

Inflation: Do the Math

Some people remember the "good old days" when gasoline prices were as low as 25¢ per gallon. Some even recall when a can of soda cost 15¢. The fact is, prices tend to rise over time—sometimes steadily, and sometimes not so steadily. If you were ever asked to define "rising prices," you might answer with one word: "Inflation." However, if asked to give an explanation of inflation, and how it affects our economy as a whole, it might be difficult to present an accurate description.

It's easy to misinterpret inflation as the rise in price of individual goods and services. Actually, inflation is the increase in the average price level of all goods and services. For example, the price you pay for oranges may rise during the winter due to unseasonably cold temperatures in Florida. On the other hand, the average prices of all other items in your local supermarket may remain relatively level. In this case, the increase in the price of oranges is not a result of inflation, but rather a function of **supply** and **demand** specific to the orange market.

What Causes Inflation?

Inflation can result when either 1) the total of all goods and services demanded exceeds production, or 2) there is a decrease in the amount of all goods and services supplied by producers. Note how, in the example using Florida oranges, the supply and demand for oranges had no effect on inflation. However, changes in supply and demand on a broader scale can result in inflation.

Let's take a look at two economic scenarios. Suppose business is booming. Unemployment is low and the average worker's wages are increasing. As a result, consumers have more disposable income available and will, therefore, be able to purchase more goods and services. Average prices will tend to rise due to the increase in *demand* for all goods and services.

Now, let's look at another scenario. Suppose the economy is suffering. As unemployment rises and wages remain stagnant, consumers will be unable to purchase additional goods and services. As a result, producers will slow down production and raise prices in order to cut losses associated with decreased production. In this case, average prices will rise due to a decrease in the *supply* of all goods and services. This can be a vicious circle.

It's also important to keep in mind that households (consumers) are not the only market participants that can affect the economy. Businesses, government agencies, and foreign markets also spend billions of dollars on U.S. goods and services. Their spending, or lack thereof, can equally influence increases or decreases in supply and demand which, in turn, can result in inflation.

Inflation and Economic Policy Decisions

To a certain extent, some inflation may be a sign of a healthy economy. In fact, one of the economic policy goals of the United States is to maintain an inflation rate ranging from 0% to 3% per year. On the other hand, too much inflation, or no inflation at all, can be a sign of troubling economic times. Thus, one of the greatest challenges facing policymakers is to make decisions that will create desired results.

There are two federal economic policies used in an attempt to control the economy. **Fiscal policy**, which falls under the auspices of Congress, uses taxation and spending to reach full employment, stabilize prices, and boost economic growth. In contrast, **monetary policy**, which is controlled by The Federal Reserve Bank (The Fed), manipulates the money supply and short-term interest rates in an attempt to spur growth or control inflation.

Congress and, especially, the Fed look at the Consumer Price Index (CPI) when making policy decisions. The CPI is considered by many to be one of the best measurements of inflation. The CPI gauges the average change in prices paid by urban consumers for a fixed market basket of goods and services over a period of time. The CPI represents all goods and services purchased by urban consumers. Each month, the CPI is calculated and constant fluctuations in the CPI will ultimately result in Congress or the Fed taking appropriate measures to attempt to regain control of inflation. However, in the short-term, it is the Fed that holds the ability to react quickly. Congress, as we all know, requires political debate and the passage of legislation before fiscal decisions can be carried out.

On a Personal Level

In addition to creating higher costs for goods and services, inflation creates a depreciation in currency values. In other words, as prices increase, the purchasing power of your income, dollar for dollar, decreases. During sound economic times, increases in prices will usually be accompanied by wage increases that are equal to, or greater than, inflation. However, during downturns in the economy when wages remain level, the cost of living increases as your purchasing power diminishes. In actuality, regardless of what state the economy is in, one of your greatest challenges will be that your personal savings and investments will have to work harder to exceed inflation. Therefore, it's always important to take inflation into consideration, not only as you save and invest, but also as you make purchase decisions.