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Understanding Inflation

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What You Should Know

Today's economy is marked by record levels of inflation. Americans face higher prices across a variety of necessities and other goods and services. This presents a serious setback for the economy as the purchasing power of American households is diminished. The inflation rate, as measured by the Consumer Price Index (CPI), hit a 30-year high in October 2021 at 6.2 percent.

Prices for particular goods have increased even more: Gas prices are up 49.6 percent from one year ago. Common grocery items are also up, such as beef (20.1 percent), bacon (20.2 percent), and eggs (11.6 percent). Families are spending 28.1 percent more to heat their homes and 25 percent more on hotel stays.

Frustrated by pain at the pump—and at every other point of consumption—Americans are looking for answers: What causes inflation? Why are we facing high prices today? What can be done to slow inflation? The Covid-19 pandemic created new economic challenges as Americans were forced to stay at home and reduce economic (and social) activity during the initial response to the novel coronavirus. What does that have to do with inflation?

The answers to these questions are of great consequence. Inflation hurts everyone, but those with the lowest incomes suffer the most. These households already commit a greater share of their spending to necessary purchases such as food, energy, and transportation, and they have less room to shift their budgets around. Policymakers should focus their efforts on slowing inflation and relieving this burden.

Why You Should Care

Government policies meant to help households and businesses during crises, such as pandemics, recessions, and wars, can backfire by overheating the economy and driving inflation higher. Rapidly rising inflation can trigger harm that ripples across the economy:

- **Inflation is a kitchen-table concern:** Rising prices reduce workers' real wages and their purchasing power to obtain the goods and services they need. Inflation also devalues savings and wealth and erodes retirement dollars.
- **Hyperinflation can kill currencies:** Prolonged and excessive inflation can lead to scarcity of goods. Eventually, the value of money diminishes to nothing or nearly nothing. Imagine carting stacks of cash to the grocery store and finding there are few loaves of bread—and the price for one is still greater than the piles of money you have.
- **Inflation slows economic growth:** Inflation rates can cause an economy to retract as it reduces economic activity and business investment. Policymakers should be wary of inflation and should take great care to foster economic growth via good economic policy.

More Information

What Drives Inflation

Simply put, inflation happens when demand for goods and services outpaces supply. This can be the effect of excess demand, or restricted supply, or both. Policymakers generally believe that an acceptable inflation rate is about 2 percent. A lower inflation rate is considered deflation and signals a weak economy. Rapid, unrestrained inflation of over 50 percent each month over a period of time is hyperinflation. In this rare situation, prices on basic goods surge as they become more scarce and the value of money diminishes, even becoming worthless. Economies can break down under hyperinflation.

After the worst lockdowns of the Covid-19 pandemic, Americans felt "pent up demand" for consumer goods and services that they had to forego during the economic shutdown. At the same time, our economy struggled to supply the desired goods and services due to several issues including supply-chain disruptions, widespread worker shortages, and increased energy costs.

Supply-Chain Problems

Among the most high-profile cases of supply-chain disruptions is the shortage of semiconductor chips, used in medical equipment, electronics, and new cars. When the pandemic started, demand for new cars plummeted as few Americans commuted to work or traveled. So car manufacturers ordered fewer of the parts needed to produce cars. But this demand dip was short-lived. Demand for cars rebounded.

However, semiconductor chips take a long time—about six months—to produce and transport. This has slowed new car production and even forced car makers to offer cars without some amenities like heated seats. Without enough new cars being produced, the price of new cars has increased. And a close substitute—used cars—have seen prices increase 58 percent since October 2019.

But supply chain disruptions aren't limited to a few parts and raw materials here or there. A shipping crisis has global ports backlogged as cargo ships wait in line for days to be parked and unloaded. American manufacturers are now waiting a record **92 days** to assemble their goods, according to the Institute for Supply Management.

Even then, goods sometimes wait in warehouses for lack of truck drivers to deliver them.

