IB ECONOMICS – INTERNAL ASSESSMENT

FRONT COVER

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Inflation soars to 5.2%

Julia Kollewe
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Inflation unexpectedly soared to 5.2% last month, the highest in 16 years, after power companies hiked gas and electricity bills.

The annual rate in the consumer prices index (CPI) was up from 4.7% in August and the highest since the series began in January 1997, official figures showed today. Economists had expected inflation to hit 5%. The figures are expected to mark the peak in the spiralling cost of living seen this year.

The government faces paying out billions more in pensions and benefits after a separate measure, the headline retail prices index (RPI), rose to 5%. Each year, the RPI figure for September is used by the government to calculate the next year's increases in the state pension and other benefits.

The main reason consumer price inflation topped 5% for the first time was sharp rises in utility bills. Electricity prices were 30.3% higher on a year ago while gas prices soared by 49.9%. The annual rate of inflation for energy and other household bills hit 15%, the highest since January 1989.

However, food inflation, another key source of price pressures this year, slowed for the first time since March as dairy prices fell. The annual rate dropped to 12.7% from 14.5%.

David Page, economist at Investec, said: "The power company hikes have pushed inflation above 5%, as we expected. However, we see this as the peak in inflation and retreats in energy prices should see inflation fall back relatively sharply over the next year."

The Bank of England said last week when it joined in the emergency global interest rate cut that although inflation could soon rise above 5%, the turmoil in financial markets had increased the downside risks to the economy and prices. Economists expect more rate cuts in coming months as tumbling oil and food prices feed through to inflation and the economy slides into recession.

Nick Kounis at Fortis said: "The outcome is unlikely to have come as a big surprise to the monetary policy committee, which is currently concerned that a severe downturn in the economy will lead to inflation undershooting its 2% target over the two-year horizon. As such, we continue to think that substantial further rate cuts are on the cards."

The headline RPI, which is usually used in wage bargaining, reached 5% last month, the highest since July 1991. While this could lead to higher pay demands, rising unemployment is likely to restrict pay growth.

The rise in the RPI spells good news for pensioners and those receiving benefits. September's RPI is commonly used by the government to calculate pension increases for the coming year. Pensions usually rise by 2.5% or headline RPI, whichever is higher.

The government should increase the state pension by more than the official inflation

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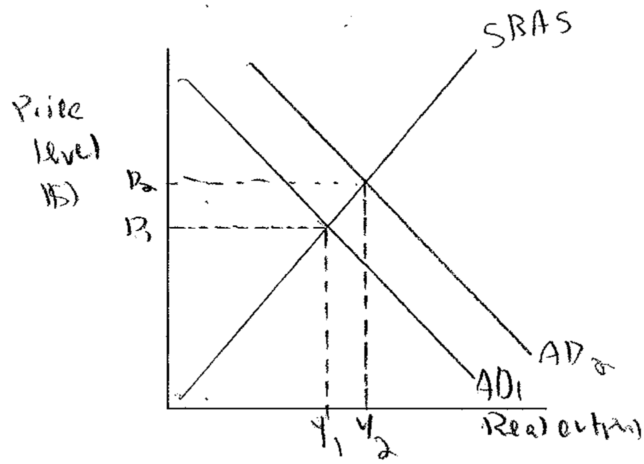
rate to reflect the real increase in living costs faced by many pensioners, charities said today.

RPI, excluding costs such as rent, council tax and mortgage interest payments, is used to calculate increases in benefits such as jobseeker's allowance and income support. That measure - the so-called Rossi index - hit 6.3%.

http://www.guardian.co.uk/business/2008/oct/14/record-inflation/print

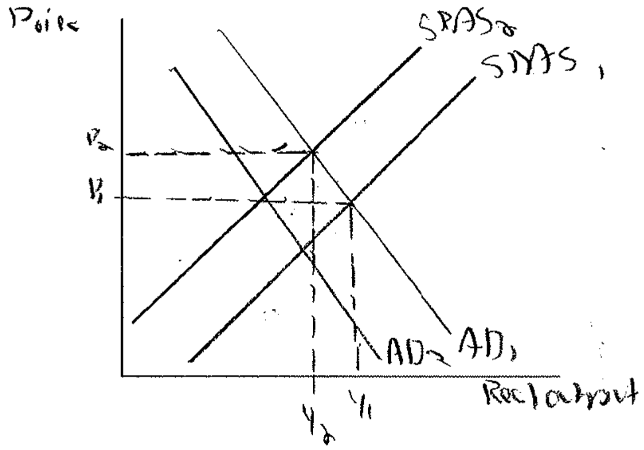
Inflation is a general increase in prices and a fall in the purchasing power of money. According to the article at hand, the "inflation rate [has] soared to 5.2%. However the unofficial inflation rate is most probably higher, as side affects such as black markets are not taken into account. The reason for this rise in inflation is brought on by payments placed on electricity, and on the inflation of food. In reality, this inflation is not expected to last long, as there will be a lowering of rates .

