

Inflation

What's Happening to the Value of My
MONEY?


- ▶ What is inflation?
- ▶ It is the rise in the general price level of goods and services.



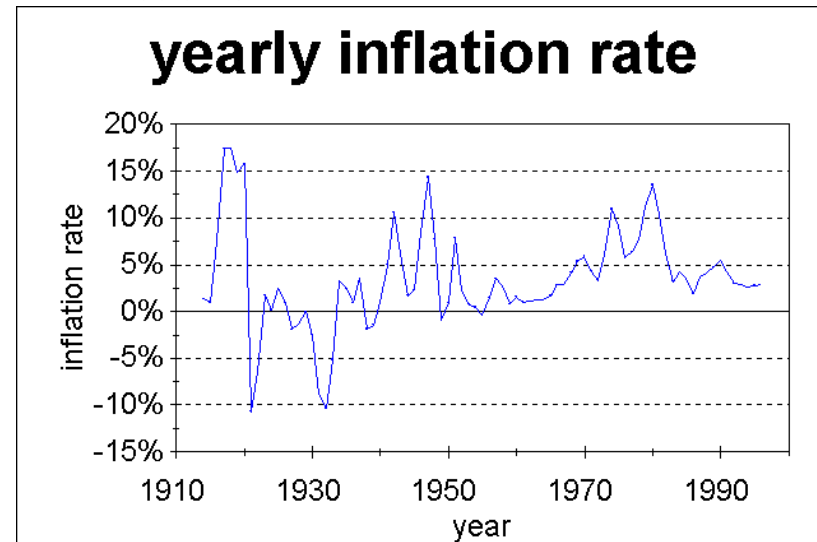
- ▶ How do we measure inflation?
- ▶ We use the CPI (Consumer Price Index). This is a “basket” of goods and services commonly purchased by consumers.
- ▶ Did the price of the basket rise from last year? By how much?



- ▶ **The CPI Market Basket**
- ▶ The CPI market basket represents all the consumer goods and services purchased by urban households. Price data are collected for over 180 categories, which BLS has grouped into 8 major groups. These major groups, with examples of categories in each, are as follows:
 - ▶ Food and beverages (ham, eggs, carbonated drinks, coffee, meals and snacks)
 - ▶ Housing (rent of primary residence, fuel oil, bedroom furniture)
 - ▶ Apparel (men's shirts and sweaters, women's dresses, jewelry)

- ▶ Transportation (new vehicles, gasoline, tires, airline fares)
 - ▶ Medical care (prescription drugs and medical supplies, physicians' services, eyeglasses and eye care, hospital services)
 - ▶ Recreation (television sets, cable TV, pets and pet products, sports equipment, admissions)
 - ▶ Education and communication (college tuition, postage, telephone services, computer software and accessories)
 - ▶ Other goods and services (tobacco and smoking products, haircuts and other personal care services, funeral expenses)
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- ▶ What is the inflation rate?
- ▶ It is the rate of change in prices over a period of time.
- ▶ What is a “normal” rate of inflation?



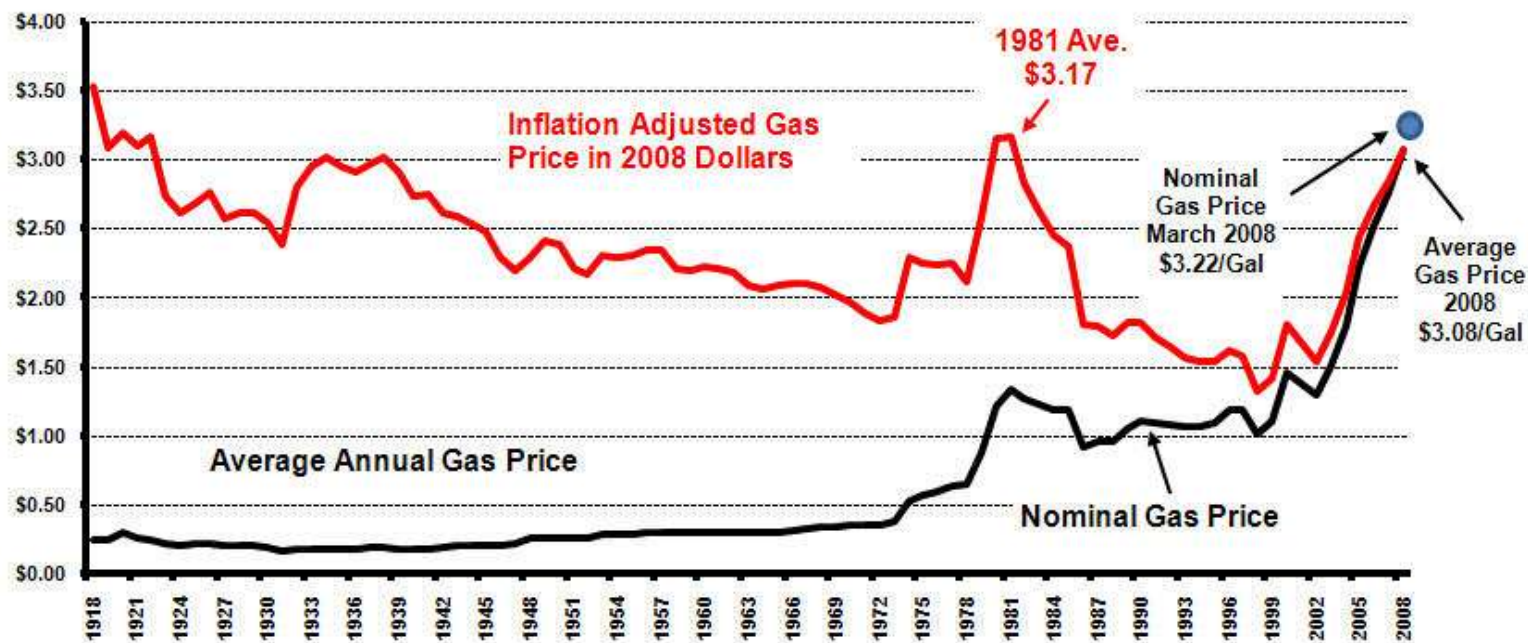
Gasoline Prices 1918-2008 Adjusted for Inflation