Labor Shortage

Millions of Americans and indeed billions of people worldwide felt their livelihoods (and their very lives) disrupted due to the Covid-19 pandemic and its economic aftermath. Many lost jobs, and many left jobs because of other pandemic-driven pressures. Notably, school and childcare closures forced many working parents, especially moms, to work less.

Many policymakers and economists have hoped that the widespread availability of vaccines (and the reopening of schools) would allow many Americans to get back into the workforce with confidence. But businesses continue to struggle to find workers, and the labor force participation rate (now at 61.6 percent) continues to lag. Today it is **1.7 points** lower than before the pandemic. This represents about 2.8 million fewer workers.

If businesses aren't able to staff their factories, restaurants, shops, and services, they face hard choices: They must either restrict their hours and services or offer higher wages to bring in additional help. This higher cost is passed along to consumers in the form of inflated prices. Many businesses are turning to automation to alleviate their labor shortage.

A labor shortage can drive wages up, but sadly today wage growth is not as strong as inflation. As a result, in the short run, real wages or wages adjusted for inflation have fallen, leaving workers unable to purchase more even with higher pay. On the other hand, rising wages can fuel inflation, as workers have more money to spend chasing the very products that are in short supply.

Increased Energy Costs

Like labor, energy is a critical input in the manufacturing and distribution of most goods and services. If energy becomes more expensive, this fuels inflation—no pun intended.

The national average **gas price is $3.40**, up one dollar per gallon from one year ago. This is a seven-year high for gas prices. Natural gas, a key component in home heating, is also more expensive: The Energy Information Administration predicts that home heating costs will be **39 percent higher** this year than last year.

Once again, demand is outpacing supply. Americans are demanding more oil at a time when oil production—both globally and domestically—is not keeping up. Hurricane Ida hurt U.S. oil drilling and refining in late August, but not all challenges for domestic oil production are weather-related. Some challenges are political, as environmental groups oppose expanding U.S. oil production. Energy policy that reduces domestic energy supplies, as well as broader economic policy, can have serious consequences for inflation and for American consumers.

Impact of Economic Policy

Federal economic policies can both accelerate and slow inflation. Policymakers need to exercise great prudence and care when pursuing even worthy goals such as stimulating the economy, boosting homeownership, or encouraging labor force participation so that they do not accelerate inflation in a harmful way.

Monetary Policy

The U.S. Federal Reserve Bank (Fed) uses economic tools to control the supply of money with the goal of promoting healthy economic growth and maximum employment. By increasing the supply of money that banks, households, and businesses have to spend or loan rather than save, the Fed aims to stimulate a sluggish economy. Rising inflation is typically a sign of an overheated or overstimulated economy. However, by decreasing the money supply, the Fed can cool down an overheated economy. Households and businesses are encouraged to build up savings instead.

Interest rates are one of the tools the Fed uses. It sets the federal funds rate, the rate that it charges to loan money to the nation's banks, and they, in turn, adjust the interest rates they charge customers who are borrowing money for purchases such as homes, renovation projects, and business expenditures. Another way to think of interest rates is this: Interest is the price of money. When interest rates are higher, it's more expensive to borrow money. When interest rates are lower, people have an incentive to borrow money (and to spend their borrowed money on homes, cars, and so forth).

Interest rates and inflation have an inverse relationship; when interest rates are low, inflation tends to rise and vice versa. Policymakers and the banking industry track the Fed's movement on interest rates when it meets quarterly as a sign of the health of the economy and how the U.S. government may address economic concerns.

When interest rates are near or at zero, the Fed may utilize another, lesser-used tool to increase the money supply: quantitative easing (QE). The Fed purchases longer-term securities such as government bonds and other types of assets, from the open market. QE was used to stimulate the economy during both the Great Recession and early in the 2020 pandemic.

One challenge with monetary policy is that its effects take time to materialize. It may be months and even years before the impact is fully felt.