In economics, there are different types of inflation. The first type of inflation being Demand Pull. Demand pull inflation is caused by an increase in aggregate demand due to a possible rise in employment.



As shown above, there is an increase in aggregate demand. This increase in demand will therefore cause a increase in prices from P1 to P2 and real output Y1 to Y2. the aggregate demand curve consequently shifts from AD1 to AD2.

Another type of inflation is Cost-push inflation. Cost push inflation, is due to an increase in the costs of production.



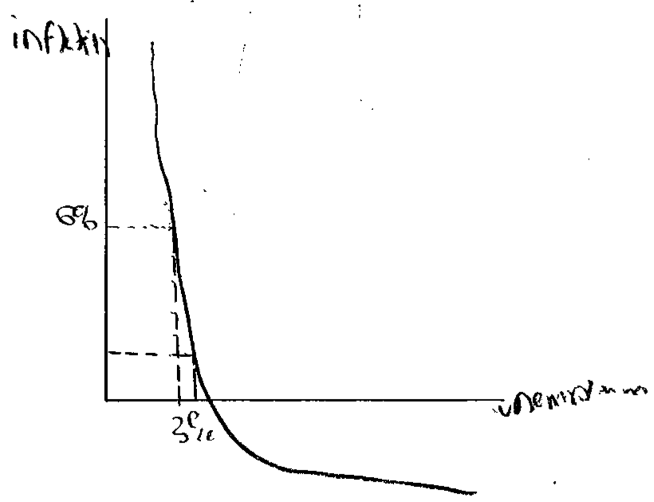
As shown in the graph above, cost push inflation occurs when the supply of a good decreases as the costs of production increase. The short run aggregate supply shifts from SRAS1 to SRAS2. This causes the Real Output to go from Y1 to Y2 and therefore prices to increase from P1 to P2, thereby causing inflation. However, the demand will also be decreasing as people will not want to spend so much money and food and electricity that they will cut down their spending causing the demand curve to shift to the left from AD1 to AD2.

In the case presented in the article, the type of inflation which is happening is supply side, and therefore is linked to cost push inflation. As the price for producing electricity or food is rising, it causes the price to be put onto the consumers.

In this case, the government is told that they dhould increase the state pension to a higher rate than that of inflation, in order to subdue the inflation. However, outside the government, the rising rate of unemployment is causing a restriction in pay growth, as the demand for jobs increases, but the supply for them is decreasing.

Inflation has many costs. The first one being loss of purchasing power. This causes people to be able to buy less goods for the same amount of money, which could eventually lead to starvation and hunger. Another cost of inflation, is the effects on savings. People who save money in banks will be less confident to do so, and therefore they will not save their money. If the interest rate of saving in a bank is at 5%, and the inflation rate of the economy is at 7%, then in reality the savers will be losing 2% of their savings per year. Another cost of inflation, is uncertainties. This factor may reduce investment, as people are afraid to lose their money, since the value of it is going down, and therefore decided to keep it or spend it directly.

In normal situations, there is a trade off between the rate of inflation, and the rate of unemployment. The usual trade off is illustrated by a Philips Curve.



As we can see from the Philips curve, as the inflation rate is high, the unemployment rate is low. As the Inflation rate is at 6%, the unemployment rate is at 3%. and vice versa.

Although the interest rate has risen significantly, there are some methods, which may help the situation get better. The first one being Fiscal Policy. Fiscal Policy the government controlling the taxes. In this case, the government has decided to lower taxes in hoping that it will get people to be more willing to spend more, raising the demand and thereby lowering inflation. Monetary Policy may work as it is the government control on printing money and interest rates. The interest rate will probably be their main method of reducing inflation, as if the rates fall, then people will have more money to spend and therefore this would “kick-start” the economy again, then inflation would not keep increasing, and may start decreasing. The consumers would benefit in the short and long run as by lowering rate, they will be able to purchase more.