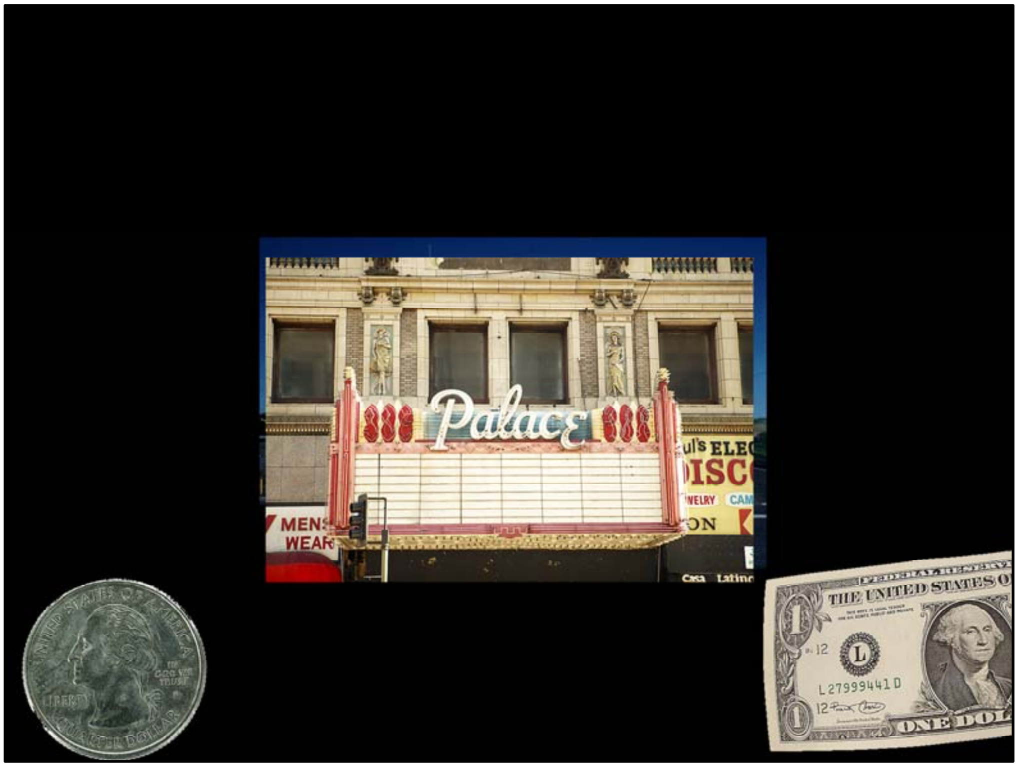
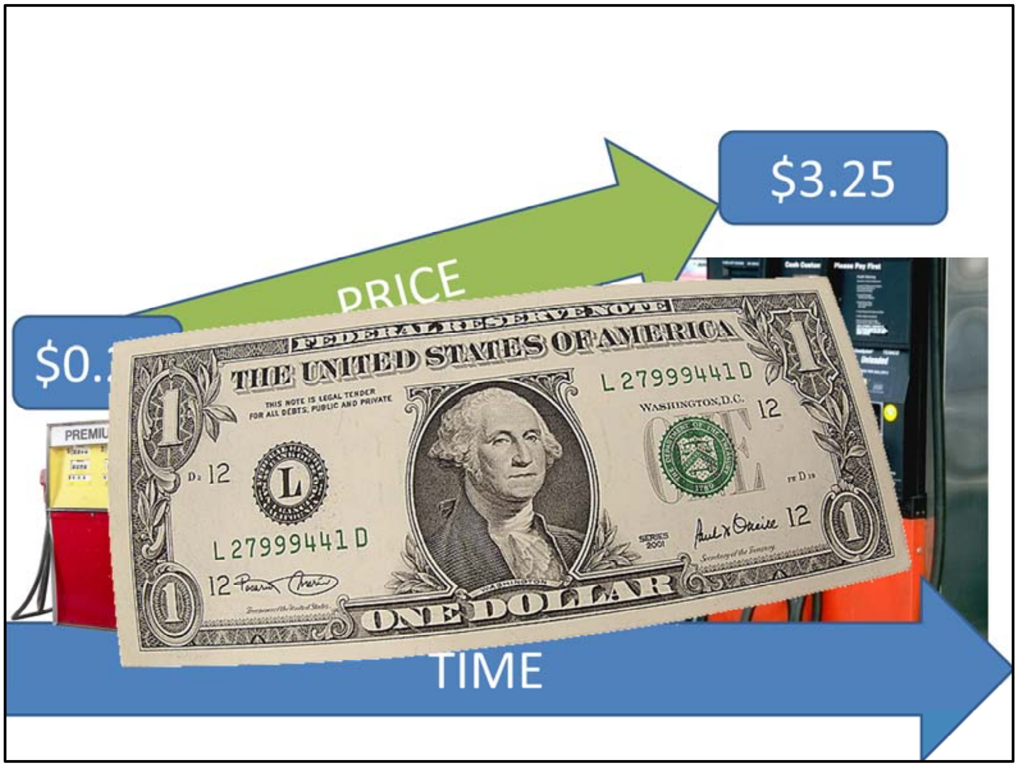


