Money and the Pandemic – Magic Prices

Anne Emerson, April 2022

What is inflation? Is it harmful? What causes it? How is it measured? This is the fourth in a series of articles about economic concepts for the general reader, inspired by contemporary media coverage and friends' questions.

What is inflation? Simply speaking, inflation occurs when prices increase, on average, over time. Many seniors remember when a McDonald's hamburger cost 15¢. On April 12, 2022, a local McDonald's sold my husband a hamburger for $1.29. That price, along with many others, has increased over several decades.

Is inflation harmful? Maybe. Suppose I borrow money in order to buy a house. Then I will both borrow and pay back, with interest, the money in dollars. If *prices in the economy increase* while interest rates remain low, I, the borrower, benefit at the expense of the lender. This is because, for example, a fixed $2,000 monthly mortgage re-payment will buy fewer (of the now higher-priced) goods and services than $2,000 would have bought when the loan was first made. So, the lender gets back less purchasing power than he or she might have expected, if prices had remained stable. Also, my monthly payment of $2,000 takes less purchasing power away from me than I might have expected, if prices had remained stable.

So, some people may benefit from inflation while others may lose. Also, when incomes do not rise as much as prices, people lose purchasing power over time. This can be relatively more harmful to those on fixed incomes, or to those whose incomes remain low while other incomes rise.

As noted above, borrowers – including indebted governments – often benefit from inflation. Much pandemic-relief spending was financed by increasing government debt. If interest rates remain low and inflation occurs, government debt repayment will usually be made with lower-value dollars, and at lower interest rates, than would have occurred under a policy directed toward higher interest rates and more-stable prices. In the U.S., price-stabilization and managing interest rates are among the missions of the Federal Reserve (the Fed).

What causes inflation? The received wisdom in economics for many years has been that adding more money to the economic system generates inflation. That is, if nothing changes except the amount of money in the system, more money will chase the same goods, and the prices of everything will be bid up. For example, hyperinflation (where prices rise more than 50% per month) is a known consequence of irresponsible money-creation. The U.S. government is generally considered too well run to allow a hyperinflation in this country.

Recently, some analysts have suggested that a strong link between the money supply and inflation has been broken. At least since the recession of 2008, the data may support that suggestion. There were significant injections of money into the economic system and relatively little measured inflation.

A different cause of price increase is more demand for a product or service than there is supply. Shortages encourage buyers to outbid the competition by offering higher prices. Also, if it costs more to produce something, then that item's sales price might increase to cover those higher costs. When higher sales prices motivate demands for higher wages (to maintain living standards), we might get a "wage-price spiral," where higher wages increase costs, which increase prices, which lead to higher wages again. We may not see overall inflation if some prices rise while others fall.

How is inflation measured? Inflation is usually measured with a "price index," such as the well-known Consumer Price Index (CPI). If the numerical value of a price index increases, say from 264.9 (CPI in March 2021) to 287.5 (CPI in March 2022), this suggests there has been inflation. The Bureau of Labor Statistics (BLS) is the U.S. government department that calculates the CPI. According to BLS,

"The CPI reflects spending patterns for each of two population groups: all urban consumers and urban wage earners and clerical workers…The CPI… does not include investment items, such as stocks, bonds, real estate, and life insurance because these items relate to savings, and not to day-to-day consumption expenses."

Notice that the CPI measures prices for consumer *spending*, not prices for instruments of consumer *saving*, such as stocks, bonds, and purchases of real estate for investment. In some situations, relatively less spending and more saving may bid up prices of investment purchases, including stocks and real estate, more than prices of consumer purchases. Some analysts have suggested that, given the uncertainties associated with the pandemic, many people and businesses waited, cautiously, before deciding how to spend money.

This, some said, kept prices lower than they might have been, releasing "pent-up demand" now that the U.S. economy has opened up. Recent price increases may be temporary as the economy adjusts to a presumed short-term spending surge while savings re-enter the consumer economy.

Meanwhile, stock prices and prices of real estate investments have increased over the course of the pandemic. Given the challenges involved in understanding inflation, perhaps we should be wary of applying customary ideas to unusual situations. For example, there has been a successful but *unprecedented* effort to avoid a deep depression that could have resulted from the pandemic.

Key questions to engage economists, concerning prices, include the following. Has a link between money and inflation been broken? Might the CPI mislead, in unprecedented times? For example, were rising stock prices a "hidden" inflationary consequence of stimulus money, a harbinger of CPI inflation to come? Do prices reflect real values, or are they illusory – like "magic"? For example, how much has really changed in a McDonald's hamburger over time, apart from its price?

To summarize, inflation is a general rise in prices over time. It is measured with reference to a price index, such as the CPI. Moderate inflation benefits some people and harms others. Moderate (or even excessive) inflation can be a goal of government policy. Price increases might be associated with increases in the money supply, and inflation persists if individuals keep raising prices and wages.

Further reading:

About CPI Overview Page : U.S. Bureau of Labor Statistics (bls.gov) (click on "Questions and Answers"); link is at: www.bls.gov/cpi/about-overview.htm For data, see also: https://www.bls.gov/news.release/archives/cpi_04122022.htm

Hyperinflation: Definition, Causes, Effects, Examples (thebalance.com); link is at: www.thebalance.com/what-is-hyperinflation-definition-causes-and-examples-3306097

Krugman on Keynes (hi.is) Increased government spending to escape recession was Keynes' idea. Prof. Paul Krugman appraises Keynes' work in this article. Link is at: https://notendur.hi.is/gylfason/KrugmanonKeynes.pdf