



Economic and Financial Committee (ECOFIN)

Topic 2: The short- and long-term impact of inflation

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1. Definition of key terms

Inflation: a general, continuous increase in prices.

Consumer Price Index (CPI): a measure of the price level in the economy based on the prices of a collection of products designed to reflect the consumption basket of the average consumer

Deflation: a decline in the general price level in an economy, signified by an annual inflation rate below 0% (negative).

Disinflation: a fall in the rate of inflation e.g. from 5% to 2%. Prices are still rising but at a slower rate.

Hyper-inflation: a period of very high rates of inflation, usually leading to a loss of confidence in an economy's currency.

Inflation rate: the annual rate of change of the average price of goods and services.

Unit labour costs: total labour costs, including social security and employers' pension contributions, and including the costs of self-employed labour, incurred in the production of a unit of economic output.

Wage-price spiral: the relationship between rising wages and rising prices. When we make more money, consumer demand for goods and services tends to increase, which can, in turn, lead to higher prices.

2. Introduction

Inflation is an increase in prices that can translate into a decrease in purchasing power over time. The rate at which purchasing power declines reflects the average increase in prices for a selected basket of goods and services over a given period.

Price increases are usually expressed as a percentage and mean that fewer units of the currency are actually being purchased than in the previous period. Inflation contrasts with deflation, which occurs when prices fall and purchasing power increases. Economists agree that persistent inflation occurs when a country's money supply growth exceeds economic growth. In response to this situation, monetary authorities (in most cases central banks) take necessary measures to control the money supply and credit to control inflation within permissible limits and keep the economy running smoothly.

Inflation has been increasing in recent years, and there are several major reasons why this is happening, such as the Coronavirus pandemic and the Russian invasion of Ukraine. Inflation is occurring now because of spending from households. When the lockdowns ended, many people started to go out again and buy things, even though the supply chains were and are facing issues. This, of course, causes shortages and increased prices.

In February 2022, Russia invaded the neighboring country of Ukraine. While politics are a significant part of this crisis, it has caused issues with economies around the world. The war has caused inflation globally and has affected four main areas: financial markets, energy, transport, and food.

3. Background information

An increase in the money supply is indeed a significant factor contributing to inflation, and this can happen through various mechanisms in the economy. Monetary authorities can increase a country's money supply by:

1. **Printing more money and distributing it to citizens:** When more money is introduced into circulation without a corresponding increase in goods and services, it can lead to inflation. This is because the increased money supply competes for the same amount of available goods, driving prices up.
2. **Fiat currency devaluation (devaluation):** Devaluing a country's currency intentionally, often through changes in exchange rates, can make imports more expensive. As a result, the prices of imported goods and services may increase, contributing to inflation.
3. **Borrowing new funds through the banking system:** Central banks can influence the money supply by buying government bonds from banks on the secondary market. This injects new money into the system, and when there's excess money chasing the same amount of goods, inflation can occur.

The mechanisms driving inflation can be classified into three main types:

