Article:

What Is Inflation?

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WAT IS INFLATION?

Inflation is defined as a sustained increase in the general level of prices for goods and services. It is measured as an annual percentage increase. As inflation rises, every dollar you own buys a smaller percentage of a good or service.

There are several variations on inflation:

- Deflation is when the general level of prices is falling. This is the opposite of inflation.
- Hyperinflation is unusually rapid inflation. In extreme cases, this can lead to the breakdown of a nation's monetary system. One of the most notable examples of hyperinflation occurred in Germany in 1923, when prices rose 2,500% in one month!
- Stagflation is the combination of high unemployment and economic stagnation with inflation. This happened in industrialized countries during the 1970s, when a bad economy was combined with OPEC raising oil prices.

1.1 Causes of Inflation

Economists wake up in the morning hoping for a chance to debate the causes of inflation. There is no one cause that's universally agreed upon, but at least two theories are generally accepted:

Demand-Pull Inflation: This theory can be summarized as "too much money chasing too few goods". In other words, if demand is growing faster than supply, prices will increase. This usually occurs in growing economies.

Cost-Push Inflation: When companies' costs go up, they need to increase prices to maintain their profit margins. Increased costs can include things such as wages, taxes, or increased costs of imports.

1.2 Costs of Inflation

Almost everyone thinks inflation is evil, but it isn't necessarily so. Inflation affects different people in different ways.

It also depends on whether inflation is anticipated or unanticipated. If the inflation rate corresponds to what the majority of people are expecting (anticipated inflation), then we can compensate and the cost isn't high. For example, banks can vary their interest rates and workers can negotiate contracts that include automatic wage hikes as the price level goes up.

Problems arise when there is unanticipated inflation:

Creditors lose and debtors gain if the lender does not anticipate inflation correctly. For those who borrow, this is similar to getting an interest-free loan.

Uncertainty about what will happen next makes corporations and consumers less likely to spend. This hurts economic output in the long run.

People living off a fixed-income, such as retirees, see a decline in their purchasing power and, consequently, their standard of living.

The entire economy must absorb re-pricing costs ("menu costs") as price lists, labels, menus and more have to be updated.

If the inflation rate is greater than that of other countries, domestic products become less competitive.

1.3 How Does Inflation Impact our Life?

Inflation always hurts your standard of living. Rising prices means you have to pay more for the same goods and services. If your income increases at a slower rate as inflation, your standard of living declines even if you are making more. Inflation's main consequence is a subtle reduction in your standard of living.

Inflation doesn't affect everything equally. Gas prices can double while your home loses value. This makes financial planning more difficult.

Inflation is really bad for your retirement planning because your target has to keep getting higher and higher to pay for the same quality of life. In other words, your savings will buy less. As a result, you will need to save more today to pay for higher priced goods and services in the future. Since everything you buy today costs more, so you have less left-over income available to save.

Inflation has another bad side-effect…once people start to expect inflation, they will spend now rather than later. That's because they know things will only cost more later. This consumer spending heats up the economy even more, leading to further inflation. This situation is known as spiraling inflation because it spirals out of control.

Inflation is important if you are holding bonds or Treasury notes. These fixed price assets only give a fixed return each year. As inflation spirals faster than the return on these assets, they become less valuable. As they become less valuable, people rush to sell them, further depreciating their value. As their value becomes lower, the U.S. government is forced to offer higher interest rates to sell them at all. This increases mortgage interest rates.

1.4 What is Being Done to Control Inflation?

The primary job of the Federal Reserve is to control inflation while avoiding recession. It primarily does this by tightening or relaxing the money supply, which is the amount of money allowed into the market. Tightening the money supply reduces the risk of inflation, while relaxing controls on the money supply increases the risk of inflation.

The tools it uses to accomplish this are:

Raising and lowering the Fed Funds rate,

Raising or lowering the amount of reserve requirement banks need to keep on hand.

Raising or lowering the discount rate it charges to allow banks to borrow funds from the Fed's discount window.

Federal Reserve Chairman Ben Bernanke said the most important role of the Fed is maintaining public expectations of moderate pricing. He said the 1970's showed us that high inflation leads to more economic volatility, as the public expects and plans for greater changes. The best prevention against inflation is to reassure the public the Fed is committed to preventing inflation. Once the public expects inflation, it becomes a self-fulfilling prophecy. The Fed can maintain confidence in the economy by demonstrating moderation, resulting in less extreme changes in public economic behavior.

1.5 How Can I Protect Myself From Inflation?

Purchase gold and silver to curb against any form of inflation and deflation. As the value of the dollar drops, the cost of the gold and silver rises. Gold and silver have been valuable since recorded history and will remain valuable most likely forever.

