Chapter 3-Your Purchasing Power

Section 3-1_Inflation and the Value of Money

What is Inflation?

- The increase in the general prices for goods and services.
  - It reflects how much prices are rising
  - When prices are rising faster than income—buyers lose purchasing power
  - Mild Inflation of 2 or 3 percent is good for the economy.

Inflation vs Purchasing Power

- As inflation rises, purchasing power of each dollar falls
- This means that you must earn more to maintain the same standard of living, otherwise your standard of living drops
- Typically employees receive a COLA-(cost-of-living-adjustments)
  - Pay increase to keep pace with inflation
  - Doesn’t provide more purchasing power
  - Keeps purchasing power equal to rising costs
  - Some workers receive merit raises and bonuses
    - These provide more purchasing power

Measuring Inflation

- Inflation is measured by the U.S. Government
- Consumer Price Index
  - Use a list of good and services commonly bought by consumers
  - Measures the price from a base or starting point in time to the current time
  - Economists use this information to assess and predict what is happening with the economy

Causes and Effects of Inflation

- Inflation can be caused by:
  - Consumers wanting to buy more goods and services than are available, driving prices up
  - Producers may have to pay more for the resources needed to produce products

Types of Inflation

- Businesses base pricing decisions partly on what consumers are buying or not buying
- Changes in buying habits show different patterns over time
- These patterns result in varying types of inflation
  - **Disinflation:** occurs when prices are rising, but the rate of increase is slowing down
    - Example: Demand for swimwear is high in spring and summer, but falls during fall and winter, so prices if prices rise for this item it is at a much slower rate than in the spring and summer
  - **Reflation**: occurs when high prices are lowered due to decrease demand, but then are restored to previous high level
    - Example: Crude oil prices-when the price of this supply goes up and down it affects gas prices
    - Example: When gas prices surge, people may not buy big cars and trucks that use more gas, when gas prices fall then the demand for this type of vehicle begins to rise again

Types of Inflation

- **Hyperinflation**: rapidly rising prices that are out of control
  - Prices rise so rapidly that consumers spend money as fast as possible because they fear prices will be even higher if they wait
  - This type of spending leads to more inflation
  - Can cause people to not be able to afford the goods that need to live comfortably
- **Deflation**: A decrease in the general level of prices for goods and services
  - Prices are slowing down (not growing very rapidly)
  - Some products go down in price
    - Example: A computer that has the latest technology when it first hits the market may sell for a high price, but a year later this computer sells for much less.

Types of Inflation

- **Real-Cost Inflation**: rising prices due to scarce resources or increased difficulty in obtaining resources
  - Example: when there is less natural gas—companies must dig deeper—so costs for providing natural gas increases
- **Demand-Pull Inflation**: higher prices as a result of consumers wanting to buy more goods and services than producers supply
  - Products sell quickly, businesses raise prices to balance supply and demand and make bigger profits
- **Cost-Push Inflation**: rising prices as a result of rising production costs
  - Wages may increase, so producers raise prices to protect their profit margins
  - Productivity-the measure of efficiency with which goods and services are made
    - Higher productivity lowers the cost of each unit produced
    - Lower costs enable the producer to maintain the same price levels

Inflation's impact on Employment

- Rising prices signal an increase in demand for product
  - Consumers are spending more
  - Producers are making more money
  - Producers will hire more employees to keep up with demand
  - Provides higher employment rates
- When prices drop for a product
  - Demand for the product is reduced
  - Producers may lay off workers
- Mild inflation of 2-3 percent is good for the economy

Inflation's Affects on Spending, Saving and Investing

- When employees do not get raises often enough to keep pace with the inflation rate they lose purchasing power
- Retirees on a fixed income also lose purchasing power
- Consumers have to make a choice to continue spending at the same level and maintaining (it will take more money) their standard of living.
  - Buy less (spend less)
  - Dip into savings
  - Borrow money
- Inflation affects consumers by:
  - The amount of money they have to spend
  - The amount of money they have to save (more of a consumer's disposable income is spent on basic needs)

Time Value of Money

- A concept that says a dollar you receive in the future will be worth less than a dollar you receive today
  - Prices are rising when this is applied
  - Example: Loan a friend $20 today and they will pay it back one year later
    - The money you receive back will not be worth the same value that it was when you loaned it to your friend
    - Your friend will be able to get more goods or services for that $20, than you will be able to get when he/she pays you back
    - Buying power is impacted by rising costs of goods and services

Fighting Inflation-Government Tools

- **Monetary Policy**-actions by the Federal Reserve System to stabilize the economy
- The Federal Reserve System (The Fed)
  - Established in 1913 by Congress
  - Controls the money supply
  - When prices are rising to fast, the Fed increases interest rates to decrease spending
  - Interest rates controlled by the Fed
    - Discount rate-rate that banks have to pay to borrow money from the Fed
    - Banks must have a reserve-amount to meet daily customer demand
    - Federal Funds rate-rate at which banks can borrow from excess reserves of other banks
    - Prime Rate-the rate that banks charge to their most creditworthy business customers

Fighting Inflation-Government Tools

- **Fiscal Policy**-actions taken by the federal government to manage the economy
  - To help curb inflation the government can raise taxes
  - When taxes go up, people have less money to spend
  - When economy is sluggish, government can reduce taxes to encourage spending