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Taking a deeper dive into the definition of inflation

Sometimes our familiarity with a topic gets in the way of our understanding of it. I often think that about inflation. It's widely known that inflation is a condition of rising prices, or what my favorite macroeconomics text defines more precisely in this way: "Inflation is an increase in the overall level of prices in the economy." And while this idea is serviceable for some purposes, it's pretty inadequate if you try to think about how a central bank goes about the business of controlling inflation.

Here's an example. Friday's retail price report for March revealed that prices rose 3.5 percent from February and averaged 3.7 percent (annualized) over the first three months of the year. I think it's pretty clear we have seen an "increase in the overall level of prices in the economy" this year. But how should the Federal Reserve respond to this rise?

I'm not going to offer an answer that question. I'm a policy adviser, not a policy maker. But we need to dig a little deeper into the textbook to get a better understanding of the inflationary process and how a central bank contributes to that process before we offer up an opinion on the matter.

The inadequacy of the textbook definition of inflation is a topic that's been bugging me for a long time. It's silent about the cause of the rise in prices and therefore does not make any distinction about whether the price increase is a corollary of the policies of the central bank or from another source that a central bank can only nominally influence. This distinction is an important one. (For what it's worth, this 1997 article I wrote explains how I think the term "inflation" has come to be synonymous with "price increase." And here's why I think a deeper appreciation of what constitutes "an increase in the overall level of prices" affects how one thinks about the inflationary experience in real time.)

Here's how economist Irving Fisher put it in his 1913 article "The Monetary Side of The Cost of Living Problem":

> "If it can be shown, for instance, that today the good things of this world are becoming scarce on the one hand while money and its substitutes are not becoming plentiful it would be reasonable to conclude that the fault lies with goods and not with money. If, on the contrary, it can be shown that money and its substitutes are becoming plentiful and that goods are not becoming scarce, it is reasonable to conclude that the fault lies chiefly on the monetary side."

Are all price increases inflation? Should central banks use their tools to fight against any rise in costs? The answers to these questions have important implications for how we measure inflation in the short run versus the long run, the horizon over which a central bank ought to be held accountable for achieving price stability, and how monetary policies should be calibrated in the face of rising prices.

In that spirit, the Atlanta Fed has developed an animated video that provides additional perspective on the issue of inflation—specifically, what sorts of price increases are part of the inflationary process that is under the control of the central bank, and which are not. This video is the first in a new series that covers economic issues and the work of the Fed. The video is part of the Atlanta Fed's new feature called "The Fed Explained," which includes a range of new and existing content. We hope these videos stimulate conversation on a range of topics important to the Federal Reserve. The format is targeted to the general public as well as to students and teachers, and we hope it provides an engaging supplement to the study of the Federal Reserve.

Let us know.

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