Have you ever heard your grandparents say that they paid a quarter for a gallon of gas? Or, have you ever heard them say that they paid one dollar to see a movie? If that was the case, then why are those things so much more expensive now?

If you said inflation you’re right.

So, what exactly is inflation and how does affect people? Is inflation always a bad thing?



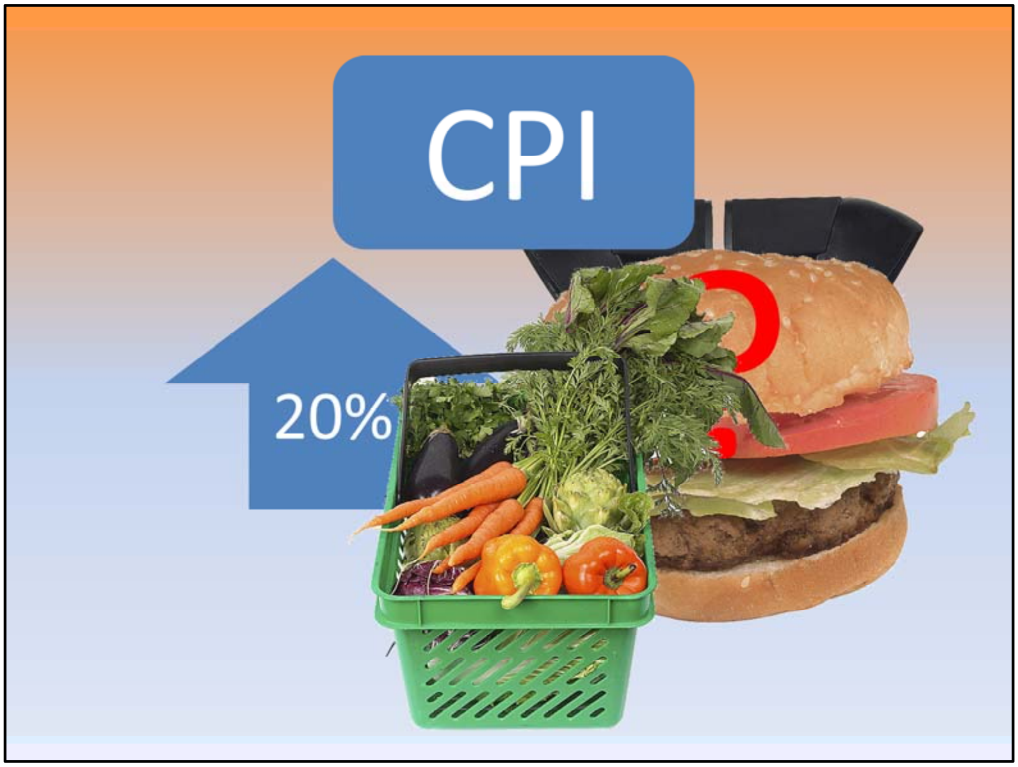
Inflation is when the average price of goods rises over time. In other words, you get less for your money today than you did in the past.

Your grandparents may talk about getting gas for a quarter. Nowadays, you're lucky to find gas for between two and three dollars. Over time, the value of your money has shrunk with respect to gasoline.

