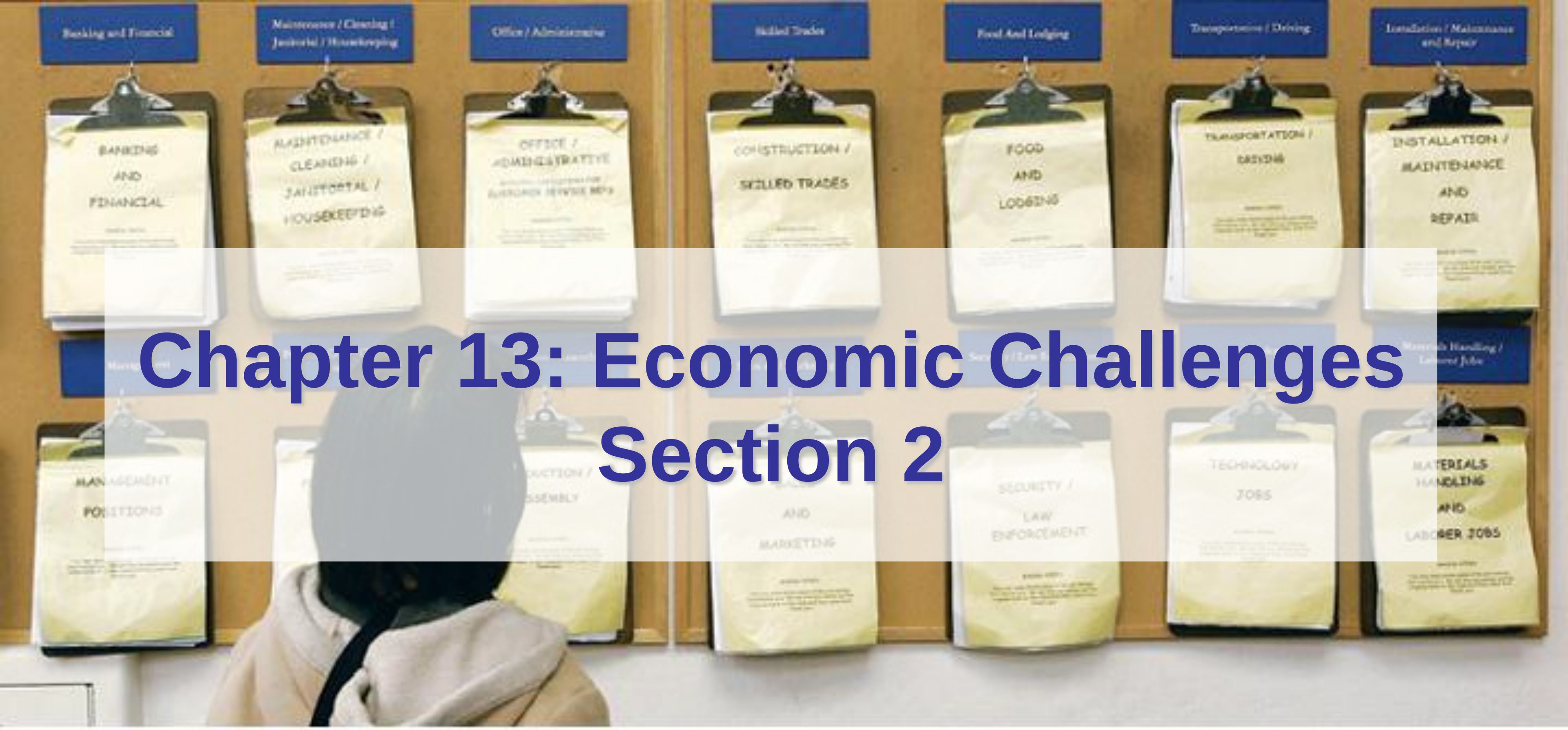

Chapter 13: Economic Challenges
Section 2

Prentice Hall

ECONOMICS

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Objectives

1. **Explain** the effects of rising prices.
2. **Understand** the use of price indexes to compare changes in prices over time.
3. **Identify** the causes and effects of inflation.
4. **Describe** recent trends in the inflation rate.

Key Terms

- **inflation**: a general increase in prices across an economy
- **purchasing power:** the ability to purchase goods and services
- **price index**: a measurement that shows how the average price of a standard group of goods changes over time
- **Consumer Price Index**: a price index determined by measuring the price of a standard group of goods meant to represent the "market basket" of a typical urban consumer

Key Terms, cont.

