10

Controlling Prices

Goal: *The goal of this unit is to understand the impact of price controls (inflation, deflation, and stagflation) on economic security for individuals, families and communities.*

A. INFLATION:

1. Defining Inflation. Think back a few years. How much did a gallon of gasoline cost? A loaf of bread? A10-inch pizza? A movie ticket? In almost all cases, these items now cost more. This routine price increase is called inflation. Inflation is defined persistent increase in the average price of goods and services over time. It causes the overall purchasing power of the dollar to fall. That is, the dollar you made last year will buy less of the same good or service this year.[1] Inflation is related to high utilization of production capacity (i.e. factories and plants), high employment, higher wages (price of labor) but also higher prices for consumer goods. It typically occurs during periods of economic expansion when average prices increase over time.

2. Types of Inflation. Inflation may result from "too much money chasing too few goods," (i.e. demand inflation) or from increases in the costs of production such as labor, equipment, etc. (i.e. cost-push inflation).

Fig. 10.1 Rising Food Prices [2]

3. Measuring Inflation.

The United States uses the Consumer Price Index (CPI) to measure the inflation rate. The CPI is reported monthly by the U.S. Bureau of Labor Statistics, a division of the U.S. Department of Labor. It is one the most frequently used statistics for identifying periods of inflation (or deflation) because large rises in the CPI during a short period of time typically denote periods of inflation and large drops in CPI during a short period of time usually mark periods of deflation.

The CPI is based on the actual retail prices (i.e. a typical market basket) of a variety of goods and services purchased by urban consumers at a given time and compared to a base set of prices that is periodically changed.

Fig. 10.3 U.S Inflation Rates Since 1900 [5]

The CPI prices refer to those experienced by a wide range of urban or metropolitan areas residents, including professionals, the self-employed, the poor, the unemployed and retired people, as well as wage earners and clerical workers. It does not include the spending patterns of people living in rural areas, farm families, people in the Armed Forces, and those in institutions, such as prisons and mental hospitals. The government calculates the CPI based on detailed information provided by families and individuals on what they actually bought or put into a market basket.

The information in the current CPI is collected from Consumer Expenditure Surveys for two specified years. In each year about 7,000 families from around the country provide quarterly information on what they spent for housing, clothing, transportation, medical care, recreation, education, communication, and a few other goods and services. Information on frequently purchased items, such as food and personal care products, is recorded in diaries kept by the same 7,000 families, detailing what they purchased during a two-week period. Taken together over that time period, the survey gathers expenditure information from approximately 28,000 weekly diaries and 60,000 quarterly interviews used to determine the importance, or weight, of the more than 200 item categories in the CPI index structure.[4]

The **Inflation Rate** is how much the CPI increases in a given year. The percentage increase is calculated by averaging price changes for each item in the predetermined basket of goods.

CPI vs. Cost of Living. The CPI is widely used as a cost of living index, but technically, it is not. The CPI measures the average change over time in the prices paid by urban consumers for a relatively fixed market basket of goods. A cost of living index would measure changes over time in the amount that consumers need to spend to reach a certain "standard of living." The CPI ignores important changes in taxes, health care, water and air quality, crime levels, consumer safety, and educational quality. Furthermore, the experience of any individual may vary dramatically from what the CPI indicates, because an individual's purchasing patterns may differ considerably from the standard. Families with children have considerably different buying patterns than elderly households, for example. The CPI also does not attempt to represent the experience of people living in rural areas.

4. Who Benefits and Who Loses from Inflation?

Inflation creates problems for some groups and helps others. This reflects what economists refer to as the "time value of money".[6]

a. Inflation helps individuals and firms carrying substantial debt called "debtors." Debtors benefit from inflation because each dollar that needs to be repaid in the future is worth less than when it was borrowed. A person or a business pays back less in real terms than the amount that was borrowed. That is, the dollar goes further. But this is not meant to encourage getting deeper and deeper into debt, which brings its own problems.

b. *Inflation hurts people working for cash wages and those on a fixed-income*, especially those with low-incomes. Why? When inflation exists but income stays the same, one can buy less with the same amount of income. The dollar just doesn't go as far as it once did.

