3-1 Inflation and Prices

OBJECTIVES

- ***Define inflation and explain how it is measured.***
- ***Describe types of inflation.***
- ***Describe the causes of inflation.***
- ***Explain how inflation and employment levels are related.***
- ***Explain how inflation affects spending, saving, and investing decisions.***

This chapter is about prices and how inflation affects what consumers can buy. Inflation is an increase in general price levels. Inflation erodes the value of money and takes away purchasing power. There are different types of inflation. Each type works in a different way to cause prices to rise. Inflation also affects the value of money, whether it is money you will receive in the future or money you have now. Selling strategies are used to convince consumers to buy goods and services. Buying strategies of consumers help them prepare for and make wise buying choices.

WHAT IS INFLATION?

Price is the amount a buyer pays for a product or service. Inflation is an increase in the general level of prices for goods and services. Inflation reflects how much prices are rising. When prices are rising faster than income, buyers lose purchasing power. In other words, the money workers earn will buy less as prices rise. Changing prices affect the spending power of both producers and consumers. The economy changes over time based on events and on habits and attitudes of producers and consumers. For example, an event such as a flood or hurricane that wipes out crops may affect prices. Habits explain how people react to changes in the supply of goods, world events, and their individual situations. For example, when consumers think they may soon lose their jobs, they tend to buy less and to buy different goods. Attitudes reflect how people think about their future and about the product being sold. Will the product help me stay healthy? Is it worth the price? These are questions a consumer might ask that reflect attitudes. All these factors affect prices and inflation.

MEASURING INFLATION

Inflation is measured by the U.S. government. The measurement tool used is called the Consumer Price Index (CPI). The CPI uses a list of goods and services that are commonly bought by consumers. The index measures changes in price from a base or starting point in time to the current time. For example, if the price of an item was $1.00 in the base year and it is now $1.12, that is a 12 percent increase in the price. If the increase happened in just one year and it happened to all the goods on the list, the inflation rate for that year would also be 12 percent. You can learn more about the CPI at the Bureau of Labor Statistics website (www.bls.gov). The government also gathers information about consumer spending. Its surveys measure spending habits of consumers and track data such as income.

TYPES OF INFLATION

Businesses base price decisions in part on what consumers are buying and not buying. Several price change patterns may happen over time. These patterns result in varying types of inflation.

DISINFLATION

Disinflation occurs when prices are rising, but at a slow rate. In other words, prices are rising, but at a decreasing rate. Some products and services do not increase in price as fast as others. Often, this happens when demand for a product is not the same throughout the year. For example, in spring and summer, the price of swimsuits may be high and rising. In fall and winter, however, if the price is rising, it is doing so at a much slower rate.

REFLATION

Reflation occurs when prices are high but then drop due to lower demand; then they are restored to the previous high level. Perhaps you have heard a news reporter use this term to describe crude oil prices. Reflation can happen when the available supply of a product, such as oil, goes up and down. Reflation can also happen when consumers temporarily stop buying a product or service. Then, for some reason, they start buying it again. For example, when gas prices surge, people may not buy as many big cars and trucks that use a lot of gas. They wait to see what will happen with gas prices. When gas prices fall, they begin buying large vehicles again.

HYPERINFLATION

When prices are rising so rapidly they are out of control, this is called hyperinflation. In the United States, there have been periods of double-digit inflation (10 percent or higher in a year). However, hyperinflation rates are much higher. Although

there is no set rule, many economists consider inflation rates of 50 percent or higher to be hyperinflation. Some countries have had rates of several hundred percent per month. For example, in Germany after World War I in 1923, the monthly inflation rate reached over 300 percent. The effects of very high inflation rates can be devastating. With hyperinflation, prices are rising so rapidly that consumers spend their money as fast as they can. They do this because they fear that prices will be even higher if they wait. This spending leads to even more inflation. Then people are unable to buy the goods they need to live comfortably.

DEFLATION

Deflation is the lowering of overall price levels. It is the opposite of inflation. In other words, prices are going down. This happens in periods when events cause consumers to buy less and when producers are able and willing to provide goods at lower prices. Some products go down in price over time even when the country is not in a time of deflation. For example, a computer that uses a new, faster processor may sell at a high price when it first comes on the market. A year later, the same computer may sell for hundreds of dollars less. The price is lower because it is no longer the newest, fastest computer available. Other, newer models have been released.

CAUSES OF INFLATION

Inflation can be caused by different factors in the economy. Consumers may want to buy more goods or services than are available, driving up prices. Producers may have to pay more to produce products and may need to raise prices. Both situations can lead to inflation.

DEMAND-PULL INFLATION

The most common type of inflation is called demand pull. Demand-pull inflation occurs when consumers want to buy more goods and services than producers supply. Consumers may spend their income as soon as it is received, and they are willing to spend future income (credit) as well. This spending causes businesses to scramble to meet the demand for goods. Because products are selling so quickly, businesses are able to raise prices to balance supply with demand and to make bigger profits. This type of inflation is often described as “too many dollars chasing too few goods.”