Buy tangible assets that hold real value across decades to centuries. Things like firearms, jewelry, and land all have solid value that will keep. This will protect you against both inflation and deflation.

Convert your dollars into strong currencies such as the Yuan, the Chinese currency. Their currency has remained relatively stable in terms of its value and will protect you against inflation and deflation here in America as our currency fluctuates.

2 Inflation in Pakistan

2.1 Price Indices in Pakistan

Four different price indices are used in Pakistan over the course of fiscal year, namely: the Consumer Price Index (CPI), the Wholesale Price Index (WPI), the Sensitive Price Index (SPI) and the GDP deflator. The CPI is the main measure of price changes at the retail level. It covers the retail prices of 374 items in 35 major cities and reflects roughly the changes in the cost of living of urban areas. The WPI is designed for those items which are mostly consumable in daily life on the primary and secondary level; these prices are collected from wholesale markets as well as from mills at organized wholesale market level. The WPI covers the wholesale price of 106 commodities prevailing in 18 major cities of Pakistan. The SPI shows the weekly change of price of 53 selected items of daily use consumed by those households The SPI is based on the prices prevailing in 17 major cities and is computed for the basket of commodities being consumed by the households belonging to all income groups combined. In Pakistan, the main focus is placed on the CPI as a measure of inflation as it is more representative with a wider coverage of 374 items in 71 markets of 35 cities around the country.

Most Commonly Used Price Indices of Pakistan

Features:

Name	CPI	SPI	WPI
Cities Covered	35	17	18
Markets Covered	71	53	18
Items Covered	374	53	425
Commodities Covered	92	-	106
Number of Commodity Groups	10	-	5

2.2 Inflation Trends in Pakistan

2.2.1 Inflation During 2000'S

The inflation rate, which was at 5.7 percent in 1998-99, was further reduced to 3.1 percent by 2002-03 (the lowest in the last three decades). This low level of inflation was supported by strict fiscal discipline, the lower monetization of the budget deficit, an output recovery, a reduction in duties and taxes, and appreciation of exchange rate. During this time period, the country had very low levels of food inflation, as domestic supply was plentiful as were international stockpiles.

During the first two years (2000-01/2002-03) overall inflation averaged 3.7% as against double-digit inflation during most periods of 1990s. As stated earlier the decline in overall inflation owe heavily to low food inflation (3.1%) compared to non-food inflation, as non food inflation averaged 4.3% during the last three years. Support price (maintenance of prices at a certain level usually through public subsidy or government) of wheat was not raised during 2001-02 one factor contributing to low food inflation.

2.2.2 Inflation During 2002-03

Inflation averaged at 3.3% during July- April 2002-03. The low level of inflation in the mildest of 12.5% increase in money supply is the result of better supply situation of essential commodities, appreciation of exchange rate, prudent fiscal management and continued sterilization of monetary impact of massive foreign exchange inflows. Food and non-food inflation have been estimated as 3.1% and 3.4% respectively as against 2.1% and 4.4% respectively in the corresponding period of last year. The higher increase in food inflation over the comparable period of last year is attributable to increase in prices of wheat, wheat flour, rice basmati, meat, tea, vegetable ghee and cooking oil. The increase in vegetable ghee and cooking oil is the result of increase in international price of palm oil and imposition of GST on the local manufacturing of ghee in the federal budget 2002-03.

Slower increase in non-food inflation as compared with last year resulted mainly on account of lesser increase in fuel and lighting group (8.55% as against 9.6% of last year) and transport and communication group (5.5%as against 7.1% last year). It is important to note that during July 1-May 15 2003-03, 22 adjustments in prices of petrol has taken place – 13 times the prices were raised and 8 times reduced while one time it remain unchanged. On July 1, 2002 the price of petrol was Rest 33.71 per liter and on May 16, 2003 it's stood at the Rest 28.88 per liter – a decline of 14.3%. The prices of petroleum products and its various grades including kerosene oil fluctuated moderately during the fiscal year 2002-03.

The contribution of non-food inflation is estimated at 61.3%, which is lower than last year (77.5%). Within non-food inflation, almost one half of the contribution has come from fuel and lighting and transport and communication.

2.2.3 Inflation During 2003-04

Inflation started rising in the second quarter of FY2004 in the wake of reports of a wheat shortage. However, despite this, SBP continued its easy monetary policy during the first half of FY2004, when money supply (M2) growth accelerated slightly to 9.1%, from 8.6% in the same period in FY2003. Private sector credit picked up further, and as a result, interest rates have started inching up.

Inflation in the first half of the year was lower than in the corresponding period of last year. However it started to rise in October 2003. Despite an upturn in inflation, the State Bank of Pakistan continued its easy monetary policy in order to sustain the economic recovery. The broad money supply increased by 9.1 percent during the period compared with an expansion of 8.6 percent in the corresponding period of last year. It said that except for a decline in September and October 2003, share prices continued their rising trend through most of the first eight months of the current year.

