ACTIVITY 18.1, CONTINUED
INTRODUCTION TO KEY ECONOMIC INDICATORS

2. Inflation: The Consumer Price Index (CPI)[2]

Inflation is a rise in the average prices of all goods and services. The consumer price index (CPI) is the most widely reported measure of inflation. The CPI compares the prices of a fixed set of goods and services (called a "market basket of goods and services") to the prices of those same goods and services in a previous month or year. Any increase in the cost of purchasing this market basket of goods and services means an overall increase in the average level of prices paid by consumers, and thus inflation is said to be present.

The inflation rate is calculated by determining the percentage change in the CPI from one month to the next or from one year to another. For example, the CPI for November 2005 was 199.2 The CPI in November 2006 was 201.7. Therefore, the percent change in the CPI was:

$$[(201.7 - 199.2) / 199.2] \times 100 =$$

$$[2.5 / 199.2] \times 100 =$$

$$= 1.3\%$$

The inflation rate from November 2005 to November 2006 was 1.3%. In other words, the average price of the market basket of goods and services rose 1.3% during that one- year period.

Over short periods of time, inflation can be caused by increases in costs or increases in spending. ***Demand-pull inflation*** occurs when overall increases in demand ***pull up*** the average level of prices. If spending increases faster than the economy's capacity to produce more goods and services, there will be upward pressure on prices. ***Cost-push inflation*** is caused by increases in costs of major inputs used throughout the economy. Increases in costs ***push up*** the average level of prices. For example, throughout much of 2007 and 2008, inflation rates increased largely because of increases in the price of oil. Because oil is an important input for many goods and services, an increase in its price leads to price increases for many other things. In the long run, inflation can also be caused by excessive growth of the money supply.

Costs of Inflation. Inflation that is greater than people expected reduces the purchasing power of money. Because prices rise over time, consumers require a larger income to purchase the goods and services necessary to maintain a constant standard of living. People on fixed incomes such as pensioners or workers without cost-of-living adjustments (COLAs) are especially hurt by unexpected inflation. High inflation makes it difficult for businesses and consumers to predict the future and can discourage long-term saving and investment. High inflation leads to high interest rates. Lenders receive higher interest payments, part of which is compensation for the decrease in the value of the money lent (due to inflation). Borrowers have to pay higher interest rates and lose any advantage they may have from repaying loans with money that is not worth as much as it was prior to the inflation.

[2] Description created using S. Buckles (2006), "A Case Study: The Inflation Rate," *EconEdLink*. Accessed at http://econedlink.org/lessons/index.cfm?lesson=EM222&page=teacher on April 23, 2007.

ACTIVITY 18.1, CONTINUED

INTRODUCTION TO KEY ECONOMIC INDICATORS

Study Guide: The Inflation Rate. Fill out the study guide in your expert group; you will share this information with your EFI group.

1. The Consumer Price Index (CPI) is___________________________________.

2. The Consumer Price Index measures____________________________________._

3. The inflation rate is calculated by_______________________________________.

4. Calculate the inflation rate if:

CPI (September 2007) = 208.5 CPI (September 2008) = 218.8

____

5. Two causes of inflation:

   a.

   b.

6. Costs when the inflation rate increases faster than expected:

   a.

   b.

   c.

   d.

7. Current (12-month) inflation rate: ______________.

8. Inflation rate trend over the last three years:_______________________________.