

Inflation

What is inflation?

A pervasive and general rise in the average price level



What is the Consumer Price Index?

The CPI measures the price increases of a particular basket of goods and services

What is the price mechanism?

The adjustment of prices in response to changing market conditions

Is any increase in prices inflationary?

No, some prices will always increase because of the price mechanism

What three roles do prices play?

- convey information
- give incentives
- provide working capital

**Which two categories
is left out of the core
inflation rate?**

Food and energy

What is the recent history of inflation?

- 1946 to 1948 - 8% annually
- 1948 to 1970 - 2% annually
- 1969 to 1979 prices doubled
- Currently <http://www.forecast-chart.com/forecast-inflation-rate.html>

Why is inflation called an arbitrary tax?

Because it lessens people's disposable income while effecting them randomly

Who measures inflation?

It is published monthly by the Bureau of Labor Statistics



What is the consumer price index (CPI)?

A measure of the cost of a fixed “market basket” of consumer goods and services

Does this “fixed basket” change?

As people’s tastes and preferences change, what goes into the basket will change

If inflation is 10% and you get a 7% raise, what has happened to your money income? real income?

Your *money* income has increased by 7% but your *real* income has decreased by 3%

**What is the percent
increase from
\$30,000 to \$32,000?**

**Take the difference and divide
by the original number**

$$**\$2,000/\$30,000 = 6.7\%**$$

If your income goes up from \$30,000 to \$32,000 and inflation is 5%, are you better or worse off?

You are better off because your real income has increased by 1.7%

What is the Rule of 72?

Take any incremental increase and divide into 72 - the result will tell you how long it will take the value to double

**At 2% how long will it take
for prices double?**

36 years

**At 10% how long will it take
for prices to double?**

7.2 years

What gives anything value?

Usefulness and
level of scarcity

What gives a country's currency value?

The goods and services
of a country which
there is a demand

**Is there anything wrong
with a slow and steady
rate of inflation?**

**No, especially when
the inflation rate is
anticipated**

How does inflation change society?

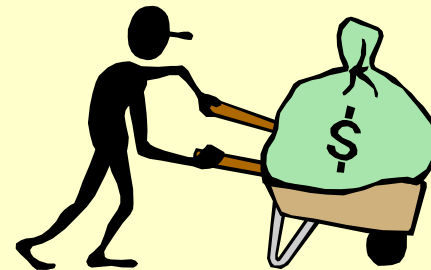
It breeds uncertainty, diminishes buying power, erodes real savings, causes unemployment, alters social traditions, and confuses the price mechanism

How did the inflation of the 1970's effect society?

- Fast food restaurants
- Two income families
- Change in family styles

What causes inflation?

The money supply has to increase more than goods and services increase



What does the foreign sector have to do with inflation?

If more money enters the country than leaves, the money supply increases

**What is the
equation of exchange?**

$$MV = PQ$$

Money

Velocity

$$MV = PQ$$

Price

Quantity

**What determines the
price level?**

$$MV/Q = P$$

What can lower the rate of inflation?

