Introduction to Inflation

The value of the dollar has declined dramatically over time thanks to inflation. Inflation is caused when the central bank (the Federal Reserve in the United States) allows the amount of money in circulation to grow too fast, or equivalently, if the central bank sets interest rates too low. Inflation causes the value of your money to decline, so you bear a direct cost. As we will see in my next series of blogs, inflation causes other problems in the economy that are severe, but are not felt directly by most people.

What Does a Dollar Buy Today?

When inflation occurs, prices of goods rise, on average. So, a dollar buys less than it used to buy. How much is a dollar worth today, compared to the past?

It takes this many dollars today	$2	$3	$4	$5	$6
To buy what $1 bought in this year	1985	1978	1974	1970	1965

As the table suggests, a dollar buys nowhere near what it used to. It now takes $6 to buy what $1 bought in 1965.

The data in the table are calculated by the federal government's Bureau of Economic Analysis and come from a measure of prices called the Personal Consumption Expenditure price index, which shows the average price of goods and services purchased by consumers in the United States. This particular price index is superior to the more common Consumer Price Index, which is biased upwards and constructed in an inefficient manner. Compiling an accurate measure of prices is quite difficult because of changes in the quality of goods and the fact that people change their tastes for different types of goods. The Personal Consumption Expenditure price index that we use in this chapter has fewer problems than any of the various indexes that the government produces.

The price index shows how much the average price of goods and services has changed over time. To get an idea of how much prices have changed in a year, we can calculate the inflation rate as the percentage increase in the price index from one year earlier. The chart below shows the results of this calculation from 1960 to 2016.

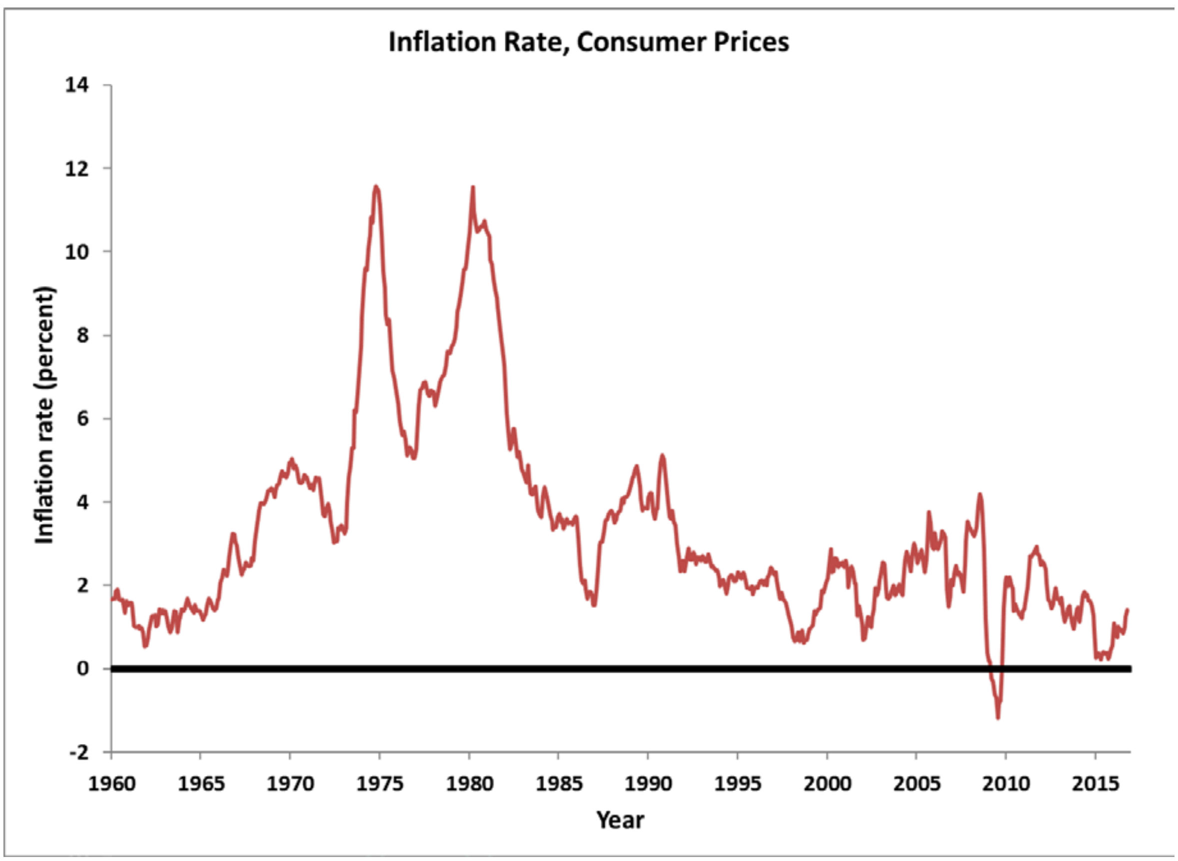

Chart: Inflation Rate, Consumer Prices

Source: Author's calculations, based on Bureau of Economic Analysis data on personal consumption expenditures price index.

In the chart, you can see that inflation in the early 1960s was very low. But inflation began to rise steadily in the late 1960s and into the early 1970s. Then, from 1974 to 1975, inflation jumped to double-digit levels. Inflation dropped for a short time later in the 1970s, but jumped up again in 1979 and 1980. Inflation began to decline in the early 1980s, rose a bit in the late 1980s, and then declined to below 2 percent in the 1990s. The 2000s saw volatility in inflation, though on average inflation remained fairly low. The inflation rate was negative for a short time in 2009, mainly because of a sharp decline in prices during the financial crisis. More recently, the inflation rate has remained below 2 percent, which is sometimes thought to be the optimal rate of inflation (more on that in a future blog).