- **market basket**: a representative collection of goods and services
- **inflation rate:** the percentage rate of change in price level over time
- **core inflation rate**: the rate of inflation excluding the effects of food and energy prices
- **hyperinflation**: inflation that is out of control

Key Terms, cont.

- **quantity theory**: the theory that too much money in the economy causes inflation
- **wage-price spiral**: the process by which rising wages cause higher prices, and higher prices cause higher wages
- **fixed income:** income that does not increase even when prices go up
- **deflation**: a sustained drop in the price level

Introduction

- What are the causes and effects of inflation?
  - Inflation is caused by:
    - The growth of the money supply
    - Changes in aggregate demand
    - Changes in aggregate supply
  - The effects of inflation include:
    - Decrease in purchasing power
    - Erodes income
    - Decrease in interest rates

The Effects of Rising Prices

- Inflation is a general increase in prices across an economy.
- Over the years, prices generally go up. Inflation shrinks the value, or purchasing power of things.
  - The effects of inflation over the years can be seen in this comparison of prices for basic food items.

Food Prices*

	March 1996	March 2008
Bread, white (per lb.)	0.85	1.35
Eggs, large (per dozen)	1.14	2.20
Milk, whole (per gallon)	2.54	3.78

* U.S. City average
Source: Bureau of Labor Statistics

Price Indexes

- To measure inflation, economists compare price levels.
  - To help them calculate price level, economists use a price index, which is a measurement that shows how the average price of a standard group of goods changes over time.
  - Price indexes help consumers and businesspeople make economic decisions. The government also uses indexes in making policy decisions.

Consumer Price Index

- The best-known price index, the Consumer Price Index (CPI), focuses on consumers.
  - The CPI is determined by measuring the price of a standard group meant to represent the "market basket" of a typical urban consumer.
  - The market basket (right) is divided into eight categories of goods and services.

Category	Examples
Food and Drinks	cereals, coffee, chicken, milk, restaurant meals
Housing	rent, homeowners' costs, fuel oil
Apparel and upkeep	men's shirts, women's dresses, jewelry
Transportation	airfares, new and used cars, gasoline, auto insurance
Medical care	prescription medicines, eye care, physician's services
Entertainment	newspapers, toys, musical instruments
Education and communication	tuition, postage, telephone services, computers
Other goods and services	haircuts, cosmetics, bank fees

SOURCE: Bureau of Labor Statistics

Consumer Price Index, cont.

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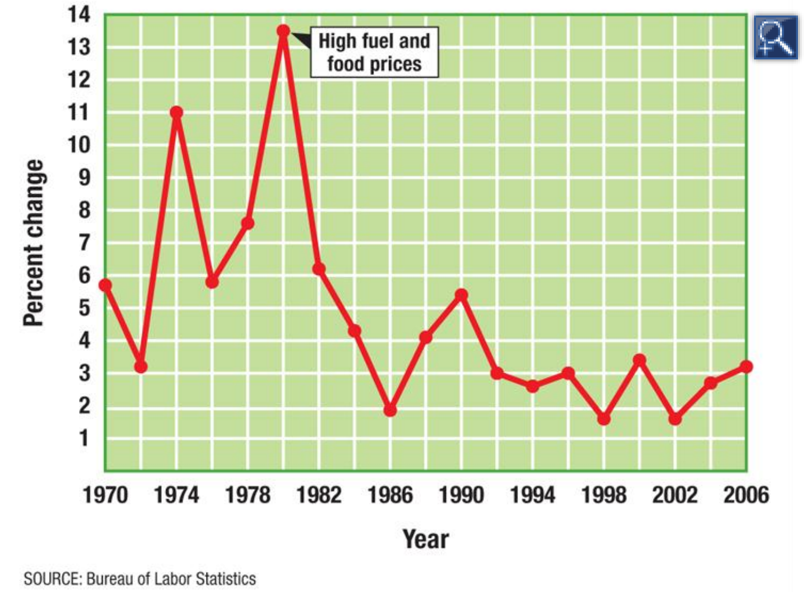
- About every 10 years, the items in the market basket are updated to account for shifting consumer buying habits.
- Economists also find it useful to calculate the inflation rate—the percentage rate of change in price level over time.
  - To determine the CPI, the BLS establishes a based period to which it can compare prices.
  - Currently the base period is 1982-1984.
  - The BLS determines the CPI for a given year using the following formula:

$$\text{CPI} = \frac{\text{updated cost}}{\text{base period cost}} \times 100$$

Types of Inflation

- Inflation rates in the United States have changed greatly over time.
  - When the inflation rate exceeds 5 percent, it makes economic planning difficult.
  - The worst kind of inflation is hyperinflation in which inflation rates can go as high as 100 or even 500 percent per month.



