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?

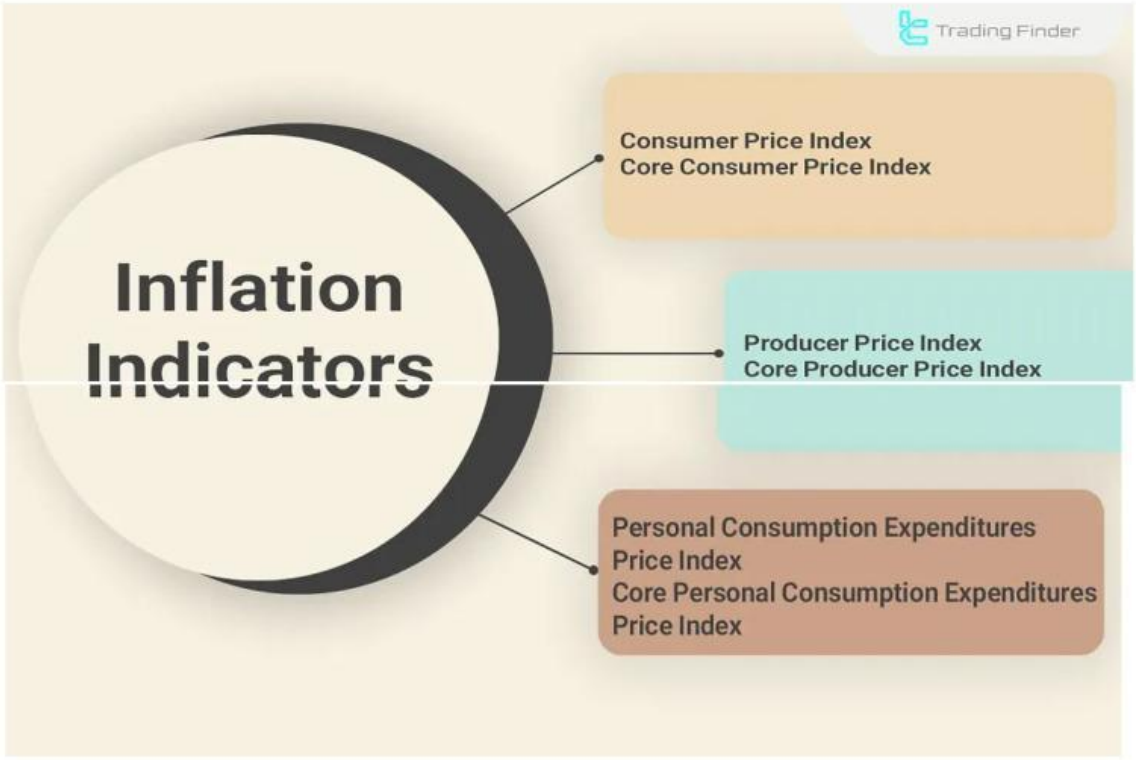
Economic inflation is the **weighted average** of price increases for a specific basket of goods and services over a certain period. The items in this basket (such as food, housing, clothing, etc.) are determined by each country's central bank.

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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.

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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)