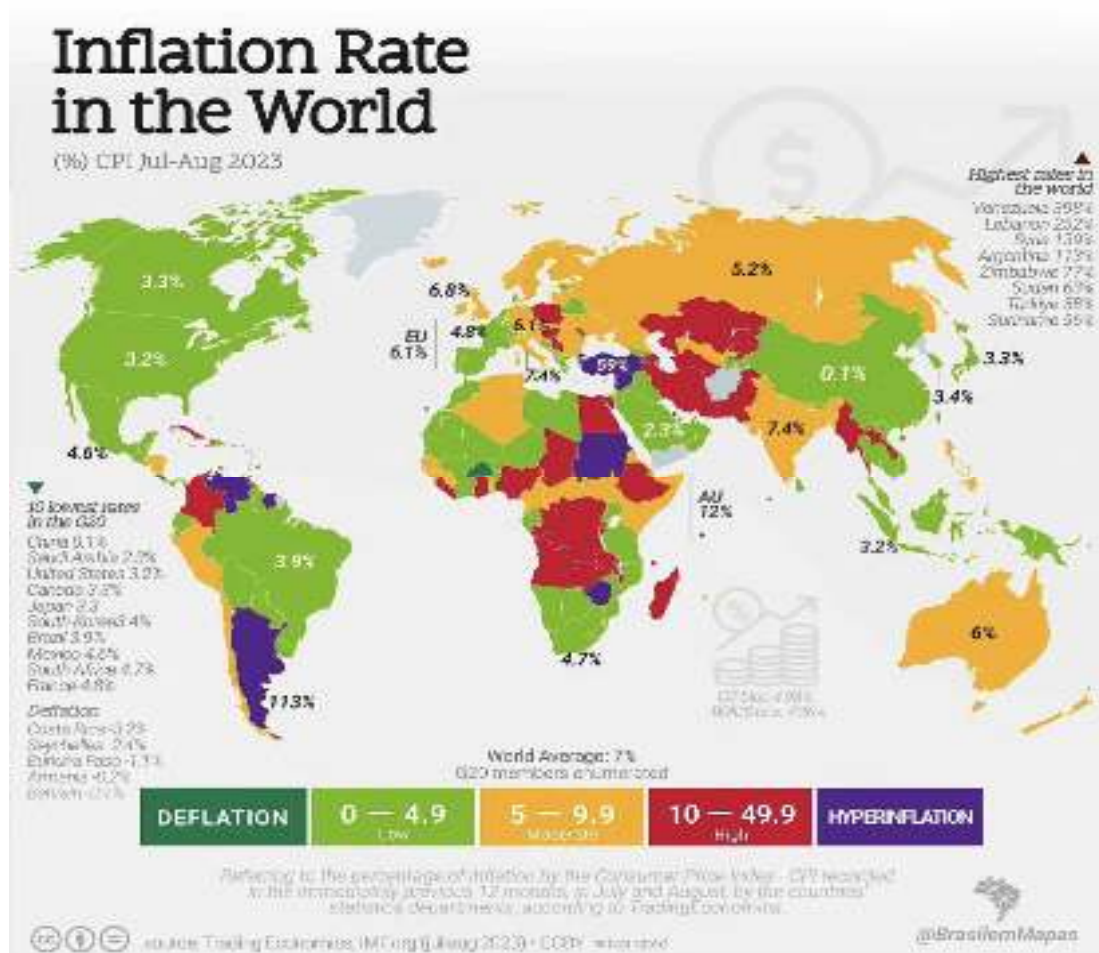
1. **Demand-pull inflation:** This occurs when aggregate demand in an economy rises too quickly. If the money supply increases rapidly without a corresponding increase in the production of goods and services, demand outstrips supply, leading to an increase in prices.

- Cost-push inflation:** Rising commodity prices are an example of cost-push inflation. When the costs of basic goods and services increase, such as raw materials or energy, businesses may pass these costs on to consumers, leading to higher prices.
- Built-in inflation:** This is related to adaptive expectations, where people expect current inflation rates to continue in the future. If individuals expect prices to rise, they may demand higher wages to maintain their standard of living. This, in turn, leads to higher costs for goods and services, creating a cycle of inflation.

Other factors, such as policy changes, a wage-price spiral, and bottlenecks in the supply chain, can also contribute to inflation. Overall, managing the money supply and understanding the factors that drive inflation are crucial for maintaining economic stability.

4. Major countries involved

The high inflation rates in the mentioned countries underscore the severe economic challenges they are facing.



Here's a brief overview of the inflation situations:

- Zimbabwe:** Zimbabwe has the highest inflation rate globally, reaching a staggering 284.94%. This has resulted in prices for goods and services spiraling out of control, making everyday items, including necessities like food and medicine, exorbitantly expensive. The

cost of living has more than doubled in just two years, and the value of the Zimbabwean currency has hit an all-time low.

- **Venezuela:** Venezuela follows closely with the second-highest inflation rate globally, standing at 282.80% in November, a decrease from the previous month. The country has been grappling with hyperinflation, contributing to economic challenges and affecting the affordability of essential goods and services.
- **Sudan:** Sudan has experienced significant fluctuations in its inflation rate over the past 62 years, ranging from -10.0% to 359.1%. In 2022, the inflation rate was calculated at 138.8%, contributing to a cumulative price increase of 3.79 billion percent from 1960 to 2023. The high inflation has substantial implications for the cost of living and economic stability.
- **Turkey:** Turkey has witnessed a notable acceleration in its annual inflation rate, reaching 62% in November 2023. This marks the highest level since December of the previous year. The increase is primarily attributed to a sharp rise in housing and utilities costs, indicating challenges in specific sectors contributing to overall inflation.

These high inflation rates can lead to various economic and social issues, including reduced purchasing power, increased poverty rates, and challenges in maintaining a stable economy. It often requires comprehensive economic measures and policies to address the root causes and mitigate the impacts of such inflationary pressures.

