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# SUMMER SESSIONS

Refresh your knowledge of essential topics in investing

## Introduction to Inflation Presented by Alberto Cavallo

### Key Points

- Inflation is measured with the consumer price index (CPI) with a similar methodology across countries.
- Investors should be cautious of the “base effect” when interpreting annual inflation.
- Inflation is primarily driven by aggregate supply and aggregate demand shocks.
- Governments can counter inflationary pressures with monetary and/or fiscal policy, but in practice, it is difficult to strike the right balance.
- The COVID pandemic caused both demand and supply shocks, which initially worked in opposite directions to limit price changes, but are now both contributing to increase prices and inflation.

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In this session on inflation, Alberto Cavallo addresses how inflation is measured, what drives inflation, and current inflation trends.

The consumer price index (CPI) is the primary measure of inflation. It is designed to capture the cost of achieving a constant standard of living for a typical consumer over time. The CPI aggregates the price changes of a basket of goods on a monthly basis. There are different versions of CPI that target different categories and populations. The two most important are the all-Items “headline” CPI and the “Core” CPI that excludes food and energy.

There are a few important nuances in measuring inflation. First, the starting point used in calculating annual inflation has a big impact, which is referred to as the “base effect.” Annual inflation is measured as the percent change in the price index from one year prior. If the starting price level is unusually high or low, the annual inflation rate will be under or over exaggerated, respectively. To view the full story of inflation, it is important to look at the CPI index, monthly inflation rate, and annual inflation rate. Also, the basket weights used in the CPI are lagged, which can cause distortions. For example, the CPI underestimated annual inflation in 2020 and is now overestimating inflation for 2021.

The two key drivers of inflation are aggregate supply and demand. A negative shock to aggregate demand can cause a recession and deflationary pressures. In theory, the government can use monetary and/or fiscal policy to offset these effects. In reality, it is difficult to properly execute these policies due to imperfect

control over money supply and individual spending behavior. In particular, governments that use expansionary monetary policy must be careful to avoid overheating the economy, which can lead to entrenched inflationary pressures. Supply-side shocks, which produce both a decline in economic output and an increase in inflation, are even harder to solve. Expansionary policy aimed at stimulating growth can exacerbate inflationary pressure, while contractionary policy aimed at taming inflation can further decrease output.

Currently, the COVID pandemic caused both demand and supply shocks to the economy. Early in the pandemic, supply and demand shocks opposed each other, which resulted in minimal price movement. However, as demand recovers while supply shocks remain in 2021, the economy is experiencing inflationary pressure.

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