3-5-1981

Inflation: What Does It Mean to You?

Philip Favero
South Dakota State University

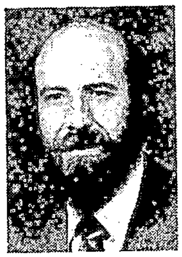
COOPERATIVE EXTENSION SERVICE United States Department of Agriculture Cooperating

Economics Newsletter

Editor: Donald C. Taylor

Economics Department South Dakota State University Brookings, S.D. 57007 (605) 688-4141

No. 158 March 5, 1981



Inflation: What Does It Mean to You?

by Philip Favero
Extension Economist

Public opinion polls, political rhetoric, and casual conversation all suggest the obvious: inflation is a major national problem. But how well do we understand inflation? How well do we know its causes and effects? What can be said about policies to combat inflation and the likely consequences of those policies? This Newsletter presents a brief overview of inflation. It also brings information on a conference intended to further enhance your understanding of inflation.

What is inflation? "Inflation is when things cost more to buy," suggests someone. Not really. At times, things cost more for reasons that have nothing to do with inflation. Wheat costs more after a drought, for example, or after foreign buyers place large purchase orders. Moreover, prices for some goods will fall, even during a period of inflation.

Inflation is a general and persistent rise in prices. Inflation may be measured by several yardsticks, the most common of which is the Consumer Price Index. This index reflects changes in the retail prices for things which most consumers buy.

Who gets hurt by inflation? In a sense, everyone is hurt. Retired people who live on fixed incomes are among the obvious losers. When prices go up, these people can only buy less. People with savings whose interest earnings are below the rate of inflation also lose. The erosion of savings undermines the value of thrift and tends to deprive our economy of savings as a resource for investment. Low income people very often lose. Food prices have been rising faster than the Consumer Price Index, and low income people have fewer opportunities to shop widely for bargains or to buy hedges against inflation.

Some people, however, may benefit from inflation in the short run. Winners include people who owe money--if they borrowed at an interest rate which does not account for a cheapened dollar. Other winners are people who own real estate--if they can sell their property and need not buy more.

In the long run, however, short run winners tend to become losers too. Sooner or later, with inflation, everyone tries to beat the game. Lenders raise interest rates. Savers demand higher interest rates or spend their money. Wage earners demand higher salary increments. A social trap is created. Whereas, in the short run, individuals may benefit from rising prices and wages, or from saving less and buying more, in the longer run the same individuals can become victims of the price increases that collectively fuel the fires of general inflation.

What causes inflation? At the core of inflation is a situation in which buyers are willing and able to purchase more than producers are willing and able to sell. Inflation can be viewed to arise from either "demand-pull" or "cost-push" pressures for upward price movements. Sometimes, both pressures act simultaneously.

Consider first demand-pull inflation. Demand-pull inflation can occur in a number of ways. The Federal Reserve System can, through its influence on banks (monetary policy), allow for an excessive increase in the supply of money. Government can, through spending and taxation decisions (fiscal policy), overstimulate demand. Foreign purchasers can also add to demand. Consumers can spend previously idle money by borrowing or drawing on savings.

Cost-pull inflation occurs when firms and workers will continue to supply their goods and services only at higher prices (or higher wages). Cost-pull inflation is double-trouble because it's often accompanied by rising unemployment. For example, the rapid increases in crude oil prices initiated in 1973 by OPEC (Organization of Petroleum Exporting Countries) have caused American companies to have higher energy costs. To avoid financial losses, these companies, in turn must sell their products at higher prices. The higher prices may result in reduced sales, which may cause production cuts and employee lay-offs.

What are the cures for higher inflation? To answer this question, the causes for inflation must first be determined. Say, for example, that a spurt of inflation is caused by excess private demand.

Such demand inflation can be combatted through increased taxes, reduced public spending and/or restricted money supplies. Problems are associated, however, with each of these polices. All take time to implement. Increased taxes are, of course, politically unpopular. Reduced government spending is often applauded in general but resisted by those who anticipate reduced incomes from specific budget reductions. Monetary restrictions usually restrain the housing industry and small businesses who rely heavily on external sources of capital. Both fiscal and monetary restrictions can also result in greater unemployment, decreased profits, and lower incomes.

A number of other policies have been suggested to cure inflation. These include moral suasion, wage and price controls, tax incentives for those who meet price guidelines, and tax credits to stimulate investment and increase commodity supplies. Each of these approaches also has its drawbacks.

Why hasn't inflation been dealt with more effectively? Numerous conflicting answers have been suggested. It does seems clear, however, that policies to control inflation involve a serious dilemma. Such policies usually involve trade-offs, with some people being hurt while others benefit. It appears that our fragmented political parties, and the ability of special interest groups to avoid adverse consequences have stalemated the policy process. Better understanding of equity problems and plans to compensate losers are needed to break the stalemate.

How can I learn more about inflation? A unique opportunity will be offered during the 1981 Agri-business Day presented by the SDSU's Economics Department at the Staurolite Inn in Brookings on March 30, 1981. An eminent guest economist, Harold F. Breimyer, and faculty from SDSU will discuss a variety of topics related to inflation. Attention will be given to the history and theory of inflation and to the impacts of inflation on ag marketing, farm and ranch management, water resource development, and transportation. The program will begin at 9:00 a.m. The public is cordially invited.

2500 printed for educational purposes at an estimated cost of 2¢ each

Issued in furtherance of Cooperative Extension work, Acts of May 8 and June 30, 1914, in cooperation with the USDA, Hollis D. Hall, Director of Cooperative Extension Service, SDSU, Brookings. Educational programs and materials offered without regard to age, race, color, religion, sex, handicap or national origin. An Equal Opportunity Employer.

Cooperative Extension Service
U. S. Department of Agriculture
South Dakota State University
Brookings, South Dakota 57007

OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE $300

Postage and Fees Paid
U. S. Department of Agriculture
AGR 101

Third class mail
(Bulk Mail)

U.S. MAIL

Economics Newsletter