The Social Studies Help Center
Social Studies help for American History, Economics and AP Government. There are class notes, numerous Supreme Court case summaries and information on how to write a research paper inside.

Inflation

Inflation is a rise in the general price level and is reported in rates of change. Essentially what this means is that the value of your money is going down and it takes more money to buy things. Therefore a 4% inflation rate means that the price level for that given year has risen 4% from a certain measuring year (currently 1982 is used). The inflation rate is determined by finding the difference between price levels for the current year and previous given year. The answer is then divided by the given year and then multiplied by 100. To measure the price level, economists select a variety of goods and construct a price index such as the consumer price index (CPI). By using the CPI, which measures the price changes, the inflation rate can be calculated. This is done by dividing the CPI by the beginning price level and then multiplying the result by 100.

Causes of Inflation

There are several reasons as to why an economy can experience inflation. One explanation is the *demand-pull theory*, which states that all sectors in the economy try to buy more than the economy can produce. Shortages are then created and merchants lose business. To compensate, some merchants raise their prices. Others don't offer discounts or sales. In the end, the price level rises.

A second explanation involves the deficit of the federal government. If the Federal Reserve System expands the money supply to keep the interest rate down, the federal deficit can contribute to inflation. If the debt is not monetized, some borrowers will be crowded out if interest rates rise. This results in the federal deficit having more of an impact on output and employment than on the price level.

A third reason involves the cost-push theory which states that labor groups cause inflation. If a strong union wins a large wage contract, it forces producers to raise their prices in order to compensate for the increase in salaries they have to pay. The fourth explanation is the wage-price spiral which states that no single group is to blame for inflation. Higher prices force workers to ask for higher wages. If they get their way, then producers try to recover with higher prices. Basically, if either side tries to increase its position with a larger price hike, the rate of inflation continues to rise.

Finally, another reason for inflation is excessive monetary growth. When any extra money is created, it will increase some group's buying power. When this money is spent, it will cause a demand-pull effect that drives up prices. For inflation to continue, the money supply must grow faster than the real GDP.

Effects of Inflation

The most immediate effects of inflation are the decreased purchasing power of the dollar and its depreciation. Depreciation is especially hard on retired people with fixed incomes because their money buys a little less each month. Those not on fixed incomes are more able to cope because they can simply increase their fees. A second destablizling effect is that inflation can cause consumers and investors to changer their speeding habits. When inflation occurs, people tend to spend less meaning that factories

have to lay off workers because of a decline in orders. A third destabilizing effect of inflation is that some people choose to speculate heavily in an attempt to take advantage of the higher price level. Because some of the purchases are high-risk investments, spending is diverted from the normal channels and some structural unemployment may take place. Finally, inflation alters the distribution of income. Lenders are generally hurt more than borrowers during long inflationary periods which means that loans made earlier are repaid later in inflated dollars.

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Inflation Worksheet

Complete the questions below using the information from the reading.

1) What is inflation?

2) The Measure the price level, economist select a variety of goods and construct a price index such as the

3) Describe 2 reasons for the causes of inflation.

4) What types of people are most negatively affected by inflation and the depreciation of the dollar?

5) ____________________ are generally hurt more than ________________________ during long inflationary periods, which mean that loans made earlier are repaid later in inflated dollars.

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Is this person helped or hurt by inflation???

A widow living on savings that carries a fixed rate of interest.

A family that bought a house and has a fixed interest rate mortgage.

Workers who have a cost of living clause in their contract that raises their wages with any rise in inflation.

A worker who signed a contract to work for a fixed amount for the next 10 years.

A retired couple who lives on $1000 a month pension payment.

A government with outstanding debt at fixed rates.

A retired man who lives entirely on income from his Social Security check.

A state government who receives revenue from taxes.

A parent who is putting money away for their child's college education.

A bank who has loaned money at a fixed rate of interest.

Cost push or demand pull

1. Carnival Cruise Lines increases fares 11% for 2010 based on 2009 occupancy rates of 95%
2. Target increases prices 3% on groceries to pay for raises for its employees.
3. Due to rising diesel fuel prices UPS charges an extra $2 on its shipping fees.
4. Toys R Us increases prices on Headbanger Elmo when the initial shipment to the stores sells out on Black Friday.

Decide whether sudden inflation of 5% hurts (A) or helps (B) the individuals involved.

5. A homeowner locks in a 30 year mortgage on their house BEFORE inflation strikes.
6. A retiree lives off a fixed pension from his employer.
7. A high school student puts money into a savings account that earns 1% interest.
8. Ford employees receive a cost-of-living adjustment based on inflation.
9. Banks who extend many fixed rate loans.
10. A farmer buys machinery with a fixed rate loan to be repaid over a ten year period.
11. Your savings from your summer job are in a savings account paying a fixed rate of interest.
12. A widow lives entirely on income from fixed-rate corporate bonds.
13. A retired man lives entirely on income from social security.
14. A firm signs a contract to provide maintenance services at a fixed rate for the next five years.
15. Your friend rents an apartment with a 3 year lease.

For questions 16-20, fill in the blank with the correct vocabulary term using the given word bank.

Deflation	Inflation	Hyperinflation
Cost – push inflation	Demand pull inflation	Price Index
CPI	Purchasing Power	

16. General rise in prices and wages ____________________
17. Decline in prices and wages ____________________
18. Inflation that exceeds 50% per month ____________________
19. Amount of goods and services you can buy given your income ____________________
20. Idea that inflation happens when producers are forced to cover increasing wages ____________________
21. Measurement that shows how prices of a group of goods changes over time ____________________
22. Measures price changes using a specific 'market basket' of goods purchased by the average consumer. ____________