Suppose you bought a pair of shoes six months ago for fifty dollars. You liked the shoes so much that you went back a year later to buy another pair and now they cost sixty dollars due to inflation. Although the money in your pocket is worth less, you may not be making more at your job, which means that you have the same amount of money to buy the same items that now cost more. Obviously, as prices go up, you either have to make more money, or buy less.

Inflation is usually referred to as a percentage. In this example, inflation for these shoes was twenty percent per year.

So, next time your parents decide to give you the same allowance that they have given you over the past few years, tell them that you need a raise due to inflation.

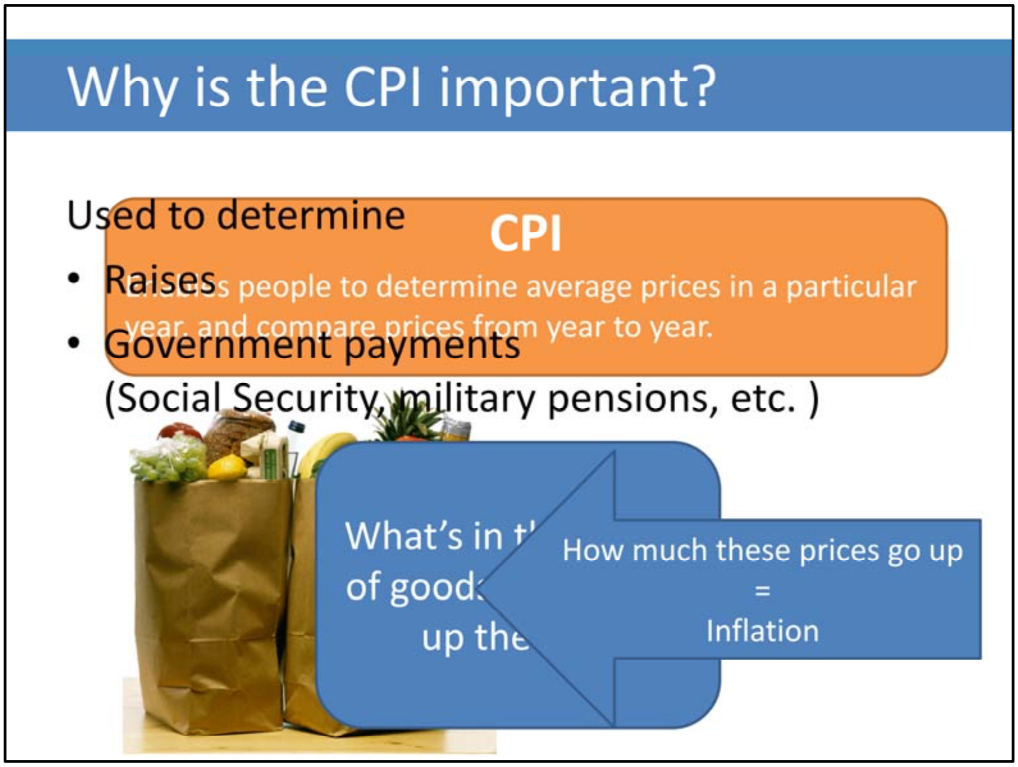


How do economists measure inflation for the entire economy?

In the last example, we saw that the price of shoes went up twenty percent in one year. Does that mean the price of all other goods also went up by twenty percent? Maybe the shoes went up so much because one of the primary components that go into the shoes, like leather, went up in price.

In order to measure inflation for the entire economy, economists had to come up with a way of measuring the prices of goods that affect the most people. They decided that rather than tracking the price of all goods, they would select a group of products that *most* people buy and look at prices for those. That way, they could compare the prices from year to year for the same items to see how much the cost of living was going up due to inflation.

The number they came up with is called the Consumer Price Index, or CPI. This index measures how prices change over time for urban consumers, who constitute eighty-seven percent of the American population.



Why is the CPI important?