The government bond market remained depressed after latest data showed inflation accelerated in December at its fastest pace so far in the current fiscal year, raising expectations the central bank may lean toward a tighter monetary policy stance in the coming months. Data issued by the Federal Bureau of Statistics show consumer prices rose 5.41 per cent year-on-year in December compared with 4.22 per cent in the previous month. Thus, the 10-year bond closed at 6.40 per cent, compared with 6.38 per cent a day before. The bond yield at the weekend, however, remained close to 6.33 per cent.

2.2.4 Inflation During 2004-05

Consumers witnessed higher inflation during 2004-05, which touched 9.3 percent by June 2005 at its highest level since 1997 and the State Bank has warned the trend to continue this fiscal. During 2004 and 2005 the growth in non-government sector borrowing has been above 30 per cent. This growth is reflected in the contribution of NGSB in inflation, which is 38 per cent in 2004-05.

Another important factor is import prices, which explains 13.6 per cent of the inflation in 2004-05. In 2004-05, two important factors for inflation were government sector borrowing and support/procurement price of wheat, contributing 17.6 per cent and 11.8 per cent respectively. The government taxes however did not cause any significant rise in prices in 2004-05. This seems logical since there has been no change in the tax to GDP ratio over the last few years. There was no further strong pressure on import costs because of a stable exchange rate. The expansionary monetary policy did contribute in promising GDP growth but it also led to the rise in consumer prices. The phenomenal growth in the flow of loose credit to the private sector played a significant role in disturbing the price mechanism. Availability of money at virtually no cost encouraged speculators and hoarders.

“Strong domestic demand and market structure issues, especially related to the continued supply shortages of some key food staples led a surge in inflationary pressures in the economy during 2004-05, with a smaller but growing contribution from international commodity prices,” said the SBP in its annual report for 2004-05.

Assuming that no unexpected sharp jump in domestic oil prices would be allowed, and continued smooth supply of key staples would be maintained, SBP estimates suggest that 2005-6 inflation would range between 7.7 and 8.3 percent. The SBP report blamed international scenario main reason behind such higher inflation rate during 2004-05 amid rising international oil prices, which had been a challenging development for global price stability during 2005.

2.2.5 Inflation During 2005-06

Inflation picked up to an average of 8.6 percent per annum during the last two years (2004-05 and 2005-06) for a variety of reasons. First and foremost was the unprecedented rise in international price of oil which more than doubled during the last two years, reaching an all time high of $78/bbl. The rise in international oil prices therefore contributed to the pick up in inflation during the last two years. Second factor has been the surge in demand, which put pressure on prices. Four years of strong economic growth (on average, 7.0 % per annum) gave rise to the income levels of various segments of the society, which strengthened domestic demand and put upward pressure on prices of essential commodities.

The government had taken several measures to bring inflation down during 2005-06. These measures included the tightening of monetary policy as well as augmenting the supply of essential commodities through liberalizing of import regime. As a result the overall inflation registered a decline from 9.3 percent in 2004-05 to 7.9 percent in 2005-06. Most importantly, food inflation declined from 12.4 to 6.9 during the same period. Non-food inflation on the other hand registered an increase from 7.1 to 8.6 percent. In 2006 the growth in non-government sector borrowing was 23 per cent. This growth is reflected in the contribution of NGSB in inflation, which was 35 per cent in 2005-06. One important factor is import prices, which explains 26.7 per cent of the inflation in 2005-06.

The government taxes did not cause any significant rise in prices in 2005-06. There was no further strong pressure on import costs because of a stable exchange rate. Such policy

2.2.6 Inflation During 2006-07

In year 2006, core inflation from 7.1 percent in June 2006 came down to 5.5 percent in December 2006, due to the tighter monetary stance.

The CPI-based inflation during July-April 2006-07 averaged 7.9 percent as against 8.0 percent in the same period last year. The single largest component of the CPI is the food group, which showed an increase of 10.2 percent. This was higher than the 7 percent food inflation observed over the corresponding period of last year. According to the State Bank of Pakistan, the food inflation during the period increased because of supply side constraints. On the other hand, the non-food prices grew at a slower pace compared to last year. The non-food inflation averaged 6.2 percent between July -April 2006-07 while it stood at 8.8 percent in the corresponding period of last year. The non-food non-energy inflation (core inflation) decelerated sharply to 6.0 percent in first ten months of the fiscal year as against 7.7 percent in the same period last. The tight monetary policy pursued by the SBP has resulted in the sharp reduction in the core inflation.