5. UN involvement

The United Nations, while not directly implementing measures to combat inflation, has raised concerns about the global surge in inflation and called for more pragmatic policies to address the issue. Olivier De Schutter, the UN's poverty expert, emphasized the need for governments to index social benefits and wages to inflation to ensure that the most basic necessities remain affordable for millions of people. He urged governments to involve individuals experiencing poverty in the design of policies to tackle the rising cost of living, citing the Guiding Principles on Extreme Poverty and Human Rights adopted a decade ago as a roadmap.

The UNCTAD's Trade and Development Report 2023 further highlighted the global economic slowdown, with growth decelerating in most regions compared to the previous year. The report called for a change in policy direction, including actions by leading central banks and institutional reforms promised during the COVID-19 crisis. It emphasized the importance of addressing issues such as inflation, inequality, sovereign debt distress, and enhancing oversight of key markets. The report proposed a balanced policy mix, incorporating fiscal, monetary, and supply-side measures to achieve financial stability, boost productive investment, and create better job opportunities, aiming to steer the global economy in the right direction.

6. Official documents and treaties about the issue

Revised estimates : Effect of changes in rates of exchange and inflation A/54/7/Add.9, 10
December 1999

<https://www.undocs.org/Home/Mobile?FinalSymbol=A%2F54%2F7%2FAdd.9&Language=E&DeviceType=Desktop&LangRequested=False>

and A/56/7/Add.4, 4 December 2001

<https://www.undocs.org/Home/Mobile?FinalSymbol=A%2F56%2F7%2FAdd.4&Language=E&DeviceType=Desktop&LangRequested=False>

and A/68/7/Add.24, 16 December 2013

<https://www.undocs.org/Home/Mobile?FinalSymbol=A%2F68%2F7%2FAdd.24&Language=E&DeviceType=Desktop&LangRequested=False>

General Assembly resolution (A/RES/40/249), December 1985

<https://digitallibrary.un.org/record/111749#record-files-collapse-header>

The Guiding Principles on Extreme Poverty and Human Rights (A/HRC/21/39), September 2012

<https://www.undocs.org/Home/Mobile?FinalSymbol=A%2FHRC%2F21%2F39&Language=E&DeviceType=Desktop&LangRequested=False>

7. Impact of the issue

Inflation, while serving some positive purposes, also brings about several negative effects, both in the short and long term. Some common negative impacts of inflation include:

1. **Disproportionate Impact on Low-Income Households:** Inflation tends to affect low-income households more significantly and rapidly than higher-income households. Those with lower incomes or fixed incomes may struggle to cover rising costs when inflation occurs.
2. **Higher Cost of Living:** Inflation leads to an increase in the prices of goods and services, resulting in a higher cost of living for consumers. Basic necessities like food and utilities become more expensive, putting a strain on household budgets.
3. **Higher Interest Rates:** Inflation affects not only the prices of goods and services but also interest rates. Central banks may respond to inflation by increasing interest rates to control the money supply. This, in turn, can lead to higher borrowing costs for individuals and businesses.
4. **Risk of Hyperinflation:** In extreme cases, prolonged and unchecked inflation can escalate into hyperinflation, where prices rise uncontrollably, eroding the value of a country's currency. This scenario can have severe economic and social consequences.
5. **Negative Impact on Bonds and Growth Stocks:** Inflation tends to result in higher interest rates. As interest rates rise, the yields on newly issued bonds also increase. This negatively affects the market price of existing bonds issued at lower yields. Additionally, growth stocks, which are often more expensive, may be adversely affected as inflation discounts the present value of their future cash flows more heavily.

Understanding both the positive and negative aspects of inflation is crucial for policymakers and individuals alike to make informed decisions regarding economic policies, investments, and financial planning.

8. Useful links

- <http://www.un.org>
- <https://www.un.org/ga/acabq/documents/all/539?order=title&sort=asc>

9. Bibliography

- <https://dictionary.cambridge.org/dictionary/english/inflation>
- <https://www.tutor2u.net/economics/reference/inflation-consequences-of-inflation>
- <https://wisevoter.com/country-rankings/inflation-by-country/>
- <https://tradingeconomics.com/venezuela/inflation-cpi>
- https://www.worlddata.info/africa/sudan/inflation-rates.php#google_vignette
- <https://www.investopedia.com/terms/i/inflation.asp>
- <https://www.investopedia.com/articles/insights/122016/9-common-effects-inflation.asp>
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- <https://www.un.org/ga/acabq/documents/all/539?order=title&sort=asc>
- <https://www.ohchr.org/en/press-releases/2022/10/increase-benefits-and-wages-line-inflation-or-lives-will-be-lost-un-poverty>
- <https://unctad.org/publication/trade-and-development-report-2023>