General Price Level

- General Price Level is the weighted average price of all goods and services in an economy during a given time period.

Price indices

- A price index is a measurement that captures weighted average of prices of a basket of selected goods and services where weights represents the relative importance of each item as reflected in its relative share in the total value of the basket.
- By using price indices the amount of money spent to buy a basket of goods and services in any given year can be compared with today's context
- Through that changes in prices of goods and services can be identified.
- Further price indices can be used to measure the purchasing power of money.

Price index can be measured as follows:

$$\text{Price index} = \frac{\text{Value of the goods and service basket in the current year}}{\text{Value of the goods and service basket in the base year}} \times 100$$

Price indices used in Sri Lanka to monitor the changes in General Price Level

1. Colombo consumer price index (CCPI)
2. National Consumer Price Index (NCPI)
3. Producer Price Index (PPI)
4. Implicit gross domestic product price index (GDP Deflator)

Colombo consumer price index

- This is the Sri Lanka's official price index constructed based on goods and services basket that is purchased by a sample of 1200 households within the Colombo district.
- This measure the changes in general price level of consumer goods and service basket used by an average Colombo district family.

- **Based year** – 2012/2013
- **Conducted** - by the Department of census and statistics based on the data observed in the Household income and expenditure survey (HIES) in 2006/07
- **Geographical Area** – sample of 1200 households within Colombo district
- **Price Collection Centers** – 14 centers in Pettah, Maradana, Wellawatta, Dematagoda, Borella, Grandpass, Kirulapona,Dehiwala,Mount Lavinia,Kotte,Nugegoda,Kolonnawa and two dedicated economic centers namely Narahenpita and Rathmalana)
- **No. of consumer items** – 373 (further categorized in to 10 groups)
- **Value of the basket** – Rs.27972.11

Category	**Weight %(base 2006/07)**
Food and beverages (without liquor)	**41.03**
Clothing and footwear	3.14
Housing, water, electricity and fuel	23.72
Furnishing, household equipment and routine HHs maintenance	3.6
Health	3.16
Transport	12.26
Communication	4.75
Recreation and culture	1.5
Education	3.94
Miscellaneous goods and services	2.89
Total	100

Limitations of Colombo consumer price index

1. Geographical coverage is only limited to Colombo district.
2. Due to the fact that more weightage is given on food items there is a tendency to overstate inflation.
3. Since this is based on a single basket of goods ,inflation reflected by CCPI is more applicable for some individuals but not necessarily all individuals
4. The basket is not updated frequently. Thus, the “appropriateness” of the basket erodes overtime (until it is updated).
5. Some of the consumer items such as Alcohol, Tobacco and Narcotics are not included in the consumer goods basket.

Importance of consumer price index/ Importance of Colombo consumer price index

1. It is an indicator to measure the changes in the general level of consumer prices and used as one of the **key indicators of inflation**.
2. Consumer Price Index is also used for **socio-economic analysis and policy purposes**, mainly in the determination of **monetary and income policies**.
3. It is used in the analysis of the **trends in wages and other monetary incomes**, for indexation of salaries and wages etc.
4. Consumer price index is also used to **deflate the current values in National Accounts** to obtain real values and therefore, a major determinant of the GDP deflator, which is a more comprehensive indicator in the overall inflation in a country.

National Consumer Price Index (NCPI)

- NCPI will be released by Department of Census and Statistics monthly commencing from November 2015 with a time lag of 21 days.
- The NCPI will have weights based on consumer spending in 2012/13, and will reflect new methods consistent with international best practices (Modified or Two stage Laspeyre's formula).
- National Consumer Price Index for Sri Lanka will be compiled using prices collected for **all of the nine provinces.**

  History and Need of NCI

  - ***From 1953 to April 2008*** *the DCS has compiled and disseminated a CPI for the* ***Colombo metropolitan area only****.*
  - *Since* ***May 2008*** *to DCS has been compiling and disseminating a CPI covering the* ***urban areas of Colombo district.***
  - *However, there is great need for an index that* ***measure price change for the entire country*** *and NCI is fulfilling that need.*

