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What Is Inflation?

By Cindy Grigg

Inflation is an increase in average prices that lasts at least a few months. What it really means to consumers is that the value of money goes down and it takes more money to buy goods and services.

Inflation affects all consumers- individuals, businesses, and government. Government spending is a large part of the U.S. economy. Government employs one out of every six workers. The costs of inflation affect everyone.

The Consumer Price Index (CPI) measures the cost of a set of goods and services and compares that to the cost of the same set of goods and services in the previous month or the previous year. The change in prices of this set of goods and services is a model. It lets economists estimate the changes in overall prices paid by all consumers.

The seasonally adjusted consumer price index was 194.1 in May 2005. In 1982, the index was equal to 100. This means that the average price for consumer goods increased by 94.1%. Another way to say this is that something that cost one dollar in 1984 cost $1.94 in May 2005.

The core CPI is the cost of the same set of goods and services, but not including food and energy. The prices of these two kinds of items vary widely from month to month. So economists give more attention to the core CPI. It tends to show trends in prices that are more lasting.

In April 2007, the CPI increased .7%. This is low compared to the rates of inflation during the 1970s and the 1980s. There is some concern, though, because over the last several months the rate has been increasing.

There are several different causes of inflation. It can be caused by increases in costs or increases in spending. Recently, the rising cost of oil has led to increasing costs for consumers. The cost of oil affects the cost producers pay to transport goods to markets. It affects the operating costs of businesses because they must heat and cool their factories and places of business. So when the cost of oil goes up, producers must increase their prices.

If demand in all areas of goods and services is higher than the supply, there is a scarcity. Producers lose customers because there is a shortage, so they raise their prices, causing inflation.

Higher prices cause workers to have less money for spending. They ask employers to raise their wages. When businesses have to pay their workers more, they raise their prices to protect their profits. This leads to a "wage-price spiral." Higher wages lead to higher prices, causing inflation.

Another reason for inflation has to do with the federal government's policy. If the federal deficit is very large, there is some shortage of money. Businesses may have to lay off workers. This causes the unemployment rate to rise and business production to go down.

When inflation is caused by changes in demand, it affects unemployment. If demand is rising faster than supply, unemployment is likely to decrease as prices increase. Producers need to hire more workers to make more goods to fill the demand. If spending is rising more slowly than supply, unemployment will likely go up while prices stay the same and inflation slows. If, however, inflation is caused by increases in cost, unemployment and inflation can both go up at the same time.

Fiscal policy is a tool the federal government uses to keep inflation and unemployment as low as possible. Fiscal policy describes the way the federal government taxes and spends. The government can change the amount of money people have to spend in two ways. It can change the amount of taxes people have to pay. It can also change the amount of money it spends. Choosing to have a deficit in order to accomplish its goals is an

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example of how the federal government uses fiscal policy. A deficit is when the government spends more than the money it has collected from taxing its citizens. Raising or cutting taxes is another way the government tries to manage the economy.

Until the 1930s, most economists thought that one of the best things governments could do for their citizens was to keep taxes low and keep the federal budget balanced. With a balanced budget, money spent is no more than money collected. In 1936, John Maynard Keynes published a book called *The General Theory of Employment, Interest, and Money.* This book suggested that the federal government could spend a country out of the depression by deliberately having a deficit. This book has been called the most important economics book of the twentieth century.

The federal government under Franklin Delano Roosevelt began to build small deficits. In the 1930s, the country was in an economic depression. In a depression, producers are unable to sell what they produce. Then they reduce the number of workers they employ. In the 1930s, unemployment was about 20%. That is, for every one hundred workers looking for a job, twenty of them could not find a job. Under Roosevelt, the federal government took a much more active role in shaping the economy than it ever had before. It continues to be active in running the country's economy.

What Is Inflation?

Questions

_____ 1. What happens when there is inflation?

A. Prices go up.
B. The value of money goes down.
C. It takes more money to buy goods and services.
D. all of the above

_____ 2. If inflation is 3% per year and the average income rose 5%, what has happened to real average income?

A. It increased 2%.
B. It decreased 2%.
C. It increased 5%.

_____ 3. If a sandwich cost $2.50 in 1982, what does it cost now with the CPI at 194.1? (Assume that the sandwich price rose at the same rate as other prices in the index.)

A. $3.50
B. $4.85
C. $2.35

_____ 4. Say that a family's annual income increased from $25,000 in 1982 to $45,000 in 2005. Considering the consumer price index, are they able to buy more or less in 2005?

A. less
B. more

_____ 5. What are the causes of inflation?

A. increases in costs
B. increases in spending
C. federal government's fiscal policy
D. all of the above

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6. What is a wage-price spiral?

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_____ 7. What is fiscal policy?
   A. describes the way the government taxes and spends
   B. a tool the government uses to keep inflation and unemployment low
   C. both A and B
   D. none of the above

_____ 8. How does the government control the amount of money people have to spend?
   A. cutting taxes
   B. raising taxes
   C. the amount of the federal deficit
   D. all of the above

9. What is a deficit?

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10. When did the American government begin having deficits?

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Explain how inflation and unemployment impose costs on individuals and government.

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Do you think the government should take a more active or less active role in managing the economy? Please explain.