COST-PUSH INFLATION

Cost-push inflation occurs when producers raise prices because their costs to create products are rising. For example, when wages go up, the cost of producing a product goes up. Producers may then raise prices. If producers did not raise prices, profits would shrink. Cost-push inflation occurs when cost increases are not offset with greater output that lowers the cost of each unit made. Productivity is a measure of the efficiency with which goods and services are made. When productivity rises, the cost of a wage or other increase is offset by producing more and better products. In this case, inflation (price increases) does not occur. Instead, more and better products and services are made at the same price level.

REAL-COST INFLATION

As resources diminish or become harder to get, prices rise in the form of real-cost inflation. For example, when there is less natural gas, or companies have to dig deeper to get it, this causes the cost of providing natural gas to rise. Over time, resources that are in high demand may shrink in supply. With a growing population’s ever-increasing demands, this may happen with many products. To avoid this type of inflation, people must find other resources to use instead of the one that is scarce.

INFLATION AND EMPLOYMENT

Economists think there is a relationship between inflation and employment. In times when prices are high, producers often make more money. They are able to hire more people. Thus, higher inflation also means higher employment. When inflation is reduced, people may be laid off. This is because prices are not increasing, and therefore profits are not increasing. With lower profits, producers may start laying off workers. In times of zero inflation, price levels are flat (not increasing or decreasing). Businesses may not be able to afford to hire workers. Thus, mild inflation of 2 or 3 percent can be good for the economy.

INFLATION AFFECTS SPENDING, SAVING, AND INVESTING

Inflation has a negative effect on the value of money. As general price levels rise, the value of money falls. Thus, employees who work for a set rate of pay are able to buy less in times of inflation when prices rise. This is because some jobs provide pay

raises only annually or less often. While prices are rising on the goods and services employees buy, their pay is not rising at the same rate. Thus, consumers have two choices: they can buy less, or they can borrow money to continue the same level of spending. Either way, it takes more money to keep getting the same amount of goods and services.

Inflation also affects the amount of money consumers may be able to save. In times of rising prices, consumers may have to use more of their disposable income to buy needed goods and services. Less money may be available for saving.

The time value of money is a concept that says a dollar you will receive in the future is worth less than a dollar you receive today. This assumes that prices are rising. For example, suppose you loan a friend $20 today. Your friend promises to pay back the $20 one year from today. The money you receive one year from today will not have the same value as the money you loaned your friend today. This is because prices will be higher one year from today, and the money will not buy as many goods one year from now as it will today.

Consumers consider the expected rate of inflation when choosing investments. They want to invest their money in a way that will provide a return that is greater than the rate of inflation. For example, suppose the inflation rate over 5 years is 5 percent. Investments such as savings accounts, stocks, or bonds must have a growth rate of at least 5 percent for the money invested to keep its purchasing power.

FOCUS ON: The Fed

When inflation is rising too fast, it hurts consumers. Two tools are used in the United States to manage the effects of rising prices. These tools are called monetary policy and fiscal policy. Monetary policy refers to actions by the Federal Reserve System. The Federal Reserve System is commonly called the Fed. The Fed is the central bank in the United States. The Fed was created by Congress in 1913. It has many roles, including controlling the money supply. One thing the Fed does is watch the economy. When the Fed sees that prices are rising too fast, it tries to slow them down. One way to slow rising prices is by raising interest rates. When interest rates increase, both individuals and businesses find it more expensive to borrow money to buy goods and services. This slows down spending. As you learned earlier, demand-pull inflation is caused by spending in the economy. There are several types of interest rates that are controlled by the Fed. The discount rate is the rate that banks have to pay to borrow money from the Fed. Banks borrow money when they have the opportunity to make loans but do not have enough cash on hand. Banks are required to have a certain amount of cash on hand, called reserves. If these reserves go below the required amount, banks must borrow money. The federal funds rate is the rate at which banks can borrow from the excess reserves of other banks. For example, if one bank has more money than it needs, it can loan that extra money to other banks. The prime rate is the rate that banks charge to their most creditworthy business customers. When the discount rate increases, the prime rate also goes up. The prime rate is usually 3 percent (or more) higher than the discount rate or the federal funds rate. Fiscal policy refers to actions taken by the federal government to manage the economy. To help curb inflation, one thing the government can do is raise taxes. When taxes go up, people have less money to spend. This slows down inflation (demand-pull). On the other hand, the economy may be sluggish because people are not buying. The government can increase spending by lowering tax rates. This gives consumers more money to spend. These actions, taken together, either speed up or slow down spending (and therefore inflation).