Comparison between CCPI & NCPI

Special Features	NCPI	CCPI
1. Base year	2012/13	2012/13
2. Geographical characteristics	All Provinces in Sri Lanka	All urban areas of Colombo District
3. Target household units	All households in each Province	All households in urban areas of Colombo District
4. Size of household unit	3.9	4.4
5.Average monthly Consumption Expenditure	Rs. 32,142.69	Rs. 27,972.11.
6. Value of one Index point	Rs.321.42	Rs.279.72
7. Major Groups	12	10
Sub Groups	105	95
8. Total number of items	407	373
9. Percentage of total weight		
i. Food	44.04	41.03
ii. Non Food	55.96	58.97
10. Price Collection Centres	03 price collecting outlets in each District town for each item	14 price collection centres covered Colombo urban areas
11. Key items included in NCPI	Inclusion of Alcohol, Tobacco and Narcotics	Excludes of Alcohol, Tobacco and Narcotics

Producer Price Index (PPI)

- The PPI measures **the average change over time in the prices received by domestic producers of goods and services.**
- Due to the introduction of PPI by Department of Census and Statistics (DCS), Central bank discontinued wholesale price index in 2015.
- The introduction of the PPI in Sri Lanka provides a more complete picture of price movement and trends for policy-makers and private sector decision-makers.
- Weights of this PPI are based on the annual value of production recorded in 2010.

- The index is expected to cover sectors of **Agriculture, Manufacturing and Utilities (electricity and water) initially, and expand to incorporate activities in the Services sector at a later stage**.

- Base period – year 2013
- Base survey – Economic survey conducted during the final quarter of year 2013.
- Geographical coverage – Entire county
- Sectors covered by the index – Agriculture – 161 agriculture products
  - Services – 13 sub sectors (75% of organization which have more than 25 workers are covered)
  - Utilities – Electricity and water
- Number of items – 16 items – agricultural – 1
  - Industries – 13
  - Utilities – 2

Importance of a Producer's Price Index

- Indicator of inflationary trends
- Deflator of economic series
- Productivity analysis
- Current cost accounting
- Business analysis
- Policy-making

Year	PPI (From all activities)
2014	101.6
2015	105.3
2016	107.1
2017	125.3

Implicit gross domestic product price index (GDP Deflator)

- This price index which measures the fluctuation of general price level of all goods and services those are included in Gross Domestic Product.
- This measurement is used in converting gross domestic product at current prices into gross domestic product at constant prices.
- So, in other words by using GDP deflator it can convert nominal GDP value into Real GDP value.

$$\textbf{Implicit GDP product price index} = \frac{\textbf{GDP at nominal value}}{\textbf{GDP at real value}} \times 100$$

Advantages of a Price Index

1. To measure the level of inflation and deflation
2. To measure the cost of living and changes of life styles
3. To monitor the international competition closely and to calculate the nominal effective exchange rate
4. To use as a price deflator when calculating economic indices such as nominal gross domestic product
5. To use as a price deflator for planners when they are calculating future financial requirements
6. To be used in implementing economic policies
7. To measure the nominal fluctuations in economy's pricing variables (ex: real salaries- nominal salaries, real interest rate-nominal interest rate)
8. To calculate cost of living allowances for salary agreements

Calculation of inflation rates based on changes in the price level

Monthly inflation

This calculates the changes of the price level of immediate two months.

$$\text{Monthly inflation} = \frac{\text{Price index of the month concerned} - \text{price index of the previous month}}{\text{Price index of the previous month}} \times 100$$

EX: 2019 May CPI value: 118.2
2019 June CPI value: 120.1
2019 June monthly inflation = (120.1 – 118.2) / 120.1 = 1.6 %

Year – on – year inflation

This calculates the changes of the price level of the same period of two different years.

$$\text{Year – on – year inflation} = \frac{\text{Price index of the concerned month in this year} - \text{price index of the same month in the previous year}}{\text{Price index of the same month in the previous year}} \times 100$$

EX: 2018 June CPI value: 113.2
2019 June CPI value: 120.1
Year – on – year inflation = (120.1 – 113.2) / 113.2 = 6.11%

Annual average inflation

This calculates the inflation based on average change of the price level of 12 months of the current year and versus average change of the price level of 12 months of the previous year.