Decrease M , decrease V , and/or increase Q

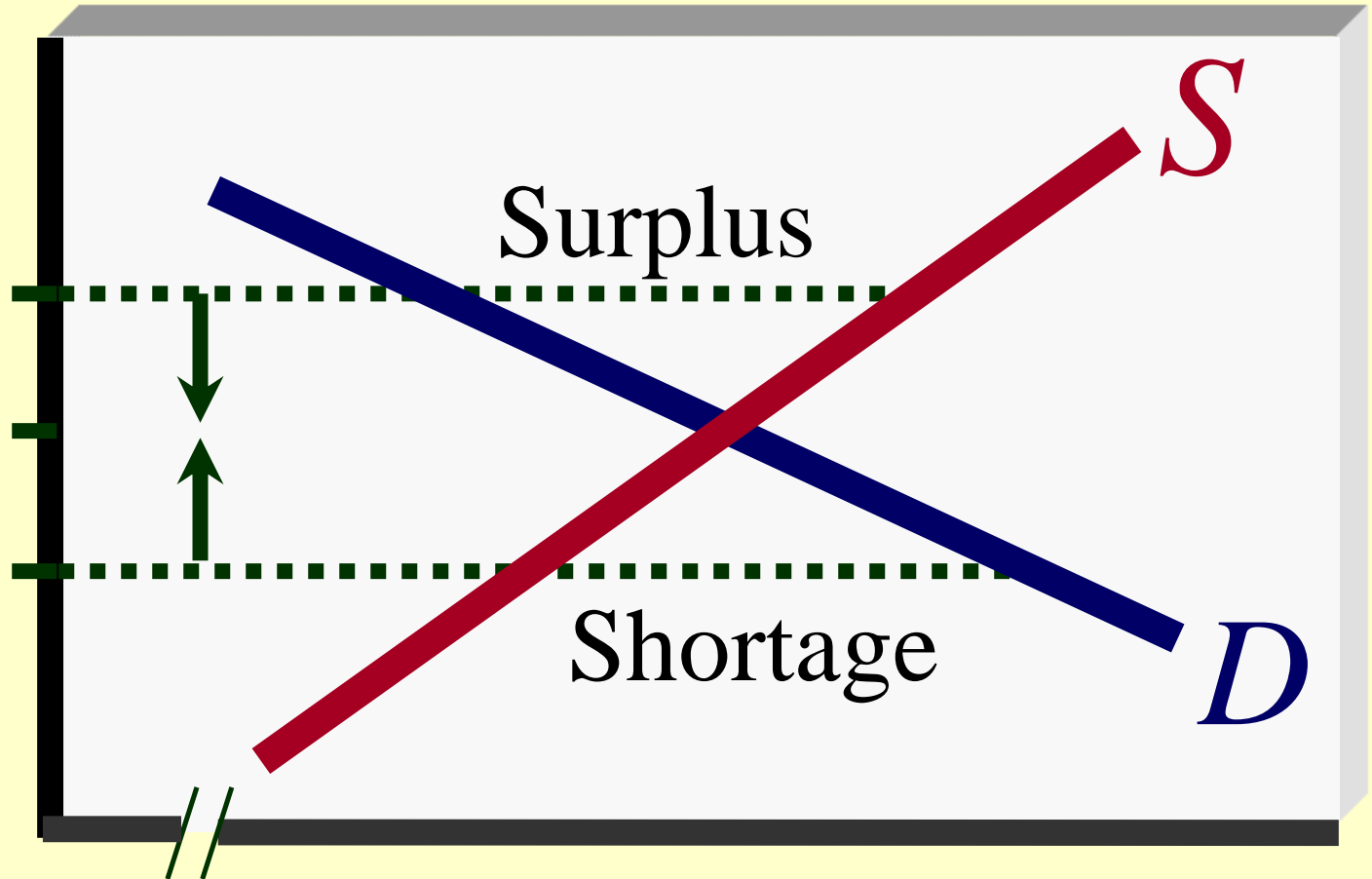
Who influences our money supply?

The Federal Reserve (Fed)



Do government mandated price controls work?

NO, they simply alter the economic system, for example, shortages in the former Soviet Union

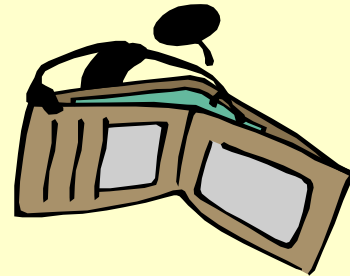


Can businesses or consumers cause inflation?

Maybe for a short time, but very quickly prices will come down due to a lack of buying power

Who is hurt the most by inflation?

Anyone on a *fixed
income* is hurt the most
by inflation



Who is hurt the most and the least by inflation?