The people most likely to be harmed by inflation are workers whose wages do not keep up with inflation. With less money to spend on basic needs, their standard of living falls. This can include many low earners such as the semi-skilled and unskilled, persons of color, older women, single mothers and their families. If the average worker also has his or her "wealth" tied up in savings and retirement funds, that person's savings can also lose value in an inflationary period because when you save money for retirement in the future, that money will be worth less than it is today.[7]

During inflationary periods, banks are also less willing to lend money because they will be repaid with dollars that are worth less than when the money was loaned. To protect themselves banks charge higher interest rates on credit and loans. This makes borrowing more expensive and less possible for the average person but also for business and industry leaving them less able to expand. Finally, if the rate of inflation varies from month to month or year to year, it becomes problematic as individuals, families, business, and government have more trouble planning for the long-term.[8]

5. How Individuals and Families Manage Inflation

Individuals and families manage the impact of inflation on their finances by working overtime, taking a second job, sending additional family members to work, lowering their consumption (i.e. cutting back on food, clothing, and entertainment expenditures), hunting for bargains, sharing with others, trying to save and/or making their own food and clothing.

These financial pressures can lead to marital difficulties, health and mental health issues, and other problems that may show up in practice. In some cases, financial problems many not be included in a client's presenting problems but should still be explored at some point. Financial pressures may also generate hostility toward government and politicians or toward business and industry, depending on whether they blame the public or private sector for the prevailing economic ills.[9]

6. How Government Manages Inflation

Congress manages inflation by using its tax and spending powers (see Economic Policy unit) to promote stable price and stable employment levels. For example,

higher taxes and less government spending can put a brake on rising prices by reducing consumer and government demand for goods and services. The Federal Reserve System can also use its control over the money supply (see Economic Policy unit) to reduce the rate of inflation or to "cool off" the economy. As noted earlier, the Fed can also "tighten" the money supply by requiring banks to hold more in reserves and by raising interest rates that make it more expensive for both business and households to borrow money. This limits purchasing power, which is also referred to as consumption or aggregate demand.[10]

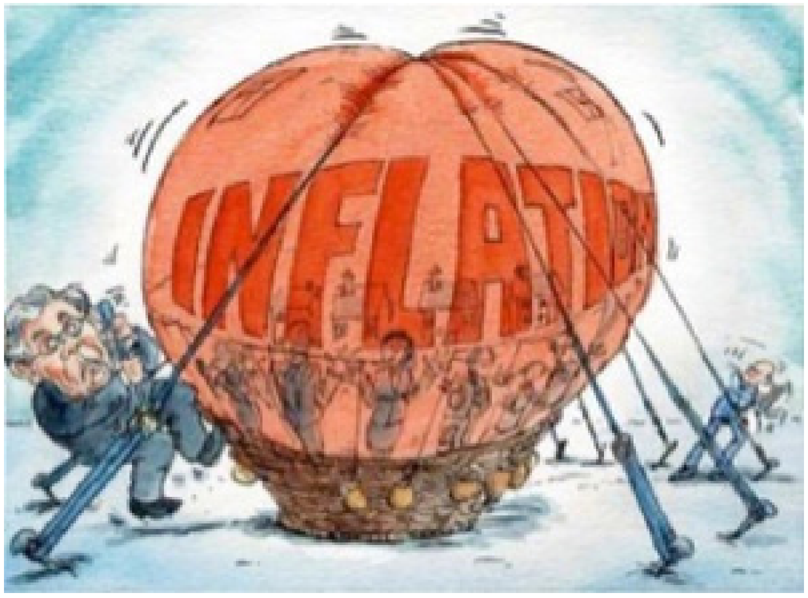

Fig. 10.4 Inflation [11]

B. DEFLATION

1. Defining Deflation. Deflation is the opposite of inflation. Deflation refers to a sustained fall in the general price level over a specific time period. It tends to be associated with periods of negative or stagnant economic growth such as the Great Depression, the Japanese economy of the 1990s and 2000s (the "lost decade")[12], and possibly the U.S. in the second decade of the 21st century.

Economists describe deflation that stems from slow economic growth or excess capacity as "too much supply chasing too little demand." That is, there is too little spending by the government, households, investors and/or a short supply of money and credit. When spending and credit dry up, business is left with more goods and services than can be sold. If the demand continues to fall, it can lead to a downward spiral as firms reduce prices in a desperate attempt to get people to buy their products and services. They also slash their inventories, buy less from other manufacturers, reduce wages and salaries and/or employ fewer workers. This translates into higher unemployment and even less consumer spending, which cuts deeper into the economy.