3-2 Price and Demand

OBJECTIVES

- ***Describe three methods of setting prices in a market economy.***
- ***Explain how consumers' buying strategies affect demand and prices in a market economy.***

In a market economy, prices are affected by a number of factors. Some factors are controlled by producers. Consumers' actions also affect prices in the marketplace. In Chapter 1, you learned that demand is the willingness and ability of consumers to buy products and services. If consumers' demand for a product is low, prices may fall or the product may no longer be produced. Sellers offer products to consumers at certain prices. Sellers must be careful, however, in setting a price. If the price is too high, consumers may not buy the product. They may not be able to afford the price, or they may simply think the price is too high for the value received. If the price is too low, the demand for the product may be low. Consumers may think the product has a low value and, again, may not buy the product. Also, if the price is too low, the company may not make any profit on the sale of the product. Setting the right price for a product can be tricky. Having products available at the right price is critical to business success.

SETTING PRICES IN A MARKET ECONOMY

Companies use different methods to set prices. Sometimes more than one method is considered when setting a price. Sellers want to set a price that will support the greatest demand and will be profitable. Some methods of setting prices are discussed in the following sections.

COST-PLUS PRICING

One way that sellers set prices is called cost-plus pricing. Cost-plus pricing computes the total cost of making and delivering a product. Then a percentage of that amount, called markup, is added to the cost. The markup is also called the profit margin or gross profit. Using this method ensures that the company will make a certain profit if the product is successful.

VALUE-BASED PRICING

Using value-based pricing, the seller tries to determine how much consumers will be willing to pay for the product. In other words, it will be sold for the highest price that the market (consumers) will bear. If consumers value the product or service, they will pay whatever price is set, within reasonable limits. This is especially true of new, high-tech, and fad items. Consumers are willing to pay high prices because there are no less expensive choices. Companies may do market research to determine what the demand for a product will be. They also want to learn how much consumers will be willing to pay for the product. Perhaps you have been asked to complete a market survey while shopping at a mall. Telephone and Internet surveys are other popular ways that companies learn about consumers' wants and needs.

MARKET-BASED PRICING

With market-based pricing, the price is set to be competitive with prices of similar products currently being sold. If one business charges a lot more than others do for a similar product, consumers are likely to buy from the other companies that offer a lower price. The manufacturer or retailer simply decides whether or not it can provide the product or service at that existing price and still make a profit. This is the easiest form of setting a price. It helps producers or sellers decide what products to include in their marketing mix. The marketing mix is the group of products or services offered for sale by a business at any point in time.

A seller may introduce a new product at a higher price than similar products on the market. In this case, the seller tries to show how the new product is different from or better than other products. For example, many models of digital phones are available. A seller offering a new phone might cite the phone's small size or new features. The phone might take digital pictures or send text messages. These features are advertised to make the new phone seem more desirable. The seller may use these new or added features to justify a somewhat higher price. This strategy is not always successful. Consumers may not think the new features are useful or worth the higher price.

BUYING STRATEGIES AFFECT DEMAND

Consumers play a vital role in setting prices in a market economy. Consumers use two basic strategies when buying goods and services. They try to spend as little as possible, or they try to get as much value as they can for the money they spend. These two approaches are not mutually exclusive; that is, buyers do not use just one plan or the other for all purchases. Consumers can use the plan that best fits their needs for different goods and services.

ECONOMIZING

Consumers are economizing when they are saving as much as possible and spending money only when necessary. Using this approach, consumers wait until it is necessary to buy a product. Then they buy as little as possible and at the lowest price. They do not buy large quantities or more than is needed at the present time. They simply try to spend as little money as they can for the needed product.

Most people go through periods of time when they economize. Others follow this spending pattern all the time. Economizing has its advantages. For example, holding back on spending often results in not buying some items at all. Economizing can lead to savings and better buying habits. For some people, economizing is the only plan that allows them to meet their basic needs. For other people, economizing is a strategy used during certain times as a way to save money for later spending or investment. When economizing, people may spend little or no money on luxuries. This can lower the demand for luxury items. People may also spend less on items for basic needs, such as food or clothing. Lower demand for products may lead to lower prices.

OPTIMIZING

Another spending strategy is called optimizing. Optimizing means getting the highest value for the money spent. High value may come in the form of a large number of products or services or in the form of high-quality products or services. For example, if a product is on sale, is used a lot, and stores well, a large quantity can be purchased. The cost per item will be lower when the item is bought in quantity. When customers are optimizing, demand is higher when prices are lower. Consumers will buy more products to take advantage of lower prices.

Consumers should be careful not to let optimizing lead to overspending. Spending too freely can lead to poor buying habits. Shoppers may buy items they do not need simply because the items are a bargain. Items that have been stockpiled may be used more freely than usual because the consumer has a large quantity of the item. Overspending can also lead to credit problems. Using both economizing and optimizing strategies at the proper times may be the best solution for many people.

