What is Inflation? [Examining the PPI, CPI, and PCE Indices]

Inflation is an economic concept introduced in the early 20th century by the German economist "**Heinrich Von**". It refers to the uncontrollable increase in the general price level of goods and services. This price increase is analyzed and defined through various **Fundamental analysis** indices such as **CPI**, **PPI**, and **PCE**.

Inflation is an economic phenomenon that occurs as a result of a decrease in the value of money or an increase in producer costs

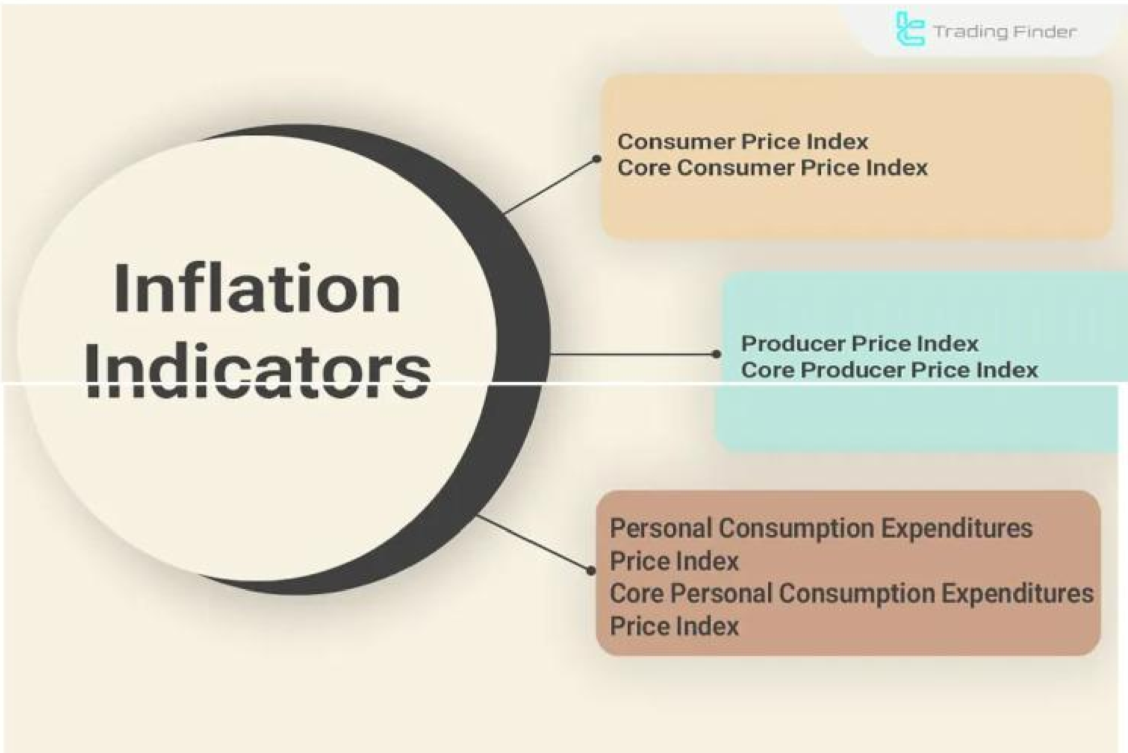
What is Inflation?

Economic inflation is the **weighted average** of price increases for a specific basket of goods and services over a certain period. The items in this basket (such as food, housing, clothing, etc.) are determined by each country's central bank.

Introduction to Inflation Indices

Inflation reports are published as inflation indices and used to **predict monetary policy trends** and **financial markets**. **Types of inflation indices:**

- **Consumer Price Index (CPI)**
- **Core Consumer Price Index (Core CPI)**
- **Producer Price Index (PPI)**
- **Core Producer Price Index (Core PPI)**
- **Personal Consumption Expenditures Price Index (PCE)**
- **Core Personal Consumption Expenditures Price Index (Core PCE)**



A glance at the types of inflation indices.

CPI (Consumer Price Index)

CPI, or "**Consumer Price Index"** reflects economic inflation. It is a weighted average of price changes for a **specific basket of goods** over a **specific period**. An important point about **CPI inflation** is the fixed nature of the **basket of goods** and their **weighted impact**.

The Consumer Price Index increases with the **devaluation of currency** and leads to a **reduction in purchasing power**.

