



Test Yourself: Inflation

The first panacea for a mismanaged nation is inflation of the currency; the second is war. Both bring a temporary prosperity; both bring a permanent ruin.
Ernest Hemingway



What is inflation?



Inflation is an increase in the general (average) price level of goods and services in the economy.





What is deflation?



Deflation is a decrease in the general (average) price level of goods and services in the economy.



What is disinflation?



Disinflation is a reduction in
the rate of inflation.



What is the most widely reported
measure of inflation?



The most widely reported measure of inflation is the **Consumer Price Index (CPI)**.



What is the Consumer Price Index?



The CPI measures changes in the average prices of consumer goods and services.



Who reports the CPI?



The Bureau of Labor Statistics
(BLS) of the Department of Labor
reports the CPI.



How is the CPI calculated?



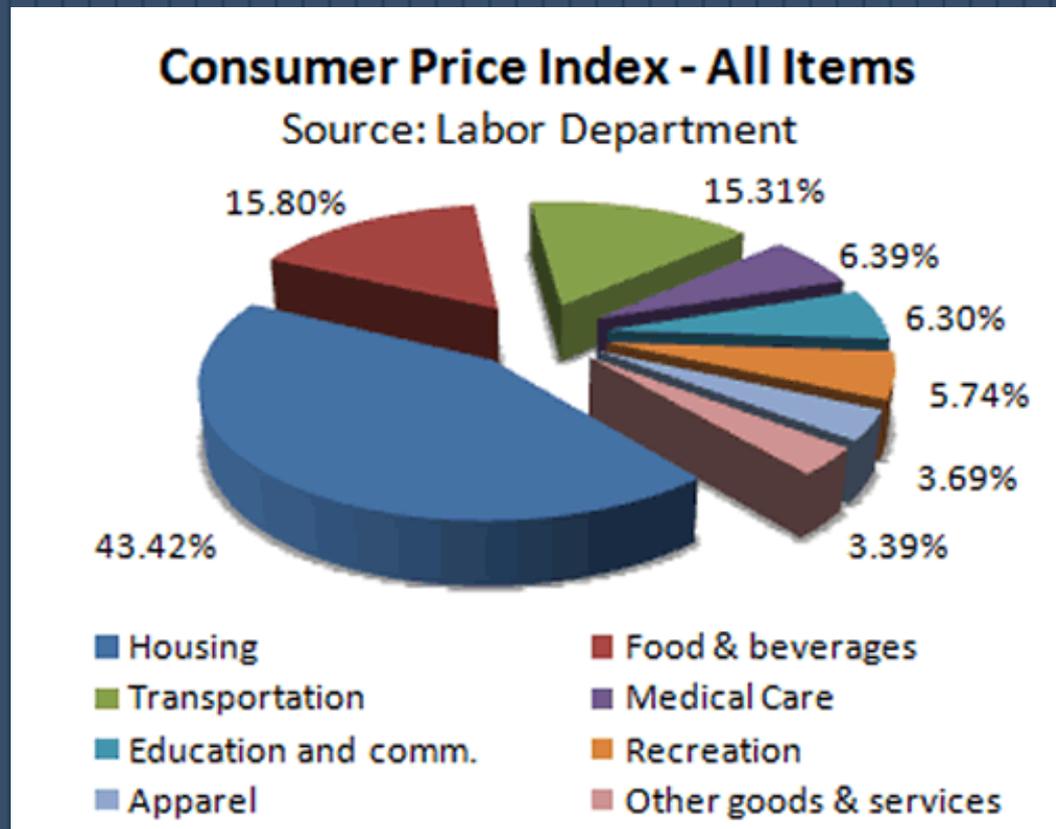
To calculate the CPI, price collectors contact retail stores, homeowners and tenants for prices in selected cities in the US every month.



Which goods and services are included in the CPI?



The BLS records average prices for a **market basket** of different goods and services purchased by the typical *urban* family.





Does the makeup of the CPI
change?



As people's tastes and preferences change, some of the goods and services that go into the basket change.



How is the CPI computed?



To compute the CPI, *current* year prices are compared to prices of a similar basket of goods and services in a *base* year.

$$\text{CPI} = \frac{\text{CYP}}{\text{BYP}} \times 100$$

where CYP is the cost of the market basket of products at current-year prices
where BYP is the cost of the market basket of products at base-year prices



What is a base year?



A **base year** is a year chosen as a reference point for comparison with some earlier or later year.



Why is the CPI always 100 in the base year?



The CPI is always 100 in the base year so the numerator and the denominator of the CPI formula will be the same in the base year.



How is the
inflation rate computed?



The inflation rate is computed by measuring the percentage change in the official CPI from one year to the next.

$$\text{ARI} = \frac{\text{CPIY} - \text{CPIPY}}{\text{CPIPY}} \times 100$$

where ARI is the annual rate of inflation

where CPIY is the consumer price index in the given year

where CPIPY is the consumer price index in a previous year



What are some criticisms of the
CPI?