The elderly are hurt the most, young married couples are hurt the least

How does inflation affect lenders and borrowers?

lenders are hurt more if the inflation is *unanticipated*

borrowers are hurt more if the inflation is *anticipated*

What is demand-pull inflation?

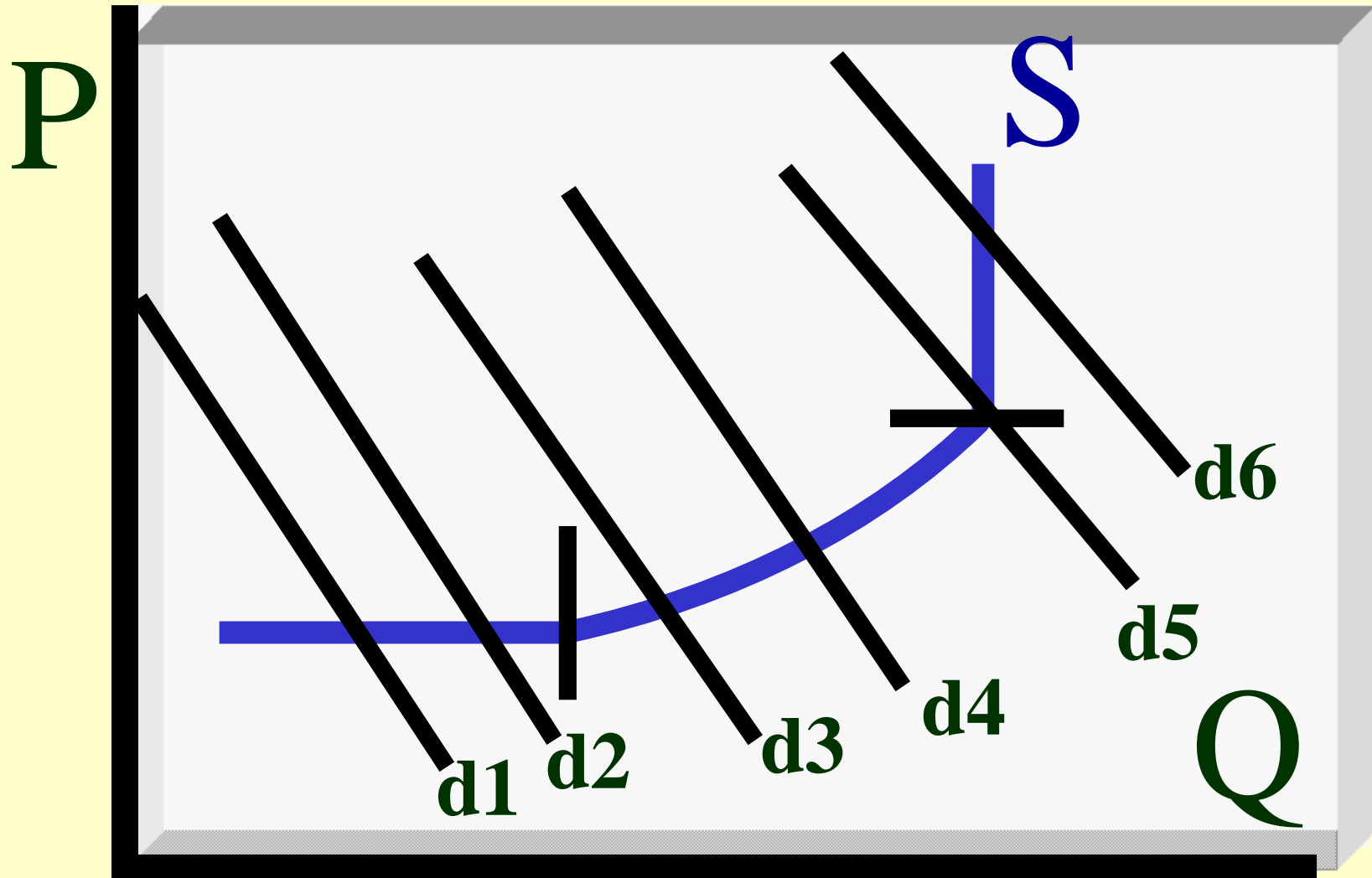
A sustained rise in the price level caused by increases in aggregate demand



Will any increase in demand cause inflation?

