.

3. ________ is a key index that tracks changes in the prices of a basket of goods and services typically consumed by households.

4. ________ can erode the ability of a currency to purchase goods and services.

5. Central banks often use ________ to control inflation.

6. ________ is an extreme form of inflation that results in the devaluation of a nation's currency and economic chaos.

7. ________ inflation, production costs rise due to factors like higher raw material prices or labor costs.