EX: 2017 yearly average CPI value: 107.4
2018 yearly average CPI value: 111.7
Annual average inflation = (111.7 – 107.4) / 107.4 = 4%

Inflation

- Inflation is an economic term used to refer to a continuous rise in the general price level for a long period of time.
- Inflation is not short term sudden price shocks but continuous upward trend of general price level over a long period of time.
- Inflation /deflation can be estimated based on any price index reflecting the general price level in a country.
- Due to inflation, purchasing power of money gets reduced.

Deflation

- Deflation is the economic term used to refer to a continuous reduction in general price level.
- Deflation can be seen in a business cycle during a contractionary period.

Inflation Rate

- The percentage increasing in general price level during a certain period of time is known as the rate of inflation
- Normally inflation rate is calculated based on the percentage change in GPL between immediate two years.

$$\text{Rate of inflation} = \frac{\text{Current year price index (P1) - Previous year price index (P0)}}{\text{Previous year price index (P0)}} \times 100$$

Concepts Related to Inflation

Disinflation

- Disinflation refers to a situation where there is a tendency that rate of increasing general price level slow down.
- In other wards disinflation refers to the decrease in the rate of inflation.
- During a disinflation even though there is an inflation rate at which GPL increases come down.
  Ex;- 10%, 8%, 5%, 3%

Headline Inflation

- Raw inflation figure as reported through the consumer price index (CPI) that is released monthly by the department of census and statistics of Sri Lanka.
- In other wards actual change of general price level during a particular time period.
- This measures inflation of overall economy.
- Headline inflation can often get fluctuated by the temporary or sudden price hikes those frequently take place in food and fuel due to seasonality and other external factors.

Core inflation (Underlying inflation)

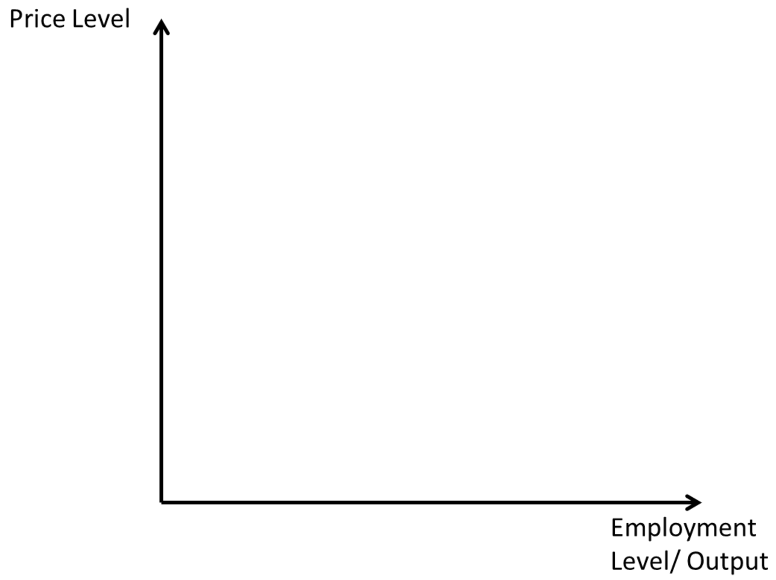
- This is a measure of inflation that excludes certain items that face volatile price movements those are included in headline inflation.
- In other words, headline inflation adjusted for seasonality or for the often volatile elements of food and fuel prices is known as the core CPI
- Core inflation represents the long run trend in the price level.
- Core inflation eliminates products that have temporary price shocks because these shocks can diverge from the overall trend of inflation and give a false measure of inflation.
- Basically this shows the trends in aggregate demand and supply.
- In order to arrive at core from headline inflation, countries use various methods but the most popular method that is followed by countries including Sri Lanka is the "exclusion method" by excluding highly volatile priced items.
- It is used by many counties as it's easy to interpret and calculate.
- In Sri Lanka, core inflation is calculated by **excluding prices of fresh food, fuel and transportation by the headline inflation**.

Causes of Inflation

- There are main three cause of inflation.
  1. Demand – pull inflation
  2. Cost – push inflation
  3. Structural inflation

01. Demand –Pull inflation

- Demand-pull inflation is the inflation that emerges due to relatively higher increase in aggregate demand compared with aggregate supply
- In other wards fundamental reason for demand-pull inflation is the aggregated excess demand.
- When a country spends more amount of money (actual expenditure) than its potential output it will create excess aggregate demand.
- This excess demand will eventually increases the nominal prices of goods and services.
- Any factor that enhanced the total expenditure of the economy (consumption, investment, government expenditure and net exports) will create demand-pull inflation.



