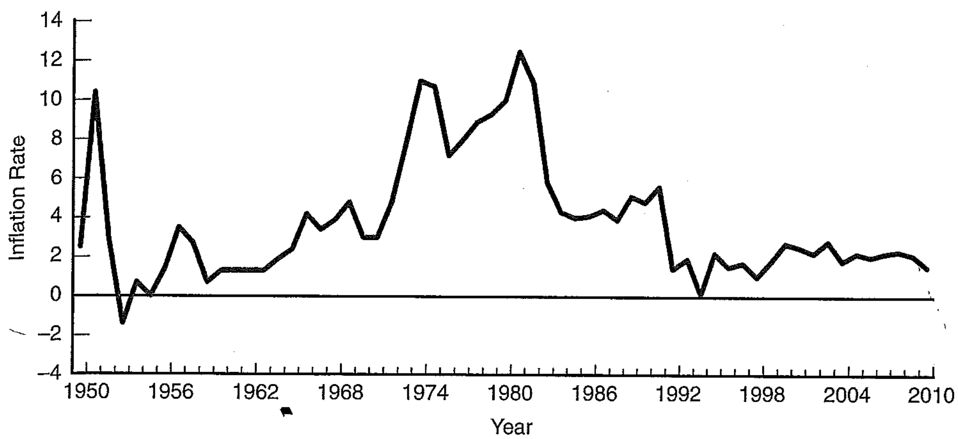


FIGURE 6–11
Inflation Rates in Canada

Canadian inflation rates rose considerably during the 1970s but have declined to much lower levels since the 1990s. Nevertheless, Canada has experienced some inflation every year since 1954.

Source: Adapted from the Statistics Canada CANSIM database, Series 737344.

6.5 Causes of Inflation

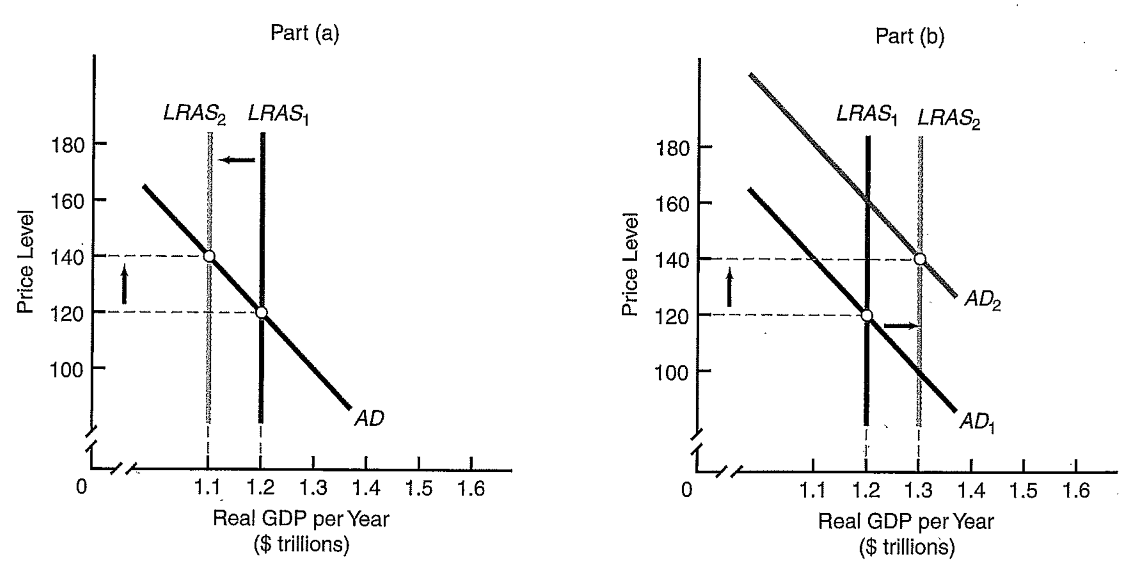
Of course, deflation has not normally been a problem in Canada. Figure 6–11 shows annual Canadian inflation rates for the past few decades. Clearly, inflation rates have been variable. The other obvious fact, however, is that inflation rates have been consistently *positive.* The price level in Canada has *risen* almost every year. For today's population, secular deflation has not been a big political issue. If anything, it is secular *inflation* that has plagued the nation.

Supply-Side Inflation?

What causes such persistent inflation? The model provides two possible explanations for inflation. One potential rationale is depicted in part (a) of Figure 6–12, which shows a rise in the price level caused by a *decline in long-run aggregate supply.* Hence one possible reason for persistent inflation would be continual reductions in the production of real output. This chapter's Issues and Applications will examine how climate change may be slowing the long-run growth of our economy.

FIGURE 6–12
Explaining Persistent Inflation

As shown in part (a), it is possible for a decline in long-run aggregate supply to cause a rise in the price level. Long-run aggregate supply *increases,* however, in a growing economy, so this cannot explain the observation of persistent Canadian inflation. Part (b) provides the actual explanation of persistent inflation in Canada and most other nations today, which is that increases in aggregate demand push up the long-run equilibrium price level. Thus, it is possible to explain persistent inflation in a growing economy if the aggregate demand curve shifts rightward at a faster pace than the long-run aggregate supply curve, as shown in part (b).



Recall now the factors that would cause the aggregate supply schedule to shift leftward. One might be reductions in labour force participation, higher marginal tax rates on wages, or the provision of government benefits that give households incentives *not* to supply labour services to firms. Although tax rates and government benefits have increased during recent decades, so has the Canadian population. Nevertheless, the significant overall rise in real GDP that has taken place during the past few decades tells us that population growth and productivity gains have dominated other factors. In fact, the aggregate supply schedule has actually shifted *rightward*, not leftward, over time. Consequently, this supply-side explanation for persistent inflation *cannot* be the correct explanation.

Demand-Side Inflation

This leaves only one other explanation for the persistent inflation that Canada has experienced in recent decades. This explanation is depicted in part (b) of Figure 6–12. If aggregate demand increases for a given level of long-run aggregate supply, the price level must increase. The reason is that at an initial price level, such as 120, people desire to purchase more goods and services than firms are willing and able to produce, given the currently available resources and technology. As a result, the rise in aggregate demand leads only to a general rise in the price level, such as the increase to a value of 140 depicted in the figure.

From a long-run perspective, we are left with only one possibility: Persistent inflation in a growing economy is possible only if the aggregate demand curve shifts rightward over time at a faster pace than rightward progression of the long-run aggregate supply curve. Thus, in contrast to the experience of people who lived in the latter portion of the 19th century, in which aggregate demand grew too slowly relative to aggregate supply to maintain price stability, your grandparents, your parents, and you have lived in times during which aggregate demand grew too *speedily*. The result has been a continual upward drift in the price level, or long-term inflation. Hyperinflation can be explained by the very rapid expansion of aggregate demand (usually due to excessive printing of money). One example of modern hyperinflation is found in Policy Example 6–2.

Figure 6–13 shows that real output has grown in most years since 1960. Nevertheless, this economic growth has been accompanied by higher prices every single year.

FIGURE 6–13

Economic Growth and Inflation in Canada, 1961 to 2009

This figure shows the points where aggregate demand and aggregate supply have intersected during the period 1961 to 2009. Canada has experienced economic growth over this period, but not without inflation.

Sources: Adapted from the Statistics Canada CANSIM database, Tables 380-0002, 380-0003.