ESSENTIAL FACTS ABOUT
INFLATION

Essential Facts About INFLATION

compiled by

Monetary Policy Communication Unit

Preface

Bank of Jamaica has undertaken to publish a series of pamphlets on topics that are integral to the policies and operations of the Bank. The pamphlets are designed to enhance the public's understanding of key central banking issues. In this regard, the pamphlets will present important economic and financial information in a manner that will benefit a wide cross-section of users. In particular, it is anticipated that the material presented will assist journalists, investors, students and other members of the public who frequently request relevant documentation and/or explanations from officers of the Bank. The Bank and its staff in continuing to serve the Jamaican public are pleased to add these pamphlets to existing publications as we strive to inform and educate.

Bank of Jamaica's primary mandate is the achievement and maintenance of price stability which, when achieved, provides an economic environment that is conducive to growth in savings and investment. This pamphlet seeks to provide some essential facts about inflation by first defining what inflation is, how it is measured, the effects of inflation on Jamaicans and explaining the Bank's role in managing inflation.

Acknowledgments

Information used to prepare this pamphlet was primarily provided by the Statistical Institute of Jamaica (STATIN), as such, we extend special thanks to STATIN for their support in the preparation of this material. All the errors and omissions however, are our own. Also, special thanks to members of the Monetary and Inflation Unit of the Sector Analysis Department within the Research and Economic Programming Division of the Bank for their input and support in completing this project.

CONTENTS

What is Inflation?	6
How is Inflation measured?	6
Why is high Inflation bad?	8
Causes of Inflation	10
How does the Bank manage Inflation?	12
Glossary	13

What Is Inflation?

Inflation is the rate at which the general price level of goods and services in the economy rises over time. Inflation reduces the purchasing power of each unit of currency. In economics, inflation simply means that you have to spend more or buy less when purchasing food and clothes or paying your utility bills as prices rise.

Bank of Jamaica (BOJ), the country's central bank, has the primary objective of ensuring price stability in the economy. In other words, the Bank is mandated to keep inflation low, stable and predictable. But why has BOJ been given this mandate? The ultimate goal of economic policy is to ensure a sustainable increase in the standard of living of Jamaican citizens. Keeping inflation under control to avoid a loss of purchasing power of earnings and savings is an important means to this end. Price stability makes it easier to plan over relatively long time horizons and therefore encourages saving and investment.

How Is Inflation Measured?

There are various ways of measuring inflation. The Consumer Price Index (CPI) is the most widely used measure of inflation. It captures the movement of prices of a specified basket of consumer goods and services over a given period of time.

The Statistical Institute of Jamaica (STATIN) measures the CPI on a monthly basis. The CPI represents a basket of goods/services consumed by the average Jamaican. The basket records a list of selected items that Jamaicans typically purchase such as phone cards, food, bus fare, petrol, school fees, utility rates, motor vehicle maintenance, recreational activities, etc. For the purpose of calculating the CPI, the number of items in the basket are held fixed and do not change month to month. Inflation therefore represents the average change in the prices of this fixed bundle of goods and services that is purchased by the typical Jamaican.

The current Jamaican CPI basket contains over 300 commodities. The commodities in the CPI basket are divided into 13 broad expenditure divisions based on the Classification of Individual Consumption According to Purpose (COICOP). Every item, class, group and division in the basket is assigned a weight which represents its percentage share of expenditure relative to total expenditure. The divisions and their respective weights are reported in the table below.

CPI Weights by COICOP Broad Expenditure Divisions		
		Current Weights
1	Food & Non-Alcoholic Beverages	35.8
2	Alcoholic Beverages, Tobacco & Narcotics	1.5
3	Clothing & Footwear	2.5
4	Housing, Water, Electricity, Gas & Other Fuels	17.8
5	Furnishings, Household Equipment & Routine Household Maintenance	3.8
6	Health	2.6
7	Transport	11.2
8	Information & Communication	4.6
9	Recreation, Sport & Culture	5.0
10	Education Services	2.4
11	Restaurants & Accommodation Services	6.7
12	Insurance & Financial Services	1.1
13	Personal Care, Social Protection & Miscellaneous Goods & Services	5.0
TOTAL		100

Source: Statistical Institute of Jamaica

STATIN sub-divides all fourteen parishes of Jamaica into three geographical reporting regions and calculates CPIs specific to each of these. The reporting divisions are Greater Kingston Metropolitan Area (GKMA), Rural Areas and Other Urban Centres (OUC). The All-Jamaica Index is derived from these individual indices.

For a more detailed guide to understanding the CPI, see Pamphlet – Understanding the Consumer Price Index.

Why Is High Inflation Bad?

High inflation can be damaging to an economy as it works against investment and is not conducive to long term planning. High inflation is the enemy of the poor, those without assets and those on fixed incomes (for example pensioners). The wealthy can protect themselves against inflation by investing in real assets, such as shares or real estate, which generally increases in value during periods of inflation. In this regard, high variable inflation induces income inequality.

Inflation effectively reduces the quantity of goods that can be purchased with a given amount of money. Since everyone uses money, it means that everyone stands to lose in an inflationary environment. Against this background, inflation actually takes money out of our pockets; it robs us by reducing the amount of goods we can purchase with a given amount of money.

By the same token, too much inflation can slow down economic growth. High inflation increases the risk premium on financial investments. In a high inflation environment, uncertainty surrounding future inflation increases and the efficiency of price signals decreases. Consequently, financial investors demand an inflation risk premium. A higher expected return will lead to a decline in investment activity, as fewer projects pay off at a higher real interest rate. Therefore, one of the most important dynamic costs of inflation is the reduction in economic growth.