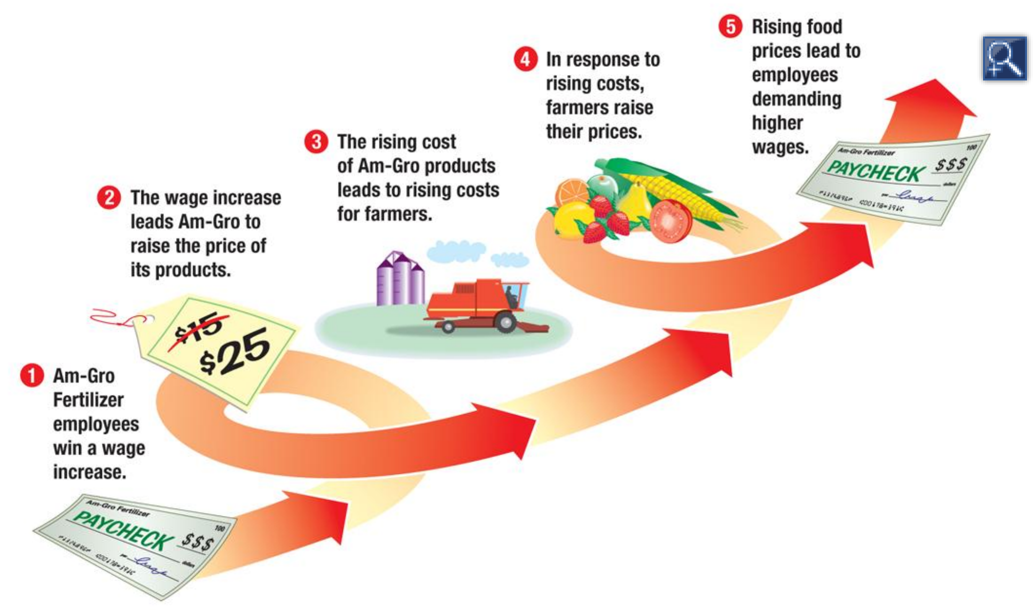
In what years was inflation so high that it made economic planning difficult?

Causes of Inflation

- Checkpoint: What are the three causes of inflation?
  - Growth of money supply—too much money in the economy causes inflation
  - Changes in aggregate demand—inflation can occur when demand for goods and services exceeds existing supplies
  - Changes in aggregate supply—inflation can occur when producers raise prices in order to meet increased costs.
    - Wage increases are the largest single production cost for most companies.

Wage-Price Spiral

- Increasing wages can lead to a spiral of ever-higher price because one increase in costs leads to an increase in prices, which leads to another increase in costs, and on and on.
  - This process is known as the wage-price spiral.



Effects of Inflation

- High inflation is a major economic problem, effecting purchasing power, income, and interest rates.
  - Inflation can erode purchasing power. It the inflation rate is 10 percent, $1.00 will buy the equivalent of only $.90 world of goods today.

Effects on Income

- Inflation sometimes, by not always, erodes income.
  – If workers' wages do not increase as much as inflation does, they are in a worse economic position than before.
  – People living on a fixed income, like retired people, are especially hard hit by inflation because their money does not increase, even when prices go up.

Effects on Interest Rates

- People receive a given amount of interest on money in their savings accounts, but their true return depends on the rate of inflation.
  - If the inflation rate is higher than the bank's interest rates, savers lose money.

Recent Trends

- Americans under age 30 have experienced fairly low inflation rates for most of their lifetimes.
  - In the 2000s, the economy actually seemed to be experiencing a period of deflation, or a sustained drop in the price levels.
  - However, by mid-2008, inflation was becoming a worry. The CPI rose 1.1 percent in June. Higher production costs, fueled by a 6.6 percent increase in energy prices, helped push the annual inflation rate to more than 4 percent.

Review

- Now that you have learned about the causes and effects of inflation, go back and answer the Chapter Essential Question.
  - How much can we reduce unemployment, inflation, and poverty?