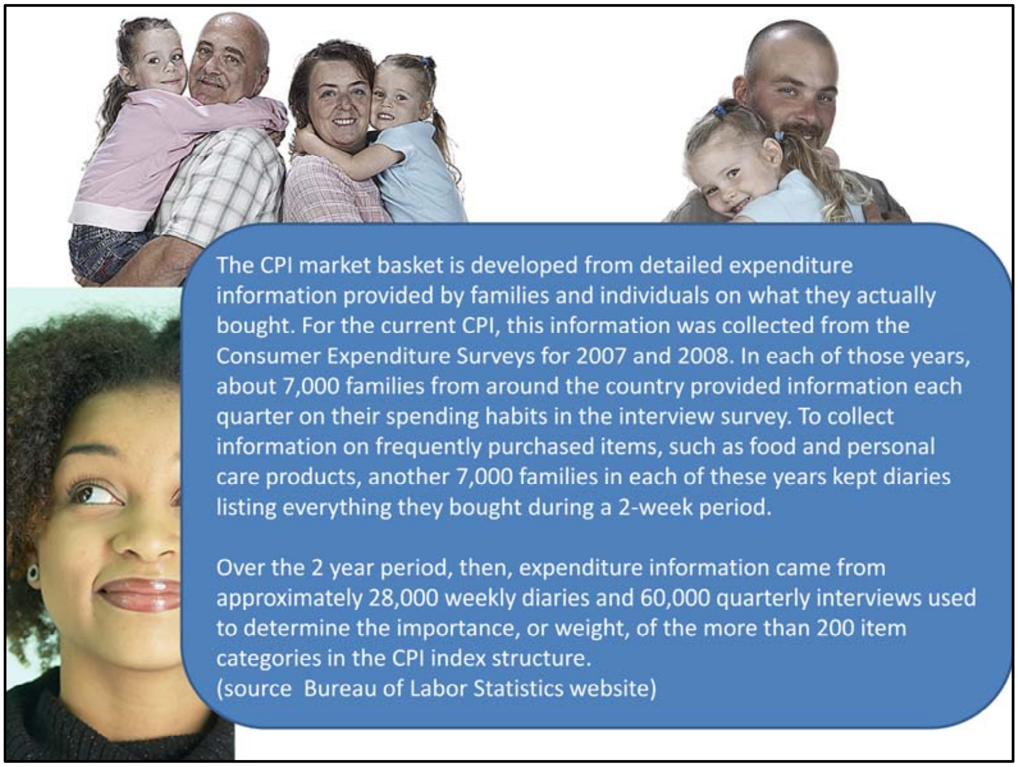
This index enables economists and regular people to find out about the average prices in a particular year, and compare prices from year to year.

Economists select an assortment of goods to create a price index, which measures how fast the prices of the things you buy every day are going up. This increase in CPI is what most people consider the inflation rate.

Beyond tracking inflation, the CPI is used to determine all kinds of real-world numbers such as raises, and government payments such as Social Security, food stamps, and military pensions, among others.

Do you know anyone who works for a company with a union? The CPI actually affects wages set by collective bargaining agreements.

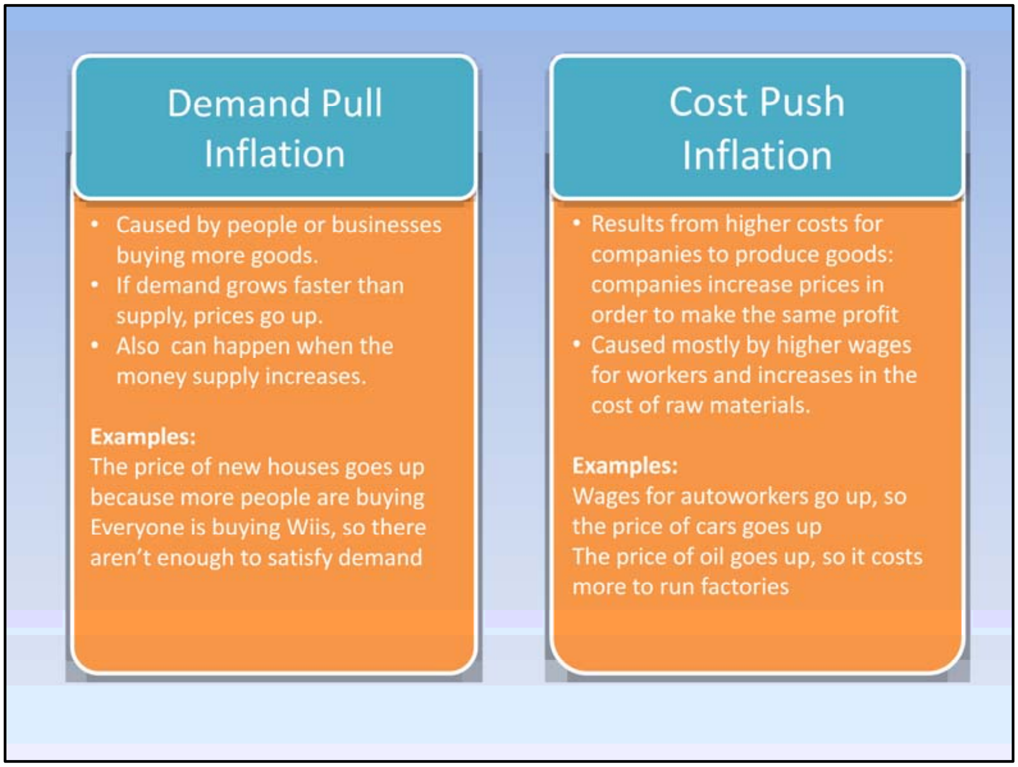
Click the box to see a more detailed explanation of how economists determine which items to track.



