PNW 207 Revised March 1981

Mini-Guide to Inflation

A Pacific Northwest Cooperative Extension Publication

If you were asked to discuss *inflation,* what could you say about it? Could you define it? Give possible yardsticks for measuring it? Tell what causes it? Give some remedies?

"Inflation is a condition of significantly or substantially rising prices," says one economist. When average prices go up 3 percent or more a year, the country is in a state of inflation.

To measure inflation, the most popular yardstick is the Consumer Price Index. The Department of Labor checks prices throughout the country every month for several thousand selected goods and services which the typical family buys. How these figures compare with the 1967 prices is shown in the Consumer Price Index. If it costs $225 to buy these selected goods and services that could be purchased for $100 in 1967, the consumer price index for the month is $225. Mass media reports this index each month.

Another yardstick is the Producers Price Index. The PPI relates the current prices paid by producers for the raw material for semi-finished goods they buy to prices charged for the same items in the past. Future retail prices are forecast by this index, as extra costs are often passed on to the customers.

Recent inflation years were 1946, 1947, 1948, 1951, 1957 through 1971, and 1973 to present.

During World War II, people saved money. (It was the fashionable and patriotic thing to do because there was little to buy, since manufacturers were busy making war goods.) After the war, people rushed out and bought all sorts of things they had not been able to buy for 5 years. They were willing to pay almost any price. Manufacturers could not fill the demand and prices rose. As plants were converted from war goods to peacetime products, output rose and inflation slowed. There was no further period of sustained, serious inflation until the one we have been experiencing for the past ten years. This inflation was started in 1967 by the extra spending for the Vietnam War added on top of the high level of spending by consumers, business, and government.

Factors that can cause inflation (or keep it going), working separately or together:

- ✓ People have increasing amounts of money to spend—incomes in general are rising.
- ✓ People are confident of the future and eager to buy things even if it means borrowing. Or they buy because they believe that the future prices of things will rise faster than the interest on savings.
- ✓ Business is spending more in new plants and equipment, bidding up materials and labor prices as shortages develop. (When in production, the extra goods from these new plants will help slow inflation—but not now.)
- ✓ Government increases its level of spending.
- ✓ Government lowers taxes.
- ✓ The output of goods and services is not rising as fast as demand for them.
- ✓ Higher costs of inputs (wheat for bread, oil for fuel or plastics, wages of labor).
- ✓ Productivity (output per worker hour) is not going up enough to match the higher costs. If productivity did increase enough, the higher costs would be divided among enough more units of that product so costs *per item* would remain the same and so could the price. It is cost *per item* that influences the price per item.

Who gets hurt during inflation? If inflation continues over a long period, everyone gets hurt. Even if your income rises, you are paying a larger percent of income as taxes. Over a short period of inflation those who feel the pocketbook crunch are:

- ✓ *Retired people:* They are often on fixed incomes, and with prices rising, each dollar buys less.
- ✓ *People with savings:* With a 10 percent inflation, each $100 in savings at the end of a year buys only as much as $90 would have bought at the beginning of the year. The interest people earn on their savings often is not enough to make up for the dollars of lost purchasing power, and thrift is undermined.
- ✓ *People who lend money, including those who own bonds (government or business):* If interest rate paid lenders is less than the inflation rate, these people lose purchasing power.

√ *Low-income people:* After paying inflated prices for goods and housing, there is little left for other things.

√ *People in jobs related to producing services rather than goods:* Their wages are less likely to rise as fast as prices, so they lose purchasing power. (The exception: Wages or salaries of producers of services that are necessities and/or in short supply, like doctors, are more likely to rise as much as prices.)

Who "wins" during inflation?

√ *People who owe money:* A $100 debt can be repaid with dollars having the purchasing power of $90 if there is a 10 percent inflation. Real estate mortgages are often viewed as a benefit to the borrower in times of inflation.

√ *People who own real estate:* They often benefit because, for many kinds of real estate (but not all), prices tend to rise. This possibility, however, is only one factor in evaluating real estate as an investment.

During inflationary periods, everybody tries to beat the game. Interest rates go up; wage earners ask for more money; people save less. People earn more, but prices rise, and few people are really better off.

Inflation is an international problem. It disrups planning for the future. Worst of all, it makes a mockery of those things that make a people and a nation strong—hard work, saving, and planning.

There is another factor that affects the economy—when people expect prices to continue to rise rapidly, they buy now to beat price increases. People may want to borrow to buy, business builds big inventories, and workers demand increased wages.

What can families do to live with inflation?

√ Increase their earnings (higher pay or change to a better paying job) or increase the number of wage-earners, so income rises as fast as prices.

√ Do without some products and services of less importance to them.

√ Compare prices and quality of products and services to get the "best buy."

√ Make and do more things for themselves.

√ Watch to see their use of credit does *not* expand faster than their incomes.

√ Use public services.

√ Make things last longer by care and upkeep.

√ Do not waste what they have.

To slow down inflation as a nation, we must reduce total spending, increase total output, or both.

1. People need to see that their use of credit does not expand faster than their incomes.
2. Business can produce more goods and services.
3. Governments (federal, state, and local) can:
   Reduce government spending.
   Increase taxes, thus reducing consumer, spending.
   Balance budgets—no deficits.
   Establish consumer credit controls by federal government. Increasing the down payment required and shortening the loan period for cars and other consumer products would lessen the demand.
4. Federal Reserve System (our central bank) can:
   Reduce the amount of loanable funds local banks have, then there would be fewer loans, less spending.
   Raise the interest (discount) rate so fewer people and businesses want to borrow and spend.
5. The real, long-run cure for inflation is to increase the *productivity* of business, labor, and government. Then we get increased output. Things that increase productivity include research and development, investment in new, more efficient plants and equipment, development of more efficient management, and better use of a more highly skilled and productive labor force.

In periods of severe inflaion the government may ask for price and wage "freezes," or controls, as in the early 1970's. Economists differ widely on the desirability of such controls, many feeling they just postpone, not cure, inflation.

When incomes do not rise as fast as prices, purchasing power drops, so families must cut the quantity they buy. As demand for goods and services slackens, the inflation will cool, so prices will not go up so rapidly, say only 6 percent a year rather than 10 percent. But not many prices will actually drop. To put it in another way, the inflation will decelerate but not disappear. Most economists feel that prices can be expected to rise at least 8 percent a year, on the average, for the next 10 years. (Some years prices may rise more than 8 percent, some years less.)

With less demand for goods and services new problems develop:

√ *Unemployment:* Young workers, women, and minority groups suffer first, as well as blue collar workers.

√ *Home building, related industries, and small business* are the first hurt by reduced funds for loans and high interest rates. Fewer houses are built and sold.

√ *The slowdown in jobs and income* will spread throughout most of the economy—a recession.

The challenge is to slow inflation but avoid a serious recession.

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Published and distributed in furtherance of the Acts of Congress of May 8 and June 30, 1914, by the Cooperative Extension Services of the University of Idaho, Fred E. Kohl, acting director; Washington State University, J. O. Young, director; Oregon State University, Henry A. Wadsworth, director; and the U.S. Department of Agriculture, cooperating. Extension programs are available to all people without regard to race, creed, color, sex, or national origin.