The consumer price index cpi

Inflation can be defined as a situation where there is a sustained increase in the average price level over time or a fall in the value of money. Thus, generally inflation is a situation where there is too much money chasing too few goods and cost of living increase. When inflation occurs, the value of a dollar does not stay constant. The value of a dollar is observed in term of purchasing power, which is real and tangible goods that money can buy. Thus, purchasing power of money will decline as inflation increase. For example, suppose that a $1 pack of gum will cost $1. 02 in a year when the inflation rate is 2% annually. However, you can't buy the same goods with the same price after inflation.

To measure inflation rate we calculate the percentage change in average price level. Average price level is measured by using price index. There are two major price indexes that measure the price level and inflation which is GDP deflator and consumer price index (CPI).

The consumer price index (CPI) is the best known indicator to measure inflation. It is an index that measures the average price level of goods and services typically consumed household. The CPI is measured as a ratio of the value of base year basket of goods at current prices to its value at base year prices and multiplied it by 100.

CPI = x 100

Assuming CPI is used to measure inflation, then the rate of inflation between 2 period, say t and period (t-1) is given by

Inflation rate = x 100

If the price level is rising, the inflation rate is positive. For a given price level last year, the higher the price level in current, the higher the inflation rate. Plus, the lower the value of money. It is also possible for inflation to be negative but it is rare. These occur when the general price level falls.

There are many different type of inflation such as deflation which is the opposite of inflation and occurs when the average price level is falling. Next, we have mild inflation which is not so serious economic condition and occurs normally when the average price level would increase up to 5%. Other than that is hyperinflation or rapid inflation which is a very serious economic condition where the value of money is persistently falling. An example of hyperinflation that has occurred is in Germany 1923 where the price rose up to 2500% in one month. Lastly, we have is stagflation which is the combination of economic stagnation and high unemployment. Industrialized countries in 1970s often face this problem because of bad economy and increase in oil price by the Organization of Petroleum Exporting Countries (OPEC).

Inflation can result from either an increase in aggregate demand or a decrease in aggregate supply. Demand pull inflation is caused by continuing rises in aggregate demand. It is normally associated with an increase in money supply, government purchases and exports. If demand is rising (and continuous doing so) and cannot be met by a corresponding increase in supply, then the general price level will increase and inflation will occur. Figure below shows the rightward shift in the AD curve from AD1 to AD2 will result in excess demand. The effect is to push price level upward from P1 to P2 .

The next cause of inflation is cost push inflation or supply push inflation. It is the results from any factor that decreases aggregate supply. It occurs when the increasing costs of production push up the general price level. The sources of an increase in cost are an increase in wage rate and the price of raw materials. When firms face with rising production costs, they will respond by raising prices and cutting back on production. The figure below shows leftward shifts in the AS curve from AS1 to AS 2. The result is a rise in prices from P1 to P2 and a fall in the output level from Q2 to Q1.

Different way of inflation can affect different people. It all depends on whether it is an anticipated inflation or unanticipated inflation. If the inflation is anticipated, we can counteract it and the bad effect can be lowered. For example, contract can be negotiate by the worker so that the wage can be hike automatically depend on the price level. However, if it an unanticipated inflation we will have a scarce of time to counteract with it. Thus, it will cost problem such as the market value of domestic product will decrease and the economy have to apply menu costs to solve this problem.

There are several ways to control inflation such as by adopting contractionary monetary policy which use some instruments to influence the economy by reducing money supply and higher the interest rate. Next, by adopting contractionary fiscal policy, this deals with reducing government expenditure and increasing the tax. Lastly, by using direct control where government intervene in the price mechanism if the country.

The inflation rate in Malaysia is still under control which is 3. 2% in 2011. If we look in the past 12 years, the average inflation rate in Malaysia is 2. 3%.

The highest inflation rate in Malaysia is in 2008 where the rate is 5. 4% compared to in 2006 with the rate of 3. 8%.