The goods included in the CPI change over time. Why do think this is?

Do you or your parents buy things now that you didn't before? What about cell phone service? As the majority of people got cell phones, cell phone service became part of the CPI.

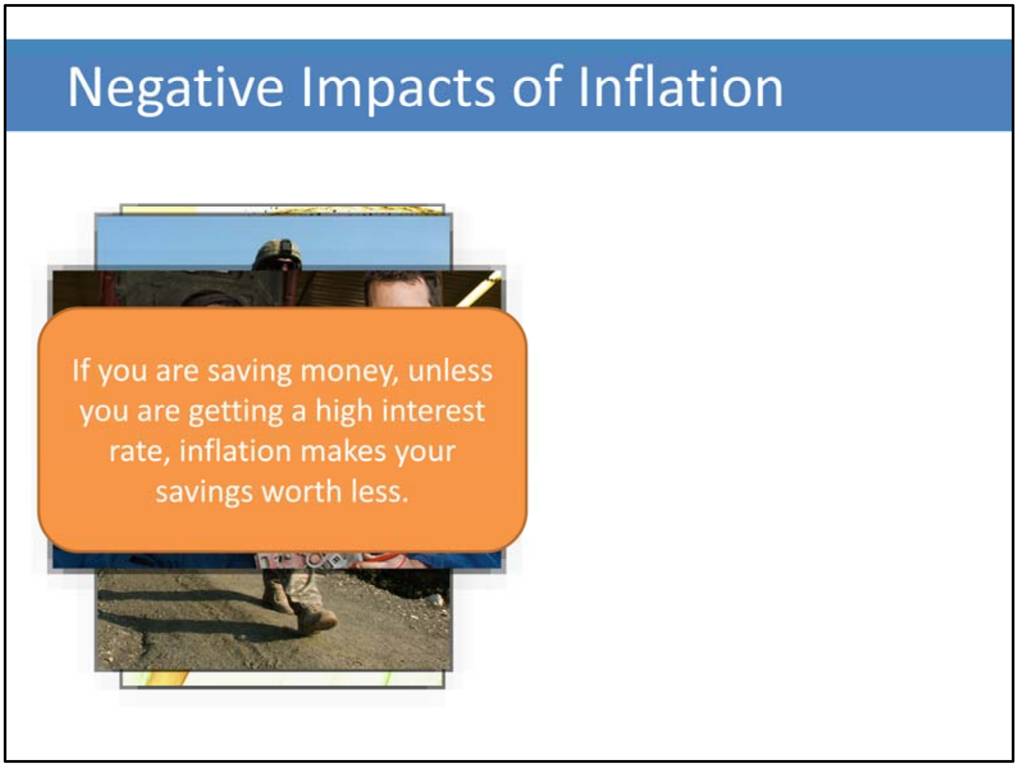
Any time the majority of people start or stop buying something, it is either added to, or removed from the CPI.



