INFLATION

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Most people associate inflation with price increases on specific goods and services. The economy isn't necessarily experiencing an inflation, however, every time the price of a cup of coffee goes up. We must be careful to distinguish the phenomenon of inflation from price increases for specific goods. Inflation is an increase in the average level of prices, not a change in any specific price.

We first determine the average price of all output—the average price level—then look for changes in that average. A rise in the average price level is referred to as inflation.

The average price level may fall as well as rise. A decline in average prices is a deflation, it occurs when price decreases on some goods and services outweigh price increases on all others.

Inflation and deflation are measured in terms of average price levels, it's possible for individual prices to rise or fall continuously without changing the average price level. Relative price is the price of one good in comparison with the price of other goods. Changes in relative prices may occur in a period of stable average prices, or in periods of inflation or deflation.

A general inflation—an increase in the average price level-doesn't perform this same market function. If all prices rise at the same rate, price increases for specific goods are of little value as market signals. In less extreme cases, when most but not all prices are rising, changes in relative prices do occur but aren't so immediately apparent.

The distinction between relative and average prices helps us determine who's hurt by inflation and who's helped. Inflation makes some people worse off, it makes other people better off , even get rich when prices rise. The micro consequences of inflation are reflected in redistributions of income and wealth, not general declines in either measure of our economic welfare. These redistributions occur because people buy different combinations of goods and services, own different assets, and sell distinct goods or services (including labor). The impact of inflation on individuals therefore depends on how the prices of the goods and services each person buys or sells actually change.

Nominal income is the amount of money you receive in a particular time period.

Real income is purchasing power of that money, as measured by

the quantity of goods and services your dollars will buy. If your nominal income doesn't change it's not mean thar real income is stable too – it will rise or fall with price level. People whose nominal incomes rise faster than the rate of inflation end up with a larger share of total income.

To my mind two basic lessons about inflation are to be learned:

- Not all prices rise at the same rate during an inflation. Some prices rise rapidly, others only modestly, and some actually fall.
- Not everyone suffers equally from inflation. Those people who consume the goods and services that are rising faster in price bear a greater burden of inflation; their real incomes fall more. Other consumers bear a lesser burden, or even none at all, depending on how fast the prices rise for the goods they enjoy.

Even if all prices rose at the same rate, inflation would still redistribute income. The redistributive effects of inflation originate not only in expenditure patterns but also income patterns. Keep in mind that there are two sides to every market transaction. What looks like a price to a buyer looks like an income to a seller.

On average, people's incomes do keep pace with inflation. Again, this is a direct consequence of the circular flow: What one person pays out someone else takes in. If prices are rising, incomes must be rising, too. From this perspective, it makes no sense to say that "inflation hurts everybody." On average, at least, we're no worse off when prices rise, since our (average) incomes increase at the same time.

No one is exactly "average," of course. In reality, some people's incomes rise faster than inflation while others' increase more slowly. Some people have fixed incomes that don't go up with inflation.

Fixed-income groups include those retired people who depend primarily on private pensions and workers with multiyear contracts that fix wage rates at preinflation levels. Lenders (like banks) that have lent funds at fixed interest rates also suffer real income losses when price levels rise. They continue to receive interest payments fixed in nominal dollars that have increasingly less real value. All these market participants experience a declining share of real income (and output) in inflationary periods.

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