Possible causes of demand-pull inflation

1. Expansion of the money supply
2. Reduction in the interest rates
3. Increase in the disposable income
4. Expansion of property ownership
5. Future expectations on Inflation
6. Existence of Inflationary gap in the business life cycle

Demand pull inflation has been evolved based on two main theories

a. Quantity theory of money (exchange equation of money)
b. Keynesian theory

a. Quantity theory of money (exchange equation of money)

- According to the quantity theory of money when velocity of money (V) and physical volume of output (T) is constant; there will be a positive relationship between general price level (P) and the money supply of the economy (M).
- Therefore quantity theory of money describes that change in money supply make an increase in general price level.
  Ex:- If money supply doubles price level doubles.
- This can further explain using exchange equation of money

$$\boxed{V \times M = P \times T}$$

$$\boxed{\overline{V}\ \underset{\uparrow\downarrow}{M} = \underset{\uparrow\downarrow}{P}\ \overline{T}}$$

V- Velocity of money (average frequency that a unit of money is spent on goods and services produced domestically in a specific period of time)

M – Money supply (quantity of money)

P – Price level

T- Physical volume of output (this is constant when an economy reaches its full employment)

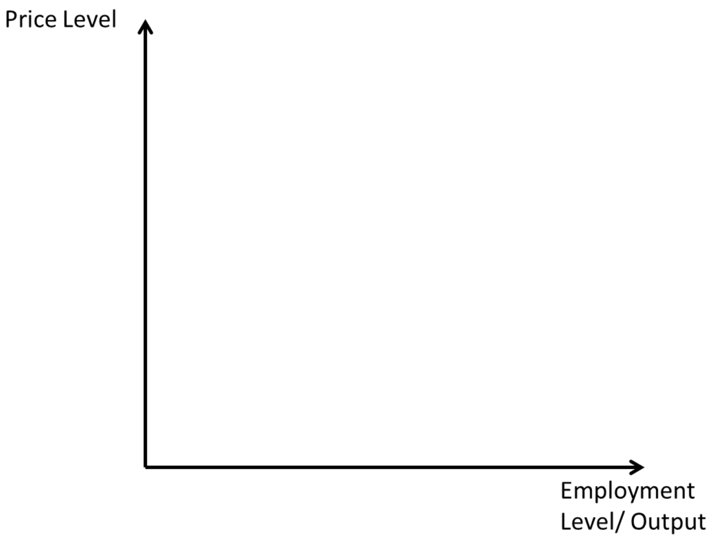
- When an economy reaches its full employment aggregate supply (AS) curve becomes a straight line (perfectly inelastic). In such a situation physical output volume becomes constant.
- Therefore, the quantity theory of money is directly related to demand pull inflation.

Assumptions used in quantity theory of money

1. Velocity of money (V) is constant.
2. Physical volume of output (T) is constant since economy has reached its full employment level.

b. Keynesian theory

- John Maynard Keynes presented this theory by analyzing economy's total income and expenditures.
- According to Keynes demand-pull inflation will occur when there is a further increase in demand even after the economy reaches its full employment level.



Do always growth in money supply leads to inflationary situations?

- According to capitalistic economists anywhere and anytime inflationary is a financial phenomenon.
- Therefore it is stated when there is a growth in money supply simultaneously general price level will increase. But this is not always the case.
- Following two conditions have to be fulfilled in order to create an inflationary situation from the growth in money supply.

1. ***When there is a growth in money supply, expenditure on goods and services should be increased***
    - *By doing so it will create more demand for gods and services.*
    - *Thus the general price level will go up. But even though there is a growth in money supply if the demand is less or expenditure on goods &services inflation will not get increased,*
    - *In such situation public will tend to hold money and velocity of money will not get improved.*
    - *As a result general price level remains constant.*

2. ***Total aggregate supply should not get improved***
    - *If total aggregate demand for goods and services increase and total aggregate supply remains constant, general price levels will go up.*
    - *But if total aggregate supply increases with the rise of total aggregate demand, then there is no inflationary situation*

02. Cost-Push inflation

- Cost-push inflation is the inflation situation which occurs due to an increase in the expenditure of factors of production (land, labour, capital, entrepreneurship).
- In cost-push inflation while keeping aggregate demand curve constant aggregate supply curve will shift into left.