There are two main types of inflation, each with different causes: demand pull inflation and cost push inflation.

Demand pull inflation is caused when supply and demand are out of balance. As you learned when you studied how supply and demand affect prices, when more people want an item than is available, the price of the item goes up, for example, when you try and buy the latest electronic gadget that everyone wants.

Cost push inflation occurs when it costs companies more to produce things. In order to keep making profits, companies raise prices. This type of inflation is caused mostly by two factors: higher wages for workers, and higher costs of raw materials that go into the products.



So, who is affected by inflation? We all are.

The groups who suffer the most when prices rise are people on fixed incomes, people that always get the same amount of money every month. Also, people with salaries that aren't rising as fast as the rate of inflation can afford less each month. Companies that lend money to people or businesses make less profit on these loans. Finally, if you are saving money, unless you are getting a good interest rate, inflation makes your savings worth less.

People whose salaries include cost of living adjustments that take inflation into account are not affected as much by inflation.

High inflation can also hurt the economy because it increases the risk of buying things. Say you were thinking about buying a car: should you buy the new one for twenty thousand dollars, or the used one for five thousand?

If inflation is high, and your salary isn't rising as fast, you might be worried that you won't be able to pay your bills, or pay for other things that are going up in price. Since you are uncertain how much money it will cost next year for all the things you need, you probably won't buy the new car since it's a riskier purchase.

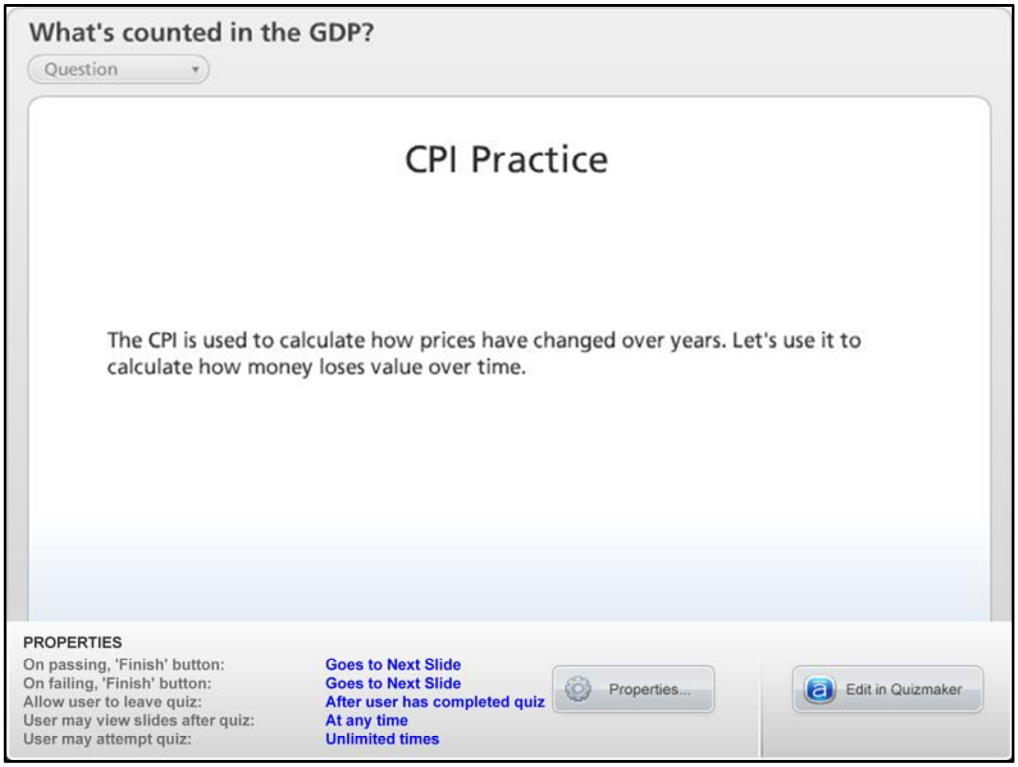
Businesses may respond to inflation in the same way. Since they are uncertain whether people will keep buying their goods, they may not hire workers or build new factories. They may even decide to reduce costs by laying off people in order to protect their profits.

