Name ____-
Financial Math
Inflation

Introduction to Inflation – Forbes Magazine Article

Directions: I have taken an excerpt from a recent article introducing our next topic – Inflation. Read the article and then answer the attached questions

What Actually Causes Inflation (and who gains from it)

Inflation Defined

Inflation is simply a rise in the average price of goods and services in the economy. Which particular goods and services depends on the measure we are examining. Consumer price inflation is the one usually in the news. It takes a weighted average of various items purchased by the typical household (the list being determined by survey and then updated periodically).

The average can rise while some prices have actually fallen. How much it reflects your personal situation depends on how closely the basket of goods and services in the index matches your buying patterns. But, the bottom line is that we say that inflation has occurred when the average price of those goods and services has increased.

This does not happen by magic. It takes someone, somewhere making a conscious choice to charge more for the good or service they sell. The initial increase does not have to be in something that is being directly measured by the consumer price index. No household in my neighborhood, for example, buys barrels of oil; and yet when they become more expensive that sends a ripple throughout all related products. In the end, consumer prices jump as well.

Many circumstances can cause inflation. I will focus on four:

Causes of Inflation: Market Power

Does a company, or group of companies, have enough power to change the price of goods themselves? Usually this happens with something like energy. OPEC has enough power to manipulate oil prices. On Long Island LIPA (now PSEG) has the power to determine your electric bill)

Causes of Inflation: Demand Pull

Another means by which inflation can take place is a **rise in demand relative to supply**. Say there is an increase in the demand for housing during an economic expansion. Bottlenecks may arise in certain building supplies like lumber. Contractors bid up these prices in an attempt to secure the materials they need; these price increases then ripple through the economy.

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Those selling goods and services in highest demand should see their profits and wages rise, even though by definition this will almost certainly cause inflation. This attracts others to sell these same goods and services, while some consumers go in search of substitutes.

To put this a little more simply, think about tickets for a sporting event on stub-hub. It could be Game 7 of the World Series, or Billy Joel playing at the tiny Paramount in Huntington. In both of these cases, more people are going to want to go than there are tickets available. This causes very high prices on Stub-Hub for this event

Causes of Inflation: Asset Market Boom

Third and very relevant today, **inflation can be injected from the asset market**.

Think shale oil in North Dakota. If you had stock in shale oil or were involved in getting shale oil out of the ground, you have made a LOT of $ the last 5 years!

The winners here are 1) those whose are invested in this product 2) the producers of the commodities in question.

Causes of Inflation: Supply Shock

Last is a **supply shock**. If a storm rages through the Gulf of Mexico, taking out oil derricks and refineries along the way, this may well raise the price of oil and gas. As it should, for this creates incentives to build more derricks and refineries and for consumers to find alternate energy sources. Again, this is what capitalism is supposed to do.

Conclusions

The bottom line is that there are a number of processes that can create inflation. Someone make a conscious decision to raise a price or wage, and they must be able to make this stick. Because every higher price you pay means someone is getting more income, inflation causes a redistribution of income. Sometimes it does so in a manner that we would endorse and sometimes not.

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Questions:

1) What is a very basic definition of inflation?

2) How is consumer inflation calculated?

3) List the four main causes of inflation and an example of each

4) Give an example of inflation as it might relate to you.

5) Is there something that you will have to pay for that will cost way more than it did or previous generations?

6) If question 5 is yes, what is it, and how could it effect things we have already learned about (DTI, DTE, etc)?