A more detailed analysis of the food group shows a considerable variation in inflation rates of the items included in the group. For example, considering the perishable and non-perishable items in the food group separately shows that nonperishable food prices rose by 9.0 percent while the perishable items prices grew by 17.6 percent. The estimated contributions to inflation for perishable and non-perishable items are 11.5 percent and 40 percent respectively when their weights are 5.14 percent and 35.2 percent respectively. Clearly, the contribution of perishable items to inflation is nearly twice its weight. An analysis of individual food items suggests that the major portion of food inflation during the current year stemmed from a limited number of items including rice, edible oil, pulses, meat, milk, tea, eggs, wheat, vegetables and fruits. These items have experienced relatively larger increase in their prices during the course of 2006-07. However, prices of other important food items like sugar, potatoes, tomatoes and chicken (farm) have shown a decline in their prices owing to improved availability of these items in the market.

2.2.7 Inflation During 2007-08

Pakistan's inflation in 2007 remained virtually unchanged from the 2006 rate, standing at 7.8%. The inflationary trend in food prices persisted through most of the fiscal year and was even higher, at 10.3% in 2007, affecting people living on low and fixed incomes. The analysis suggests that the inflation was largely food price driven. Prices of various types of pulses have increased this year because of the short supply of these pulses in the country. Since milk powder and tea are also importable items, the domestic prices were higher on the back of higher international prices.

The inflation in 2007 was fuelled by global increases in some commodity prices, higher utility tariffs, and by local supply- and demand-driven factors. To contain food inflation, Pakistan's government expanded the public-sector utility-store network, extending it even into rural areas. Through the network the government provides large subsidies for the sale of essential edibles. The central bank responded to high inflation by tightening monetary policy: it simultaneously raised the discount rate, the cash requirement on demand deposits and the statutory liquidity requirement of demand and time deposits.

Considering the other CPI groups, the highest inflation was in the medicare group and energy with reported 10 month inflation of 9.1 percent and 7.3 percent respectively. But since their weights are small in the CPI basket (2.1 percent and 8.7 percent) their contribution to inflation was small. On the other hand, house rent, which has a 23.4 percent weight in the CPI, showed a fall in inflation from 10.3 percent to 6.7 percent.

2.2.8 Inflation During 2008-09

"A delay in including more areas and in revising consumption patterns for measurement of inflation has helped the government to conceal actual inflationary pressures in the economy", claimed Dawn.

Before the start of the year, the government had completed the family budget survey, launched in July 2007 for the purpose of revising the base for measurement of inflation. The exercise was delayed for years on the pretext of non-availability of funds.

A senior official at FBS said that the excuse of non-availability of funds for conducting survey to revise the base year of CPI was unjust because the government had started a number of other surveys and projects, reported Dawn.

Analysts say the government wanted to continue with the old pattern because it was based on a survey of urban areas only, ignoring rural consumers who comprised 70 per cent of the total population.
Moreover, many items covered by the survey are either outdated or their consumption has declined drastically with the passage of time.

The present average rate of inflation is around 25 per cent and if the base year is revised it will go up to over 30 per cent.

This exceptionally high trend is mainly a cause of soaring food inflation. Inflation during 2008 indicates that prices of a few (18) essential food items registered sharp increase particularly during the second half of the fiscal year 2008.

Other significant contributors to 2008's upward inflationary trend included house rent, which is the index that measures the cost of construction in Pakistan, racing to 11.35 percent by April 2008.

Annual Rate of Inflation (Percentage) in Pakistan for Period 2000-2009

Period	**CPI**	**SPI**	**WPI**
2000-2001	4.41	4.84	6.21
2001-2002	3.54	3.37	2.08
2002-2003	3.10	3.58	5.57
2003-2004	4.57	6.83	7.91
2004-2005	9.28	11.55	6.75
2005-2006	7.92	7.02	10.10
2006-2007	7.77	10.82	6.94
2007-2008	8.01	11.03	10.26
2008-2009	24.43	30.96	27.98
2010	20.77		

2.2.9 Inflation During 2010

The inflation rate in Pakistan was 13.04 percent in March of 2010. Inflation rate refers to a general rise in prices measured against a standard level of purchasing power. The most well-known measures of Inflation are the CPI which measures consumer prices, and the GDP deflator, which measures inflation in the whole of the domestic economy.

3 Inflation Trend in Pakistan and Data Analysis

Inflation in Pakistan over the last 18 years had been fluctuating between 13.0 percent and 3.1 percent. This was mainly due to:

1. Decelerating economic growth

2. Loose monetary policies

3. Output set-backs

4. Higher duties and taxes

5. A depreciating Pak Rupee

6. Frequent adjustments in the administered prices of gas, electricity, POL products as well as the support price of wheat

7. Political instability