Positive Impacts

Does anyone benefit from inflation?

Well, if you took out a five-year loan for a car at five percent and the rate of inflation is ten percent, then the car is costing you less over time because your payments remain the same. The same could be said about your mortgage, if the payments are the same every month.

This isn’t to say that inflation is a good thing. The higher prices you pay for all the other things may wipe out these benefits. It’s important to consider inflation, however, especially when you’re making a long term decision about buying something like a house, a car, or taking out a student loan. Inflation may decrease the cost more than you expect.


What's counted in the GDP?
Question
CPI Practice
The CPI is used to calculate how prices have changed over years. Let's use it to calculate how money loses value over time.
PROPERTIES
On passing, 'Finish' button: Goes to Next Slide
On failing, 'Finish' button: Goes to Next Slide
Allow user to leave quiz: After user has completed quiz
User may view slides after quiz: At any time
User may attempt quiz: Unlimited times
Properties...
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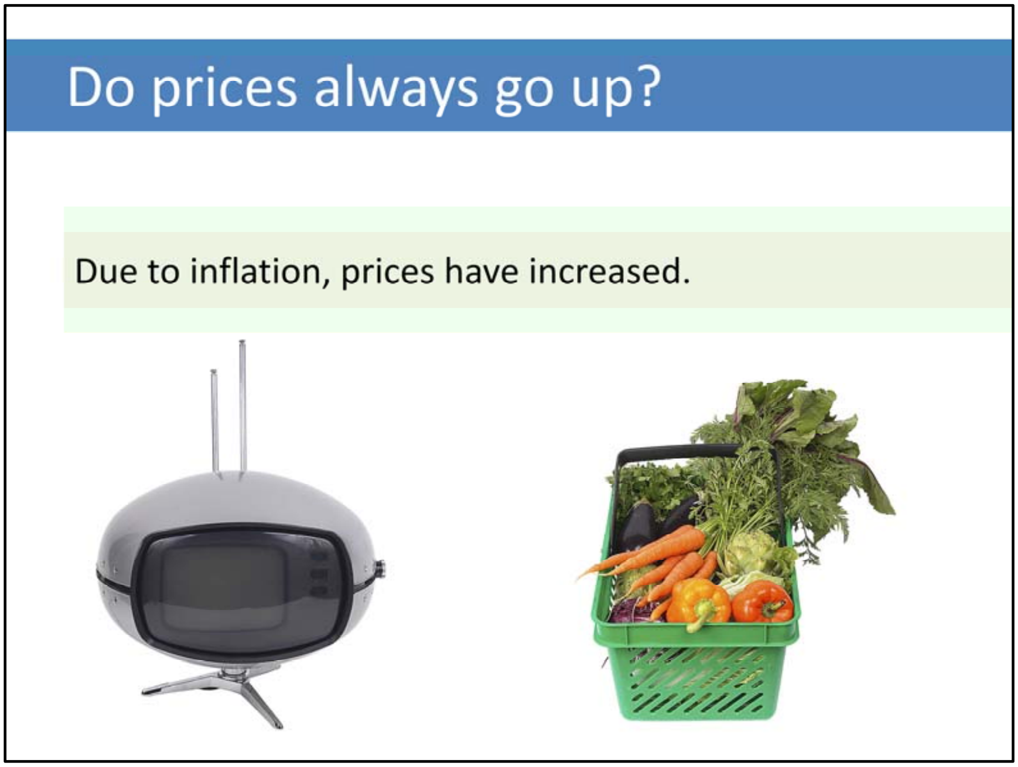

Have prices increased or decreased since you were born? Due to inflation, prices have increased.

This is not always the case. Have you ever bought a really expensive high tech product when it first entered the market? Prices for these goods often decrease as companies learn how to produce them more cheaply. Think about new technology like flat screen TVs that seem to be replaced almost daily by newer, better goods.

It may seem like prices are always going up, however, prices for goods can go up at different rates, so that some things may take up less of your total paycheck. For example, food takes up much less from the average household's income than it used to. Even though prices for food have risen due to inflation, they've risen at a slower rate making them "cheaper."

Understanding how economists determine the rate of inflation and how it impacts your life can help you make better decisions about the present and the future.