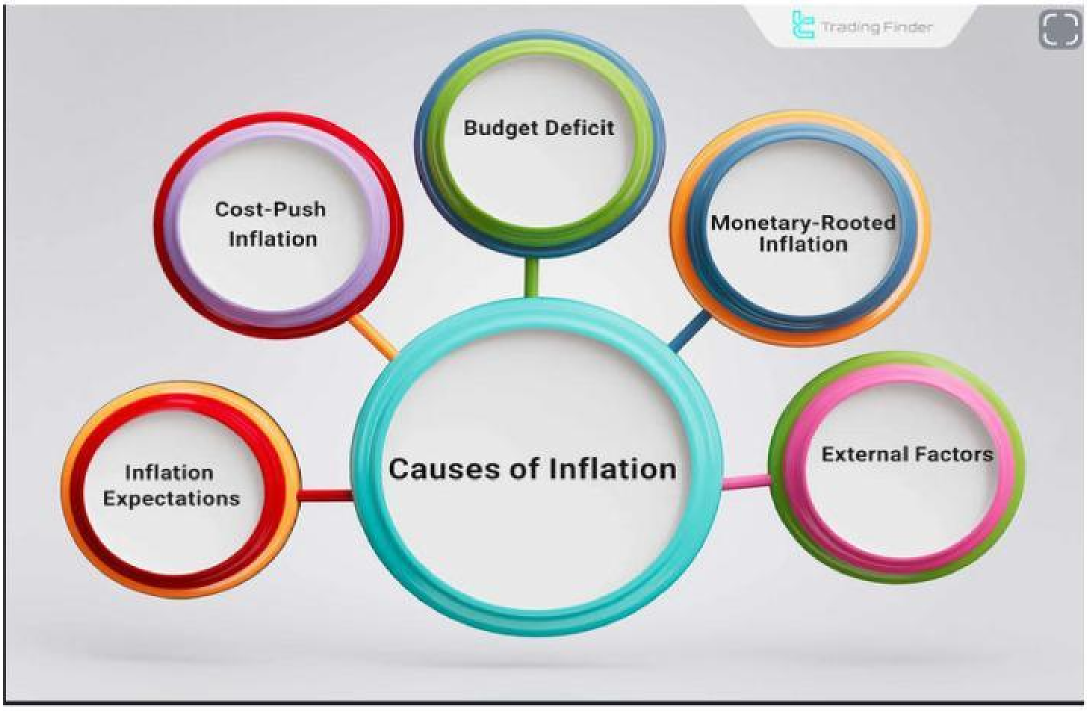
Core CPI (Core Consumer Price Index)

The **Core CPI** or "**Core Consumer Price Index"** represents **CPI inflation**, excluding **food** and **energy**.

External factors such as **geopolitical risks**, **supply chain disruptions**, or **supply shortages** significantly impact the prices of **food** and **energy** [volatile items], making their control largely outside the government or central bank's reach.

Therefore, central banks use the **Core CPI** as the basis for evaluating economic inflation.

Note: In inflation indices, whenever the term **Core** is mentioned, it means the exclusion of **food** and **energy** from the calculations.



PPI (Producer Price Index)

The **PPI** or "**Producer Price Index"** reflects **producer inflation**. This index accounts for price changes in **raw materials** and **service providers' costs**.

An increase in **oil** and **energy prices** significantly impacts the **PPI** and leads to **cost-push inflation**.

A crucial point about **PPI** is its role as a **leading indicator** and a warning sign of consumer inflation before it rises. As production costs increase, their impact on consumer inflation becomes evident months later through **increased final product prices**.

Core PPI (Core Producer Price Index)

In the **Core PPI** or "**Core Producer Price Index"**, price changes in **food**, **energy**, and **services** are excluded.

The exclusion of the **services sector** is because **wages** constitute a major part of service companies' costs, and **sharp fluctuations in wage growth** cause significant changes in the **PPI**.

PCE Price Index (Personal Consumption Expenditures Price Index)

The **PCE Price Index** or "**Personal Consumption Expenditures Price Index"** is a comprehensive inflation measure reported **only in the United States**.

In addition to inflation and price increases, the **PCE** index provides complete data on **income**, **monthly inputs per individual**, and **savings rates**.

Core PCE Price Index (Core Personal Consumption Expenditures Price Index)

The **Core PCE Price Index** or "**Core Personal Consumption Expenditures Price Index"** is one of the most important economic indicators reviewed by the **Federal Reserve** (the U.S. central bank).

A crucial point about **PCE** and **Core PCE** is the seasonal changes [based on **higher demand**] in the **basket of goods considered**. Additionally, the **weight** of goods in the **PCE** calculation is variable.

This feature makes **PCE** a better indicator of **economic inflation** and **consumer living costs** than **CPI**. For this reason, since **2000**, the **Core PCE** has replaced the **Core CPI** as the **preferred index** of the Federal Reserve for evaluating inflation.