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www.InflationData.com

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Note: Prices are Average Annual prices not Peak Prices
so peaks are smoothed out considerably

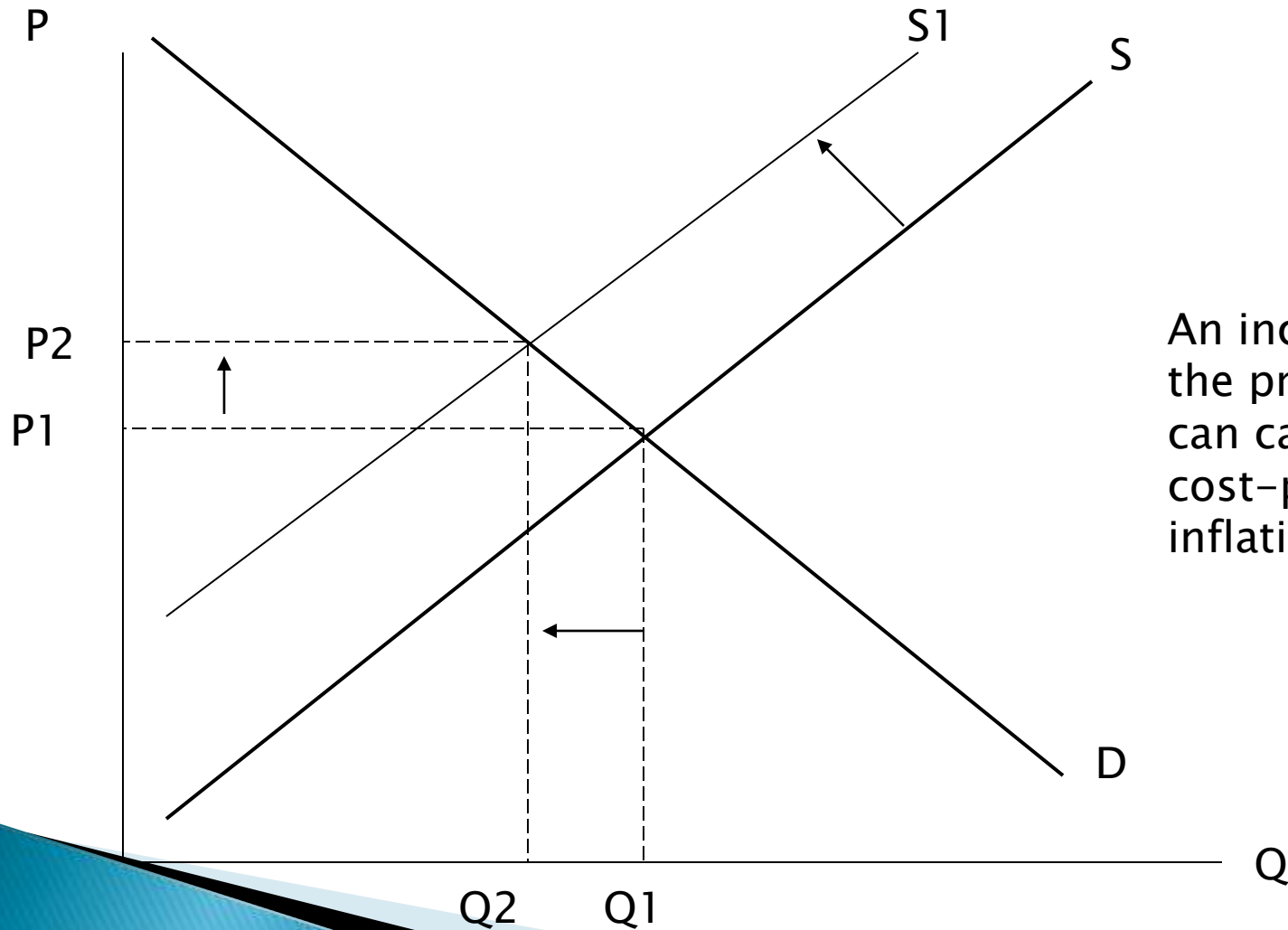
Source of Data: US Energy Information Administration
CPI-U Inflation index- www.bls.gov

What causes inflation?