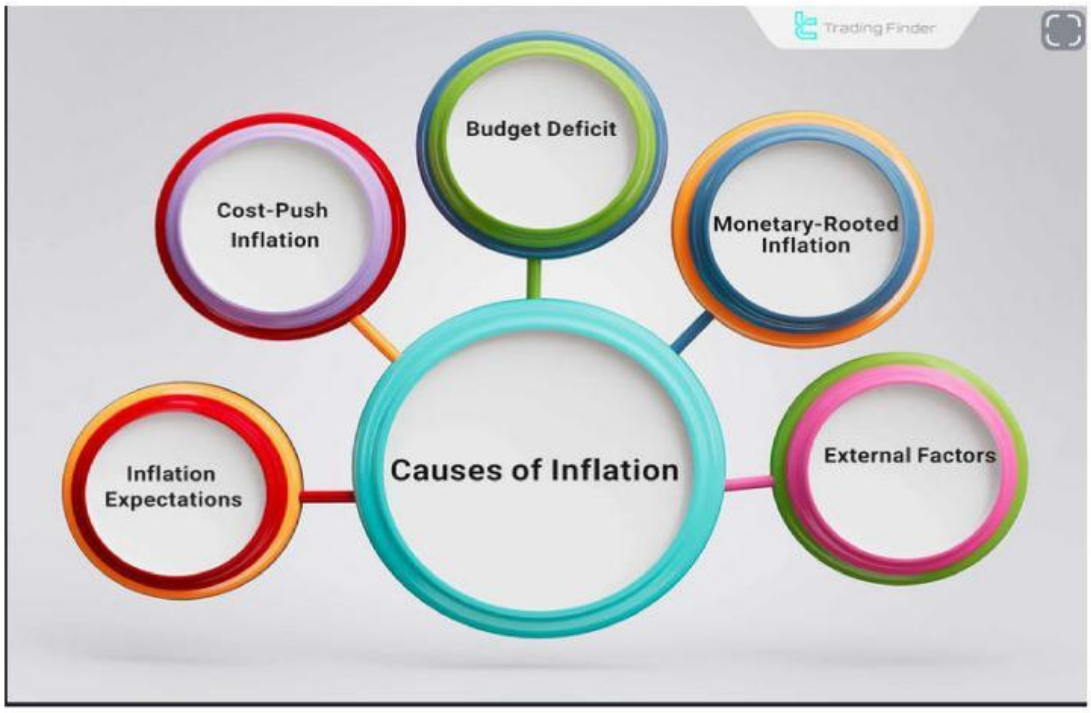
The **Core CPI** or "**Core Consumer Price Index"** represents **CPI inflation**, excluding **food** and **energy**.

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.

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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**.

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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.**

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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**.

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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.

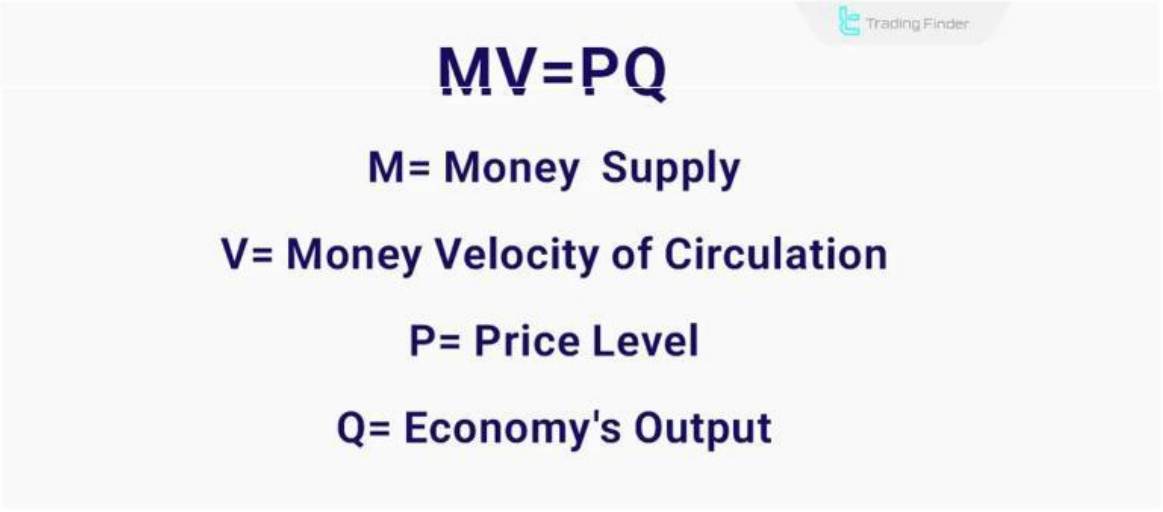
Difference Between Monetary and Cost-Push Inflation

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.

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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

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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:

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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.

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source:

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

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