Reasons for decrease in aggregate supply

1. Imposing new indirect taxes and increasing existing tax rates by the government
2. Increase in the prices of production factors.

Ex- Increase in the salary levels due to actions taken by employee unions

Increase in the interest rates under strict monetary policies

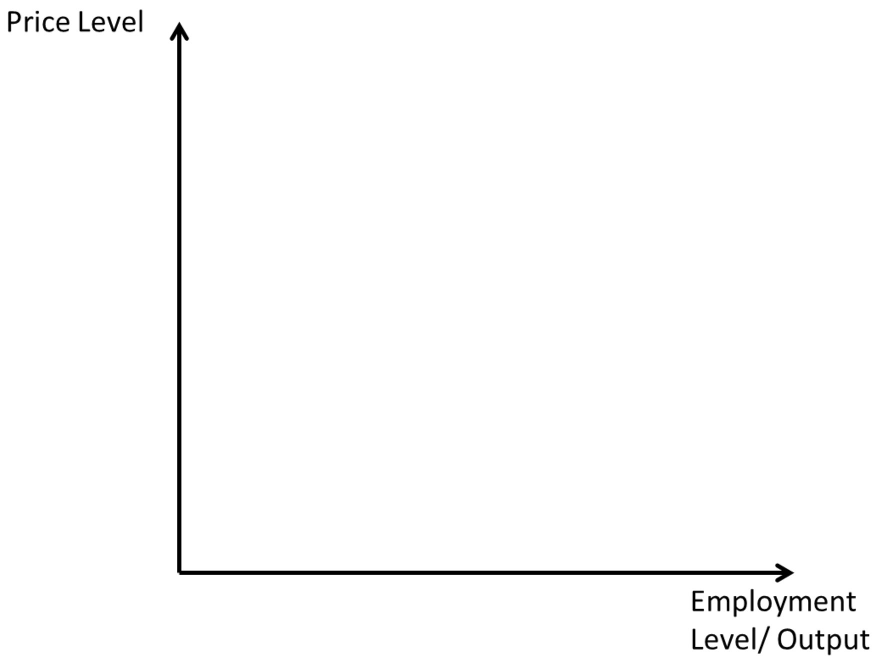
Increase in profit margins by monopoly and oligopoly firms

3. Accretion in the prices of domestic raw materials
4. Due to decrease in foreign exchange rates or increase in the prices of export raw materials , eventually the prices of products which are heavily depend on export raw materials will increase
5. Reduction in the production due to natural disasters, civil wars etc

- But in order to highlight main factors of cost push inflation, following two concepts can be presented,
    1. Wage push inflation
    2. Profit push inflation

1. <u>Wage push inflation</u>

- This is created by trade unions through bargaining higher wages than the increase in their productivity.
- As a result of workers bargaining for salary increments, the cost of production rises leading aggregate supply to fall.
- Thus, as aggregate supply curve shifts to left, the price level will increase (inflation).



2. <u>Profit push inflation</u>

- This is created by suppliers in effort to increase their profit share by increasing prices over the increase in cost of production.

  EX: if the increase in production cost is 5%, suppliers increase product price by 8%, leading to an increase in the price level.

- In most developed countries this special feature can be seen amongst oligopoly market structure because they have capability to influence the market during an inflationary situation.
- In this situation during high market prices, by forming CARTLES oligopoly firms will further more increase prices by maintaining higher profit margins.

According to above concepts,

1. Organized labour (Trade unions)
2. Suppliers (Oligopoly firms) are the most prominent groups that influence cost push inflation.

Supply shocks

- Supply shocks can be identified as another deviation of cost push inflation.
- A supply shock is a sudden and unexpected rise in the prices of raw material / energy inputs which have a potential to increase production cost and product prices.