- ▶ It depends on what type you're talking about!
- ▶ Cost-push: the price of producing a good increases, shifting the supply curve to the left.



How does decrease in S affect the price of the product?

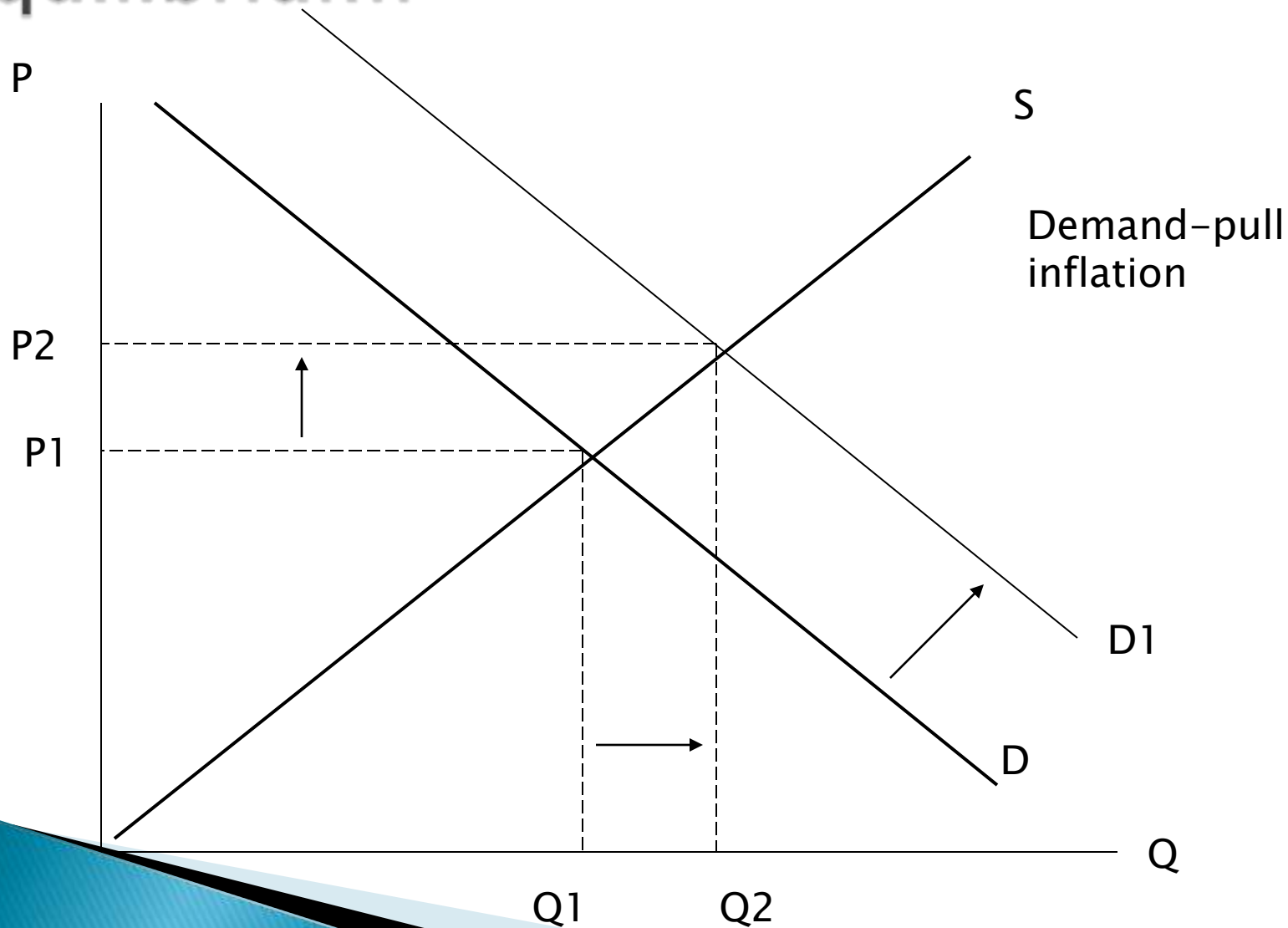


An increase in the price of oil can cause cost-push inflation.


- ▶ What is the other type of inflation?
- ▶ Demand-pull: demand for goods and services rise faster than production. This can be caused by printing too much money. What happens when demand curve shifts to the right?



How does increase in D affect equilibrium?



What about interest rates?

- ▶ When prices increase with inflation, interest rates tend to rise as well.
 - ▶ Real interest rate = nominal interest rate - inflation
 - ▶ For example, if your savings account pays 5% interest, but inflation is 3%, then your real rate of return is 2%.
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Does anyone benefit from inflation?

- ▶ Borrowers do!!
- ▶ If the nominal interest rate on my car loan is 7%, but inflation is 4%, the real interest rate is_____.



- ▶ Those on a fixed income (does not change over time) are hurt most by inflation.

