

Measuring Inflation

1. Estimate a general price level P

→ Weighted-average of prices

$$P = \sum w_i p_i$$

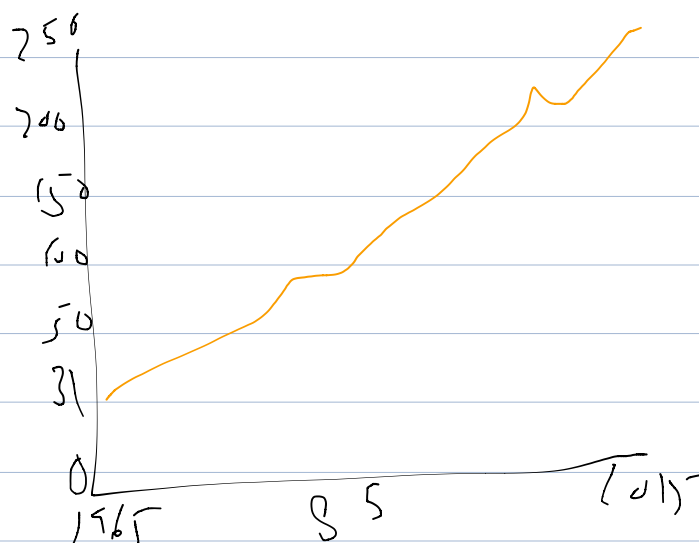
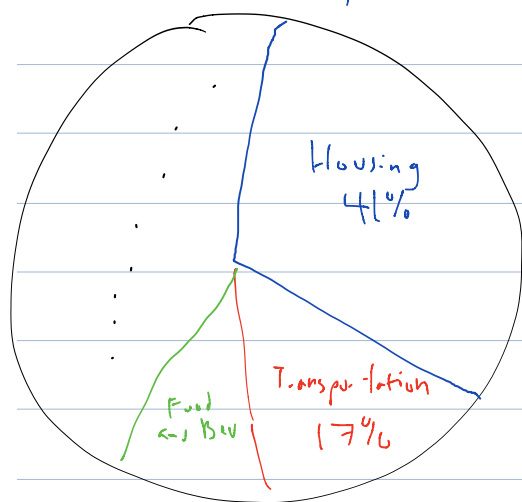
Consumer Price Index (CPI)

Based on the consumption patterns of a typical consumer

GDP Deflator:

Includes the prices of all final goods and services in GDP

CPI Major Category Weights



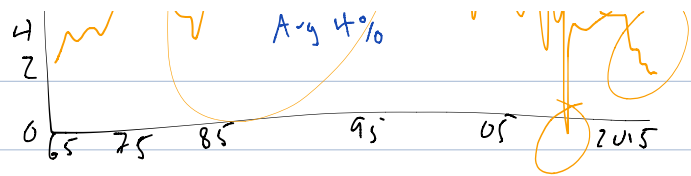
2. Calculate Growth Rate

$$i_{2014} = \left(\frac{P_{2014} - P_{2013}}{P_{2013}} \right) \times 100$$

$$\frac{236 - 234}{234} = \frac{2}{234} \approx 1\%$$

Not all prices rise...



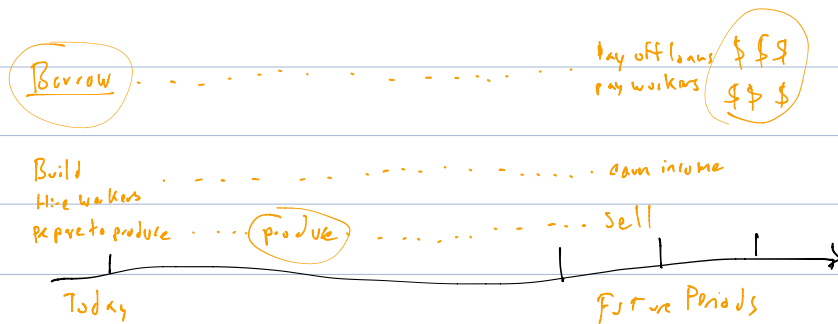


Problems with Inflation (in book)

But first... a **Mis perception**

The big problem with inflation is that it lowers living standards by reducing the real value of incomes.

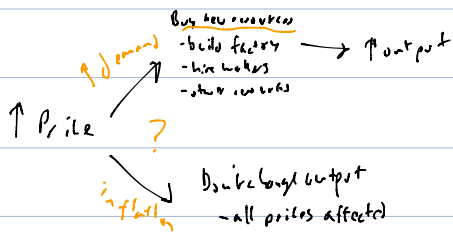
1. Future Price Uncertainty



* **Result:** If the future price levels are uncertain people unlikely to make long-term contracts

2. Price Confusion "Signal extraction problem"

Suppliers can't discern the source of price increases



* **Result:** If firms are confused about the source of price changes, they misallocate resources

3. Money Illusion

Nominal Wage: expressed in current dollars

Real Wage: adjusted for price level changes

Money Illusion: People interpret nominal changes as real changes

4. Tax Distortions

5. Wealth Redistribution

6. Shoe-leather Costs

7. Menu Costs

Cause of Inflation

cause = $\frac{\text{Money}}{\text{Growth}}$