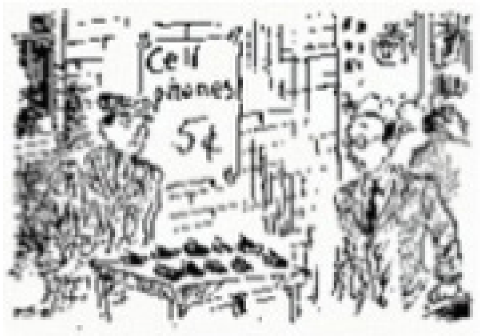

Fig. 10.5 Deflation

2. Types of Deflation. Deflation typically follows on the heels of a major societal buildup in the extension of credit (and its flip side, the assumption of debt). But deflation can also stem from an increase in a nation's productive potential if that increase leads to an excess of aggregate supply over demand, that is, more goods are produced than can be sold. This creates a downward pressure on prices.[13]

The psychological impact of deflation cannot be overstated. As creditors become more conservative, they slow their lending. As debtors and potential debtors become more conservative, they borrow less or not at all. When producers become more conservative, they reduce expansion plans. And as consumers become more conservative, they save more and spend less. These behaviors press prices down. In sum, this is a rapid decline in prices and spending triggers in an accelerating, downward spiral that tends to be self-reinforcing and difficult to stop.[14]

Deflation is not common in the U.S. economy. It is most likely to occur during a depression, a prolonged period of stagnation or a lengthy recession. But in the summer of 2010, talk of deflation surfaced among many U.S. economists and politicians who worried that the weak economic recovery, high unemployment rate, and extremely low rates of inflation signaled an increased risk of deflation.[15]

3. Measuring Deflation. Deflation is officially measured by a decrease in the Consumer Price Index (CPI). However, this measure can provide misleading cues given the items that are officially included or excluded from the CPI. That is, deflation or falling prices may not be consistent across all categories and it may be specific to a specific sector.[16]

4. Who Benefits And Who Loses From Deflation?

- **Who Benefits?** For individuals, a little deflation may not be a problem as long as it does not turn into an ingrained deflationary spiral. With a little deflation, paychecks will stretch further because shoppers will enjoy sales and lower prices, especially those needing to make a big-ticket purchase (i.e. stove, car, new home, etc.). Deflation also benefits people on fixed-incomes because they receive a fixed number of dollars, but due to low prices, each dollar buys more.[17]

- **Who Loses?** At first glance deflation may seem positive for consumers. However, falling prices also worsen the position of debtors, by increasing the real burden of their debts and causing them to cut their spending.[18] Companies whose prices fall faster than theirs costs face lower profits. Weaker profit margins can press companies to go out of business or to reduce costs by laying-off or firing workers. Falling prices also have a negative effect on stock markets because of a fall in expected profits and dividends to shareholders.[19]

5. How Individuals Manage Deflation: Buyer Procrastination

When businesses and individuals expect falling prices, they become less willing to spend and borrow. This buyer procrastination can have a negative impact on corporate profits and employment as well as business and consumer spending. Once people expect price declines, they delay purchases as long as possible. They gamble on the belief that the longer they wait, the lower the price will be. After all, when prices are falling, just sitting on cash becomes an investment with a positive real yield.

Economists talk about the risk of a deflationary trap: When people expect deflation, the economy may get and stay depressed – and deflation may continue because the economy remains depressed. This further decreases demand, contributing to the downward spiral noted above.

Fearing job loss, underemployed workers do not dare protest their falling wages because they don't think they can find other jobs. On the other hand, individuals may also accelerate debt payments in order to pay while the prices are down or to avoid a future increase in the value of the money that they owe.[20]

6. How the Government Manages Deflation: Stimulate Spending

To combat deflation, the government has to stimulate the economy with expansionary monetary or fiscal policy. It can try to jump-start the economy using one or all of its monetary policy tools to increase the money supply and deliberately cause prices to rise (i.e. inflation). The goal would be to encourage individuals and firms to start spending in hopes of causing prices to rise in the future. The government can also offset deflation with expansionary fiscal policy. It can increase consumption by lowering taxes, increasing government spending, and incurring a temporary deficit. However, deflation is very difficult to combat once it is entrenched because it sets in place a cycle of problematic behaviors by business and individuals as previously described. In November 2010, to forestall deflation, the Federal Reserve purchased $600 billion of U.S. Treasuries, designed to expand the money supply thereby encouraging banks to increase lending.