In a high inflation environment, consumers spend more freely and save a lot less, since the value of savings quickly diminishes. In this environment, aggregate demand therefore quickly outstrips supply in such cases, pushing prices even higher and the value of money even lower.

Benefits of Small Positive Inflation

Although consumers may see inflation as a bad thing, since it means prices are going up, the truth is that a little inflation, in particular, low, stable and predictable inflation, can be good for the economy. When the prices of goods and services increase, company revenues grow, and increased revenues lead to salary raises and the creation of more jobs. The psychological boost of increased salaries encourages consumers to spend money on the goods they want and keeps the economy flowing and growing. In this context, low, stable and predictable inflation makes it easier to plan over relatively long-time horizons and therefore encourages saving and investment.

The flip side of inflation is deflation. Central banks do not target zero inflation for several reasons. The threat of deflation is perceived among economists as very costly to an economy as deflation increases real interest rates, which reduces demand and hence output. Nominal interest rates cannot be negative (or more precisely "very negative") because of the zero lower bound and hence conventional monetary policy is not well suited to getting an economy out of recession or preventing further deflation.

In addition, it is generally not easy to negotiate wages downwards, hence, inflation might be necessary to reduce real wages in case of some adverse economic shocks.

Causes of Inflation

Inflation may arise from a variety of factors but the basic reason for inflation is having too much money competing to buy the available goods at their existing prices, allowing those prices to rise.

There are two main types of Inflation:

Inflation can arise through an increase in the cost of inputs and ultimately the costs of producing goods/services. Generally, inputs can be characterized into three main categories: (i) labour (wages); (ii) land (rent); and (iii) capital. When the cost of these inputs rise they can be passed on to the consumer who buys these final goods and services at higher prices. This results in **cost push inflation**.

Two important sources of cost push inflation are imported inflation and wage-related inflation. For an open economy like Jamaica, the ***cost of imported inputs*** represents a large portion of the cost of production. Variations in the cost of imported inputs are highly dependent on the price of the imported input from the foreign suppliers and movements in the exchange rate.

An ***increase in wages*** can result in inflationary pressures. Higher wages lead to higher costs for the firm which are eventually passed onto consumers of the final good/service. Inflation also arises when consumers wish to buy more goods/services than what is available for sale. Buyers want the product so much that they are willing to pay higher prices. This is referred to as **demand pull inflation**. Increasing the supply of money in the economy can result in too much money chasing too few goods, which puts an upward pressure on prices. This fact makes the work of the central bank of central importance in the fight against inflation.

Other factors influencing the level of inflation

Inflation can arise from people's **expectations of future inflation**. If individuals believe prices will increase in the future their actions/decisions now will result in an increase in prices. For example, if a store owner believes that the cost to rent the building will increase, he/she is likely to raise the price for their goods/services in order to compensate for this expected rise in operating cost. Another example, when prices rise, labour (workers) generally expect or demand an increase in wages to be able to maintain the same standard of living.

Fluctuations in the exchange rate can affect inflation. The exchange rate measures the cost of one US dollar in terms of Jamaican dollar. This cost varies over time in a flexible exchange rate system. When the cost of one US dollar increases (the exchange rate depreciates), we need more Jamaican dollars to purchase one US dollar. Similarly, when the cost of one US dollar decreases (the exchange rate appreciates), we need less Jamaican dollars to purchase one US dollar. These changes can affect the cost of imported consumer goods, as well as the cost of imported intermediates or input goods.

The location and topography of countries like Jamaica also makes them vulnerable to **adverse weather shocks** like droughts, floods and hurricanes. These shocks have had a significant impact on the production and prices of major commodities such as agriculture and energy.

How Does The Bank Manage Inflation?

Bank of Jamaica utilizes monetary policy to manage inflation. One of the principal objectives of Bank of Jamaica is the maintenance of price stability. The Government has set a medium-term inflation target for the Bank of 4.0 per cent to 6.0 per cent. STATIN measures and announces the actual inflation rate, which is calculated from the CPI.

The Bank's main policy tool used to influence the level of inflation in the economy is the policy interest rate. This is the interest rate the Bank pays deposit-taking institutions (DTIs) on their current account balances at the Central Bank. This rate signals the monetary policy stance of the Bank. For example, if the Bank reduces its policy rate this signals an accommodative monetary policy stance which is expected to influence the interest rates on loans by commercial banks. When the policy rate is lowered, this signals that the cost of borrowing should go lower. The Bank's monetary policy framework also utilizes other policy tools to influence the rate of inflation such as the reserve requirements.

For more details on the design and implementation on monetary policy, see Pamphlet – Monetary Policy Management in Jamaica.

Glossary

Exchange rate: This rate indicates the number of units of one currency offered in exchange for another. For example, a Jamaica dollar/United States dollar exchange rate of ‘one hundred and forty-two dollars to one’ indicates that one hundred and forty-two Jamaican dollars are needed to obtain one US dollar.

Inflation: The increase in the general price level.

Monetary policy framework: This defines the transmission process through which policy actions taken by the Central Bank make an impact on the final target - inflation.

Productive inputs: These are raw materials and labour used to produce a final good or service. For example, eggs, flour and sugar are used as productive inputs for a cake.

Purchasing power: The capacity of a given amount of money to purchase goods and services. This capacity is eroded by inflation.

Real interest rate: This represents the return on assets after accounting for the effects of inflation on the purchasing power of the return.

Nethersole Place
Kingston
Jamaica
Telephone: (876) 922 0750-9
Fax: (876) 922 0854
E-mail: library@boj.org.jm
Internet: www.boj.org.jm
ISBN 976 8044 13 6