In 1970 decade most supply shocks occurred due to,

1. The rapid increase in crude oil prices
2. Variations of exchange rates
3. Natural disasters

Economic consequences of Inflation

- In an inflationary situation nominal value of money or the purchasing power of money get reduced. Because of that below parties will get adversely affected.
    a. Fixed nominal income earners
    b. Savers'
    c. Creditors

a. Fixed nominal income earners

- People such as government employees, private sector employees, pensioners, people who are depending upon government welfare allowances are known as fixed nominal income earners.
- In other wards people who cannot adjust their income based on inflation.
- In an inflationary situation the standard of living of fixed nominal income earners will decline.
- It is because due to inflation, nominal income of fixed income earners remains constant while real income (purchasing power) of them falls with increase in prices of goods and services.

- With this, fixed income earners are spending more money than earlier on goods and services and that money will flow in to the hands of businessmen (variable income earners).
- But if the growth rate of fixed nominal income is more than the growth rate of inflation, the growth rate of real income will rise.

b. Savers

- In an inflationary situation when general price level is rising, the real value of saving (purchasing power) will decline.
- Real value of savings decline as people is unable to increase their income through their savings relative to the inflation rate.
- Further during inflation since people has to spend more expenditure on consumption they will have less balance at hand for savings.
- But on the other hand people will tend to invest their money in real assets such as lands, buildings at the time of inflation.

c. Creditors

- Inflation creates advantages for debtors and disadvantage for creditors.
- Redistribution of income occurs due to the above fluctuation in the relationship between debtors' and creditors income
- Therefore, creditor must put a high interest rate in order to prevent from the disadvantage occurred in the time of inflation

Shoe Leather Cost & Menu Cost

- Shoe leather cost – due to high inflation the opportunity cost of holding cash balances increase and can induce people to hold a greater portion of their cash in interest paying accounts. However, as cash is needed in order to carry out day – to – day transactions, people should go to the bank and withdraw more money which means more trips to the bank leading to wearing of the shoe leather with each trip.

- Menu cost – with high inflation, firms must change their prices often in order to keep up with the economy's wide changes and often changes in price is a costly activity as it needs to print new menus with every price change.

The way in which inflation influenced various economic variables

01. Economic growth

- In inflation undetermined expectations about future profits will lead to a decline of the economic growth.
- Less savings, demotivated investors, capital flows from nominal assets to real assets are the incidents that will happen in such a situation.
- But it is argued that low and solid inflation is important to economic growth.

02. Income distribution

- Under an inflationary situation the real income of fixed income earners will decline due to the inability of negotiating their salaries with the rate of inflation.
- Even though the salaries are increased the increasing rate is lower than the rate of inflation
- But for variable income earners (traders, producers), they are having the ability to negotiate their income with the rate of inflation.
- Their income will automatically adjust to the inflation.
- Therefore under inflation the difference between fixed and variable income earners is widened. Thus public will be motivated to invest in non-productive assets such as land.

03. Imports

- Inflation encourages imports due to high prices of domestic products, so imported products are relatively cheaper and absorb more demand.

04. Exports

- Inflation discourages exports due to high cost of production, so selling price will not be as competitive as earlier.
- In this explanation It is assumed that domestic inflation growth rate is more than the international inflation growth rate.

05. Balance of payment

- This should discuss based on Sri Lanka's inflation growth rate and world inflation growth rate.

- If Sri Lanka's inflation growth rate is more than the world inflation growth rate, Sri Lankan products are relatively expensive to the foreigners and thus they will move in to substitutes.
- As a result exports are discouraged.
- Imports are encouraged due to relatively low prices of imported goods.
- External value of money declined.
- This will adversely affected to the balance of payment.
- On the other hand if Sri Lanka's growth rate of inflation is lower than the world growth rate of inflation exports are encouraged and imports are discouraged.
- Thus this creates favorable results to the balance of payment.

06. Exchange rate

- If Sri Lanka's inflation rate is more than the other country's inflation rates exchange rate get depreciated as a result of increase in imports and decrease in exports.

07. Investment

- During inflation due to fewer saving, resources of investment become scarce.
- So, cost of investment become very high.
- Since the risk and unpredictability of the investment are larger investors become demotivated in long term investments.
- In fact they are going towards short term investments and investments on non-productive assets such as land.