Fiscal Policy

The U.S. government can also impact the economy using its tools to tax and spend. Cutting taxes and increasing spending via government programs puts more money into people's hands and thereby increases the demand for goods and services, which stimulates the economy. For example, the government may provide direct payments to households (i.e. stimulus checks), grants to businesses, and infrastructure projects. Again, rising inflation occurs when the economy is overheated. Conversely, the government can cool the economy down by increasing taxes and/or reducing spending.

COVID Shutdowns

When the global pandemic began and the federal government advised states to shut down all non-essential operations, the economy came to a near standstill. Unemployment skyrocketed as over 20 million workers were suddenly unemployed and many temporarily shuttered businesses faced the specter of permanent closure.

The U.S. government and the Fed implemented extraordinary fiscal and monetary policies to stimulate the economy. The Fed **cut the federal funds** rate by a total of 1.5 percentage points, bringing it down to a range of 0 percent to 0.25 percent and purchased trillions in securities. It also implemented targeted loan programs to small businesses and nonprofits among other measures.

The U.S. government has spent upwards of **$6 trillion** over five COVID relief packages beginning in early March 2020. The various bills have provided funding for COVID-19 testing, contact tracing, vaccine research and distribution; expanded unemployment benefits; multiple rounds of stimulus checks to most households; forgivable loans to small businesses and nonprofits; rental assistance; funding for schools, public transit, and child care assistance; and much more.

Whether directly or indirectly, federal funding has allowed millions of households to boost their savings to the **highest recorded levels** during the 2020 shutdowns and created the pent-up demand that was unleashed when states reopened in the spring of 2021. Meanwhile, the supply of goods simply could not meet demand in part because of supply-chain disruptions and because of a significant national worker shortage due to generous benefits, mass retirements, and childcare issues.

Even as the pandemic wanes, the current rapid inflation rate is expected to continue for some time to come. According to the **San Francisco Federal Reserve**, the $1.9 trillion relief package (the American Rescue Package) passed in 2021 will cause inflation to rise by 0.3 percentage points in 2021 and 0.2 percentage points in 2022.

Who Does Inflation Affect Most Severely?

Inflation is a tax on all consumers, but not everyone is impacted the same way. Rising costs for goods such as food and gasoline disproportionately affect low-income, working poor, and elderly Americans. According to government data, the **lowest quartile** of households spend twice the proportion of their budgets (36 percent) on food compared to the middle quartile (15 percent), and four times that of the top quartile (8 percent). Higher-income families can increase their incomes or tap into their savings to offset price increases unlike low-income families, especially those on a fixed budget. Also, prices tend to increase on basic needs like food, shelter, and energy more than on luxury goods.

To help alleviate the impact of inflation on these households—and on all Americans—policymakers should promulgate policies that help, rather than hurt.

What You Can Do

Get Informed

Learn more about inflation. Visit:

- IWF's Inflation Tracker
- Bureau of Labor Statistics
- U.S. Federal Reserve

Talk to Your Friends

Help your friends and family understand these important issues. Tell them about what's going on and encourage them to join you in getting involved.

Become a Leader in the Community

Get a group together each month to talk about a political/policy issue (it will be fun!). Write a letter to the editor. Show up at local government meetings and make your opinions known. Go to rallies. Better yet, organize rallies! A few motivated people can change the world.

Remain Engaged Politically

Too many good citizens see election time as the only time they need to pay attention to politics. We need everyone to pay attention and hold elected officials accountable. Let your Representatives know your opinions. After all, they are supposed to work for you!

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Independent Women's Forum (IWF) is dedicated to building support for free markets, limited government, and individual responsibility.

IWF, a non-partisan, 501(c)(3) research and educational institution, seeks to combat the too-common presumption that women want and benefit from big government, and build awareness of the ways that women are better served by greater economic freedom. By aggressively seeking earned media, providing easy-to-read, timely publications and commentary, and reaching out to the public, we seek to cultivate support for these important principles and encourage women to join us in working to return the country to limited, Constitutional government.

We rely on the support of people like you!

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