C. STAGFLATION

Stagflation refers to the economic trend in which inflation and unemployment rise while general growth of the economy slows down. Economists coined the term in the 1970s, when inflation soared to 12% and the unemployment rate nearly doubled to 9%.

The principal factors were the fourfold increase in oil prices imposed by the Organization of Petroleum Exporting Countries (OPEC) in 1973-74, increases in the price of other raw materials, and the end of the Vietnam-era government wage and price controls.

How Government Manages Stagflation

Economists disagree on the causes of stagflation and how to correct it. Governments try to avoid stagflation through fiscal policy that promotes growth and prevents inflation. However stagflation can be difficult to correct because focusing on one aspect of the problem can exacerbate other aspects.

For example, the use fiscal and monetary policies to stimulate the economy and reduce unemployment can exacerbate inflation.[21] Years of continued stagflation in the 1970s helped to undermine the Carter Presidency and Democratic Party proposals for welfare, health care, and labor law reforms.

D. POLICY DEBATE: WHAT IS COMING NEXT - INFLATION OR DEFLATION?

There has been a non-stop debate in U.S. policy circles that began in 2008, concerning whether deflation or inflation was on the horizon. Most conservative economists predicted massive amounts of inflation due to the Fed's easy monetary policy (low interest rates), and the trillions of dollars of government spending by the Obama Administration. Most liberal economists worried about deflation, which would lead to further declines in home prices and the CPI.[21]

1. ***It's Deflation.*** Paul Krugman, the liberal Nobel prize-winning economist, has argued that there was little sign of inflationary pressure in the U.S. and that high unemployment rates would rule out inflation anytime soon. He was more worried about deflation. He suggested that period's depression might be akin to the depression that followed the Panic of 1873 that was somewhat less devastating than the Great Depression of the 1930s. Krugman also stated that the economic turbulence in Europe — especially plans to cut government spending —would negatively impact the U.S. economic recovery. He called on the U.S. government to spend more money to prevent a slip into a deflationary depression.

Krugman noted that the worries about inflation amounted to fear-mongering by economists and was at least partly political. These economists inconsistently supported government tax cuts that contributed to the deficit but scolded government spending to rescue the economy. He charged that their real goal was to bully the Obama administration into abandoning those rescue efforts,

Those who think inflation will stay at the current low rates for several years urge the government to inject more money into the economy to address deflation and to get the economy back on its feet. To this end, in November 2010 in a bid to lower unemployment and avert deflation, the Federal Reserve Board Chairperson announced the purchase of $600 billion in U.S. Treasuries. To counter his critics who feared such a large stimulus would lead to inflation, the chair of the Fed added that "we do not want inflation to be too high but you also don't want it to be too low." [24]

2. ***It's Inflation.*** Former International Monetary Fund (IMF) chief Simon Johnson argued that the economy was more susceptible to inflation than deflation. He held that by injecting money into the system (i.e. printing money), the Fed will cause inflation even if unemployment remains high and there is still a lot of slack in the system. He stated that spending to offset deflation will increase the budget deficit and eventually force the U.S. government to print more money to pay off its debt.[25]

3. ***A third position*** holds that the deflation is part of the normal workings of the market and if left alone the market will adjust back to normal. Finally some economists have argued that a deliberate policy of moderate inflation can usefully encourage lending and reduce private debt burdens.

For Discussion:

Inflation comes in cycles. Imagine that inflation returns and that instead of just inching up, prices soar. The media reports that the Fed will be raising interest rates.

1. What fiscal and/or monetary policies would you recommend to the federal government and why?

2. Your client, a divorced mother of three, came to you suffering from depression and panic attacks. She mentioned that she is having difficulty managing mortgage payments and doesn't know how she'll pay for her children to attend college. She told you that two people from her work group have just been laid off. Without giving financial advice, what would you think about as you helped your client figure out her next steps?

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