



WHAT IS INFLATION?

Inflation is the rate at which the general level of prices for goods and services increases over time, resulting in the gradual reduction of purchasing power - meaning that each dollar buys less than it did previously. Essentially, inflation represents the cost of living rising, affecting everything from food and housing to transportation and healthcare.

Inflation is measured using indexes like the Consumer Price Index (CPI), which tracks the average price changes in a “basket” of goods and services.

For example, if inflation is 3% over a year, this means that prices have generally risen by 3% compared to the previous year.

Inflation can be caused by several factors, including:

1. Demand-pull inflation occurs when demand for goods and services exceeds the economy’s ability to supply them, often due to strong economic growth or increased consumer spending.

2. Cost-push inflation arises when the costs of production, such as wages or raw materials, go up, leading businesses to raise their prices to maintain profitability.

Moderate inflation can signal economic growth, but high inflation erodes purchasing power, making everyday items more expensive.

For example, a \$3 cup of coffee might cost \$3.15 the following year if inflation rises by 5%. While 15 cents may seem minor, if wages don’t keep up, people can buy less over time. This effect is even more significant for those on fixed incomes, like retirees, whose spending power diminishes without income adjustments.

To manage inflation, central banks, like the Reserve Bank of Australia, aim for a balanced annual rate, typically 2-3%. They often adjust interest rates as a primary tool: when inflation is high, raising interest rates makes borrowing more costly, reducing spending and cooling inflation. If inflation is too low, they may lower rates to encourage spending and investment, stimulating economic activity.

By managing inflation effectively, central banks aim to create stable conditions where prices remain predictable, helping people and businesses plan for the future and promoting steady economic growth.