08. Unemployment

- Due to inflation prices of goods and services will go up.
- Producers are trying to enhance their quantity of supply.
- As a result more employment opportunities (especially in the informal sector) will create and unemployment get reduced.

Policies of controlling inflation

01. Control the growth in aggregated demand

- In order to control demand-pull inflation, growth in aggregate demand should be controlled.

- To do that :
  a. Implement contraction monetary policies (increase interest rates)
  b. Control money growth through contraction government fiscal policies

02. Speed up growth in aggregated supply

- In order to control cost push inflation, growth in aggregate supply should speed up. By doing so inflation could be control.
- This can explain through exchange equation as well (MV=PT).
- To speed up the growth in aggregate supply,
  a. Cut off taxes
  b. Privatization
  c. Improve productivity

03. Direct intervention of the government to control inflation

- Implement salary control income policies
- Create background to increase productivity

04. Eliminate obstructions to the efficient distribution of resources

- Eliminate trade barriers such as minimum salary policy, price control acts, custom duty, subsidies and decrease tax rates, implement better environment rules and policies will enhance the efficient distribution of resources.

Inflation rates of Sri Lanka

Various inflation rates

Price index	2011	2012	2013	2014	2015	2016	2017	2018
NCPI					3.8	4	7.7	2.1
CCPI	6.7	7.6	6.9	3.3	0.9	4	6.6	4.3
GDP deflator	3.8	10.8	6.2	2.9	0.8	4.1	8.2	4.3

a. Creeping inflation/ Moderate inflation

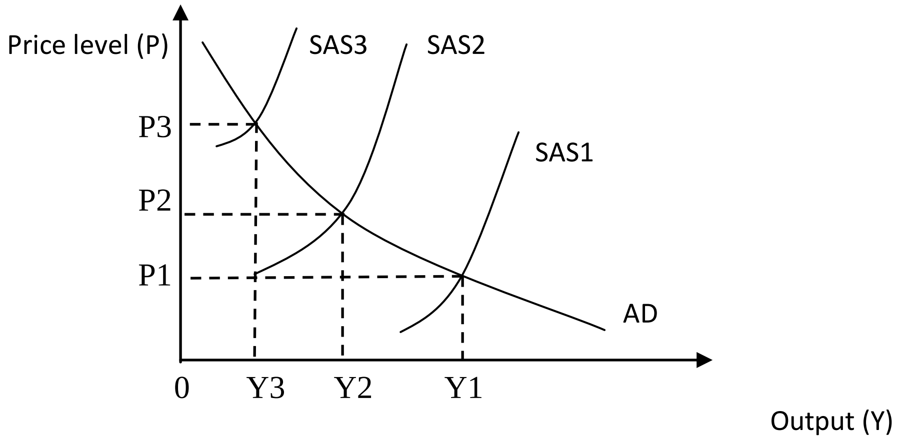
- Inflation of a nation increases gradually, but continually overtime.
- Most of the time inflation rate is not exceeding 5%.
- Most of the develop countries having creeping inflation.
- Importance of creeping inflation can be states as follows,
  1. When prices are relatively stable it support the effective functioning of the financial system.
  2. As the value of money (purchasing power) doesn't depreciate rapidly people will keep money balances with them.
  3. Low level of inflation will stimulate economic expansion.
  4. As output increases at a higher rate than the increase in input prices, the profits of businesses will be increased creating more business expansion and more employment opportunities.
- The only disadvantage of creeping inflation is that the cumulative effect of inflation is several times higher than the initial rate.
- But, as along with years it is not much affecting to the peoples' living standard to decrease.

b. Stagflation

- This is the combination of high unemployment and economic stagnation with inflation.
- This happened in industrialized countries during the 1970's.
- There are two ways to explain stagflation,
  1. Aggregate supply shocks
  2. Misguided full employment policies
  3.

1. <u>Aggregate supply shocks</u>
   - In this situation it creates inflation by increasing general price level along with unemployment by falling aggregate supply (A shock in aggregate supply) without any change in the aggregate demand.
   - Due to fall in aggregate supply it reduces the real income and unemployment along with increase in price level creating inflation.