Note: If **Core PCE** is released higher than expected, it usually strengthens the currency in **Forex market.**

How Does Economic inflation Occur?

Price increases in the long term are due to **money supply** and **increased liquidity**. However, this is not the only cause of inflation, and several factors contribute to its occurrence:

Budget deficits, monetary inflation, external factors, cost-push inflation, and inflationary expectations are among the causes of inflation

Demand-Pull Inflation (Monetary Inflation)

This type of **Economic inflation** arises from **strong demand**. In this situation, **demand** exceeds **supply**. **Expansionary monetary policies** such as lowering interest rates, central bank bond purchases, or **increased government spending** (e.g., increased government investment in production, wage hikes, or subsidies) contribute to this type of inflation.

Cost-Push Inflation

This type of inflation occurs when **producers' costs** increase, forcing them to **raise final product prices**. Increases in **raw material prices** or **wages** are the main causes of this inflation.

Inflationary Expectations

Inflationary expectations lead to the **creation** or **continuation** of inflation. When businesses or consumers expect inflation to rise, they rush to purchase, increasing demand and leading to **inflationary pressure**.

Government Budget Deficit

Budget deficits and **government borrowing from the central bank** also cause inflation through increased **monetary base** and **liquidity**.

A **budget deficit** arises from an imbalance between **government expenditures** and **revenues**. In other words, a deficit occurs when government spending exceeds its income.

In such cases, if the government borrows money from the central bank to address the deficit, inflation occurs due to increased **monetary base** and **liquidity**.

External Factors

Sometimes, external factors such as **geopolitical risks** or **supply chain disruptions** lead to increased consumer costs by reducing the supply of goods, increasing transportation costs, or raising raw material prices.

Difference Between Monetary and Cost-Push Inflation

Monetary inflation is caused by **increased liquidity**.

In this type of inflation, if **production** does not grow alongside increased liquidity, inflation occurs.

In other words, **the money supply** increases, but **the goods supply** remains constant or grows slower than liquidity.

$$MV=PQ$$

M= Money Supply

V= Money Velocity of Circulation

P= Price Level

Q= Economy's Output

The formula for monetary inflation is MV=PQ.

According to this formula, if **the money supply** exceeds **the goods supply**, more money must be paid to purchase goods.

However, monetary inflation can be controlled through **central bank monetary policies**. The central bank can reduce liquidity in the economy by **raising interest rates** and curb price increases.

How Can Economic inflation Be Controlled?

Contractionary monetary policy and **reducing government spending** are ways to **control inflation**.

Additionally, policies supporting **production** strengthen **goods supply** and are effective in controlling inflation.

Some **government-imposed policies**, such as **price controls** or **multiple exchange rates**, are also used to control inflation. However, these policies [if not properly monitored] can lead to black markets and sometimes **financial corruption**.

Contractionary Monetary Policy

The most common method of controlling inflation is the **contractionary monetary policy** of the central bank. In this policy, the central bank aims to **reduce liquidity** in the economy by **raising interest rates**.

Raising interest rates reduces liquidity through two methods:

- **Attracting liquidity** to the banking system for higher returns;
- Reducing producers' demand for loans due to **high interest rates**.

Reducing Money Supply

The government attracts liquidity from the economy by increasing bond yields, as higher returns on bonds are seen as a low-risk investment.

Is Negative Inflation and Price Reduction Beneficial?

Deflation occurs when the average price level decreases over a specific period compared to the previous period.

Deflation is often caused by **reduced demand**, **currency appreciation**, or **increased goods supply** and is accompanied by **reduced inflationary expectations** and **continued weak demand**. Therefore, it is not considered economically beneficial, and central banks strive to prevent it.

Deflation, if prolonged, leads to **economic recession**. To better understand this, the **inflation** and **economic growth** (GDP) trends of Japan are shown in the images below:

This image shows Japan's inflation and periods of deflation over the past two decades

What Level of Inflation is Beneficial for the Economy?

A **controlled level of inflation** is beneficial for **economic growth** and **labor market prosperity**. For developed economies, **2% inflation** is ideal, while **2-4% inflation** is beneficial for developing economies.

However, if inflation exceeds this level, it leads to **reduced purchasing power**, **labor market stagnation** (increased unemployment), and ultimately **reduced economic growth** in the long term.

Conclusion

In most cases, inflation results from **increased money supply** and leads to higher living costs for consumers.

Price increases and inflation can be **beneficial** or **harmful** depending on their level, and one of the central banks' responsibilities is to control and stabilize it within the **2-4%** range.

source:

1.our website link :
https://tradingfinder.com/education/forex/what-is-inflation/

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