No, it depends on where the aggregate demand curve falls on the aggregate supply curve

Aggregate Supply Curve



Is it easy to fight demand pull inflation?

Yes!



When we lower demand prices will soon drop

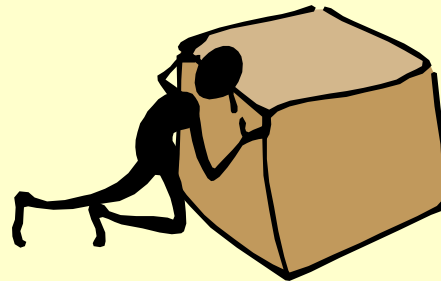
What is supply side inflation?

Inflation caused by
reductions in
aggregate supply



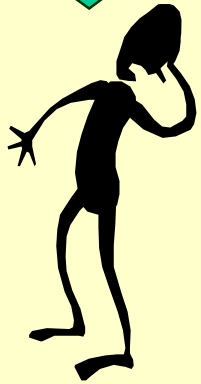
What is cost-push inflation?

An increase in costs
leading to an increase
in prices



Is it easy to fight cost push inflation?

No!



When we lower demand with cost push inflation it will take longer before prices decline

How bad was the inflation rate of the 1970s?

Inflation average 10% a year during the 1970s



What caused the inflation of the 1970s?

- OPEC greatly increased the price of oil in the early 70s
- Union bargained for higher wages greater than their increase in productivity

What is creeping inflation?

The slow but steady
increase in prices



What is hyperinflation?

A very high rate of inflation



What is an example of hyperinflation?

In 1923 the German mark inflated from 2,000 to the dollar to 4 trillion 200 billion to the dollar

What is deflation?

A sustained decrease
in the price level

What is disinflation?

A reduction in the
rate of inflation

What does interest mean?

The dollar amount paid to lenders to forgo present consumption and imposed on borrowers

What is interest rate?

Interest per year as a percentage of the amount loaned or lent

How are savers effected by inflation?

With an inflation rate of 3% and an interest rate of 3%, a saver breaks even, not considering the increase in their taxes

What is the nominal rate of interest?

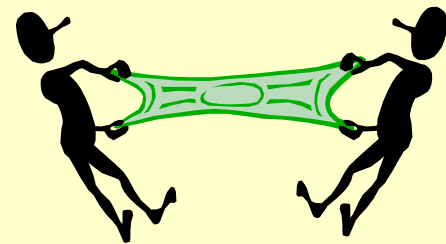
The interest rate expressed in current dollars as a percentage of the amount loaned

What is the real rate of interest?

The interest rate expressed in dollars of constant purchasing power as a percentage of the amount loaned

How do we measure the real rate of interest?

The nominal rate of interest minus the inflation rate



Why does higher inflation cause higher interest rates?

Lenders have to be rewarded in real terms

Also, the Federal Reserve may raise interest rates

How are investors effected by inflation?

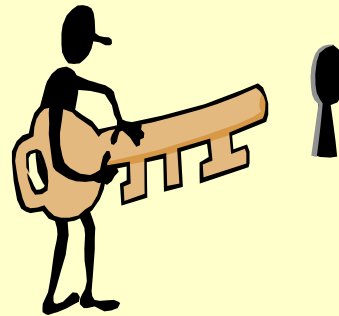
Because investors make decisions based on expectations, unanticipated inflation leads to uncertainty and a decline in investments

What fiscal policies would we use to bring down inflation?

- Cut government spending
- Raise taxes to pay debt
- Relax trade restrictions
- Increase productivity

How to protect yourself from hyper inflation?

- real estate
- art
- gold



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