- This can be shown by following diagram,



In 1970's in US aggregate supply shocks are caused by following factors,

1. An abnormal increase in the prices of crude oil
2. Increase in the prices of imports due to depreciation of the price of the dollar.
3. Fall in the productivity of labour
4. Inflation expectation among people

<u>2. Misguided full employment policies</u>

This is a situation where the inflation and unemployment happens as a result of misguided policies about unemployment by the policy makers in the economy.

In any economy, there is a level of unemployment that is occurring naturally due to frictional and structural unemployment that cannot be avoided which is called as 'Natural unemployment.'

But, in this situation some of the policy makers by thinking that economy still faces unemployment that can be avoided try to increase employment by following expansionary monetary and fiscal policies.

As a result, the price level increase by increasing inflation expectation among people by increasing the nominal wages by losing the jobs. Although unemployment gets adjust after sometime, inflation will increase more than the previous level creating a stagflation situation.

c. Galloping inflation

- Prices rise by double or triple digit inflation rates like 100% or 200%. (annually)
- This will affect the economy extremely adversely and some of the impacts are,

  1. Value of money get depreciated rapidly
  2. Public preference for holding money balances reduced (Reduce liquidity preference).

d. Hyperinflation

- This is a situation where there is 50% monthly inflation.
- Main reason for hyperinflation is rapid growth of money supply.
- In most of the countries due to over printing money to cover up war spends hyperinflation takes place.

e. Suppressed Inflation

- In a situation when general price level is going up rapidly government suppress inflation with various policies such as price control, ration system, minimum wage levels etc.
- Such situations are known as suppressed inflation.
- In other wards government artificially hold prices down than the actual prices those would have been under free market situation.

f. Spiral inflation

- It is a trend towards higher levels of inflation as a result of continuous increase in wages and prices.
- During this process, producers increase prices to cover the increasing production cost because of rise in wages, fuel and other material prices.
- Meanwhile workers bargain for more wages due to increase in the cost of living along with the increase in prices of goods and services.
- This will continue as a spiral infinitely if an external party didn't absorb this rising cost of firms by giving subsidies and other incentives.

Inflation Expectation

- An inflation expectation is defined as **economic agents' beliefs or perceptions about inflation in the future.**
- Inflation expectations influence wage and price setting behaviours at different horizons, thereby being an important determinant of actual inflation.
- The two commonly used methods of measuring inflation expectations are **survey-based and market-implied measures**.
    a. Survey based measures gauge **people's expectations of inflation by simply asking them** what they expect inflation to be in the short, medium and long term.
    b. Market-implied measures are derived from observed prices of certain financial instruments, with the payoffs linked closely to future expected inflation outcomes. The most often used market-implied measures are based on **prices of index-linked financial securities.**

A/L Question

I. Distinguish between headline inflation and core inflation. (4 mark) – A/L 2017

II. Identify the components of aggregate expenditure and with the help of a diagram, explain how increase in aggregate spending in an economy might result in inflation. (4 mark) – A/L 2017

III. What is the difference between the quantity Theory of Money and the Equation of exchange? (04 marks) – A/L 2016

IV. What are the advantages of the National Consumer price Index over the Colombo Consumer price Index as a measure of cost of living in Sri Lanka? (04 marks) – A/L 2016

V. How would you distinguish between demand-pull inflation and cost-push inflation? Explain your answer using necessary diagrams. (4 marks) – A/L 2015

VI. Present a brief exposition on "the quantity theory of money". Identify the assumptions associated with it. (04 Marks) – A/L 2008

VII. Define the terms “inflation” deflation” and “disinflation” (03 marks) – A/L 2008

VIII. Name four indices used in Sri Lanka to measure general price level (04 marks) – A/L 2008

IX. What are the limitations of the Colombo Consumers Price Index (CCPI) as a measure of general price level? (04 marks) – A/L 2008

X. What are the economic costs of inflation? (04 marks) – A/L 2008

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XI. Explain the effect of the change in money market on aggregate demand. (5 marks) – A/L 2005

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XII. "Nominal interest rates are always positive" Do you think that real interest rates are also positive? (02 marks) – A/L 2003

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XIII. How does inflation affect the following: – A/L 2003

a. Imports
b. Exports
c. Exchange Rate

XIV. What is meant by inflation? What indicators are used in Sri Lanka to measure inflation? – A/L 2001