Some criticisms of the CPI are:

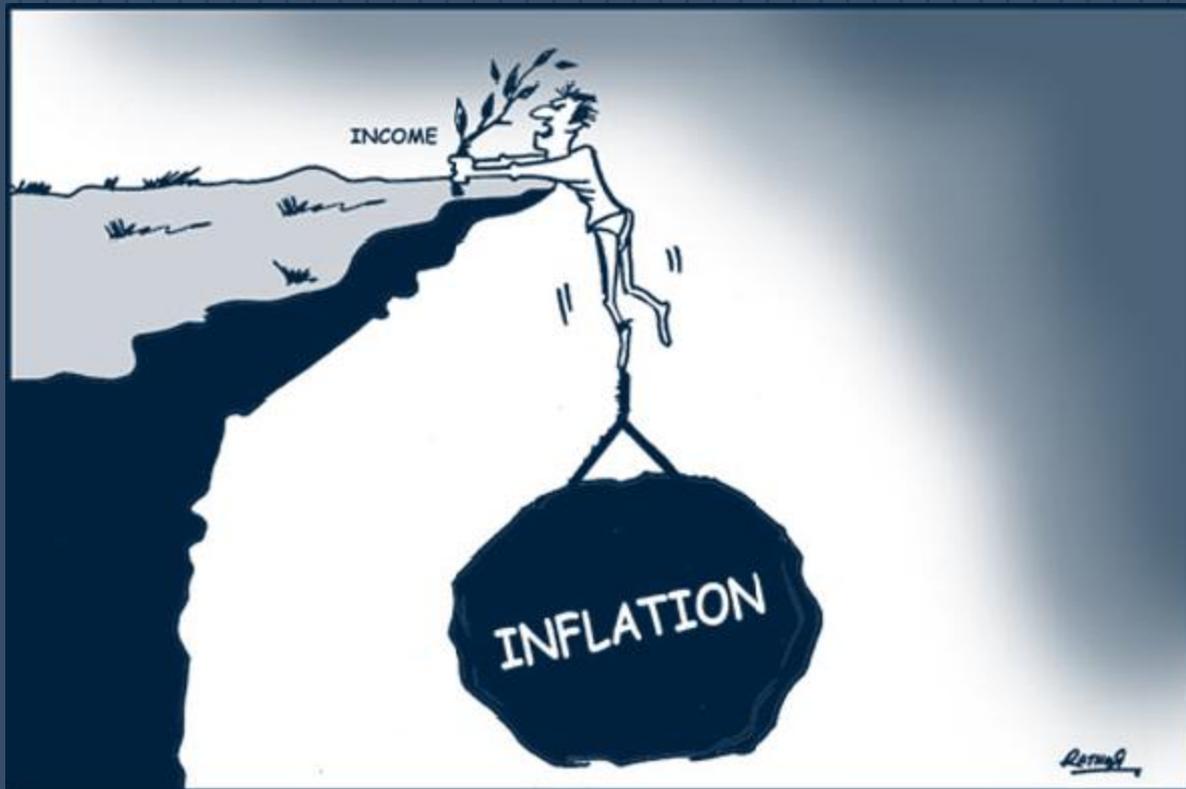
- It can overstate or understate prices for certain groups.
- It does not measure quality.
- Substitutes are ignored.



What does inflation do to people's
income?



A general rise in prices will
shrink people's income.





What is
nominal income?



Nominal income is the actual number of dollars received over a period of time.



What is real income?



Real income is the actual number of dollars received (nominal income) adjusted for changes in the CPI.

$$RI = \frac{NI}{CPI}$$

where RI is real income

where NI is nominal income

where CPI is CPI as a decimal or $CPI \div 100$



What is wealth?



wealth is the value of the stock
or assets owned at some point in
time.



How is wealth affected by inflation?



Inflation can benefit holders of wealth because the value of their assets tends to *increase* as prices rise.



What will cause your real income to decline?



If the rate of inflation is
greater than your rate of
income, your real income will
decline.



How does inflation affect borrowers
and savers?



Borrowers and savers can win or lose depending on the rate of inflation and interest.



What is the
interest rate?



The **interest rate** is the cost of money, the interest per year as a percentage of the amount loaned.





What is the
nominal interest rate?



The **nominal interest rate** is the actual rate of interest earned over a period of time.



What is the
real interest rate?



The **real interest rate** is the nominal rate of interest minus the inflation rate.



What are the two basic types of inflation?

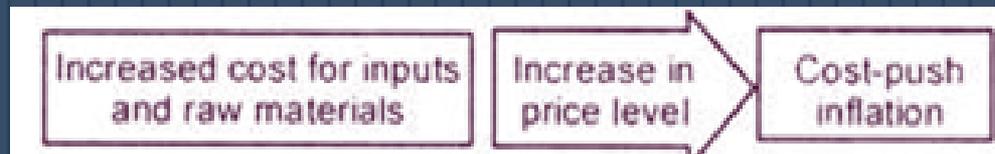


The two basic types of inflation are:

- **Demand-pull** - a rise in the general price level resulting from an excess of total spending (demand) that occurs when the economy is operating at or near full employment



- **Cost-push** - a rise in the general price level resulting from an increase in the cost of production that occurs due to cost increases for labor, raw materials, equipment, borrowing, etc





Do people's expectations affect inflation?



Yes, people's expectations can influence both demand-pull and cost-push inflation.



What is hyperinflation?



Hyperinflation is an extremely rapid rise in the general price level.





What is a
wage–price spiral?



A **wage-price spiral** occurs when increases in nominal wage rates are passed on in higher prices, which in turn, result in even higher nominal wages and prices.





How did you do?! If you didn't do as well as you'd like, review the margin notes and presentations and test yourself again.



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