3-3 Selling and Buying Strategies

OBJECTIVES

- ***Describe strategies used by businesses to sell goods and services.***
- ***Explain how businesses are able to create demand for a product.***
- ***Discuss strategies buyers can use before, during, and after a purchase.***

SELLING GOODS AND SERVICES

Business owners take the risk of bringing products and services to the market. To stay in business, they must sell those products or services to customers and make a profit. Sellers use other strategies, in addition to price, to promote the sale of goods and services to customers.

CONVENIENCE

One strategy companies use to promote sales is to make shopping convenient and pleasant for customers. A store location that is easy for customers to visit makes shopping more convenient. A clean, comfortable, and safe place to buy goods and services makes the shopping experience more pleasant for customers. Friendly and helpful salesclerks also help promote sales. An important part of convenience is the payment method. Most businesses allow for cash and credit purchases. This includes the use of debit and national credit cards, as well as writing checks or having store credit.

CUSTOMER SERVICE

Businesses depend on good customer service to promote sales. Good customer service includes a lot of things. A warm, friendly greeting and prompt and courteous help when it is needed are examples of good customer service. Good customer service increases the chances that shoppers will return to the store to buy again. Satisfied customers also tell others about their experience. This word-of-mouth promotion is good for sales. Poor customer service may keep shoppers from returning to buy again. Even if prices are low or the store is convenient for the shoppers, they may not return if they had a bad experience. Dissatisfied customers also tell people about their bad experience. This message can be very harmful to future sales.

MEETING NEEDS AND WANTS

Businesses try to make available to customers the types of products they need or want. Making the right products available increases the chances of business success. Some products meet basic food, clothing, and shelter needs. Everyone needs to be able to eat and stay warm and safe. Examples of products that fill basic needs include groceries, clothing, shoes, and housing.
Products that save time are valuable to consumers. Often, these same products also save energy. Examples of products that save time and energy include washing machines, power tools, and food processors. Products that make users feel or look younger or more attractive are appealing to consumers. These products have emotional appeal. Although the products may fill wants rather than needs, they represent great profits to sellers. Examples of these products include makeup and hair dye. Products that support good health and help users feel better also appeal to consumers. These products tend to be more expensive and specialized. Examples are vitamins and organic foods.

CREATING DEMAND

To sell goods, businesses may need to create or stimulate demand. Advertising is a method of informing consumers and promoting and selling products. Advertising, also called ads, comes in many different forms. They all have the same purpose—to get people to buy.

NEWSPAPERS AND MAGAZINES
Placing ads in newspapers and magazines is a popular way to reach large numbers of people. The ad may promote a product or a company. It may be a short one-item ad or a full-page color ad showing many products. Typically, ads include special prices, coupons, or other incentives to bring customers into the store.

TELEVISION AND RADIO
Television ads are very expensive. However, they reach large numbers of people. Television ads are written to appeal to a target audience. A target audience is a specific group of people who are likely to be watching and are likely to buy the product. For example, different people watch various TV programs or tend to watch TV at certain times. Some people watch news shows. Others watch on Saturday mornings or on Super Bowl Sunday. Companies design ads that will appeal to these target audiences. They run the ads on certain shows and at specific times. Radio advertising attracts audiences with special interests. Radio programs range widely in content. News programs, talk shows, religious messages, and many types of music can be found on radio. Radio ads often involve appeals to emotions. They may use slogans or have catchy tunes. As with TV ads, radio ads target people who are thought likely to listen to a particular program.

THE INTERNET
The Internet is a popular place to shop. Many types of advertising can be found on the Internet. The ads help sell products by informing shoppers and encouraging them to buy. Banner ads span the top, bottom, or sides of a Web page or site users visit. They have bold statements or pictures that grab the user's attention. Pop-up ads appear while the user is visiting Web sites or browsing. They pop onto the screen. The user must click No or a similar command to close them. Some people buy special software to block pop-up ads. Many online retailers customize ads to shoppers who have visited their site. The user logs in and does some shopping. The site tracks the products clicked and Web pages visited. The retailer may send the shopper an e-mail offering a product or service that he or she showed interest in previously. Such e-mails often offer specials, such as free shipping or a price reduction for online purchases.

Other Web sellers place cookies on the shopper's computer. Cookies enable the seller to recognize the shopper in the future. They may also contain information about products the user viewed or bought in the past. Some online sellers share this data with other retailers. Shoppers may get e-mails, pop-ups, or other forms of targeted ads from online sellers they have never visited. Some sellers use electronic newsletters sent monthly or at other set times to encourage customers to buy. These ads feature pictures and prices of products. Users sign up to receive them and are usually able to cancel them if desired.

DIRECT ADVERTISING OR SALES
Direct advertising takes the product directly to consumers. It involves actions such as sending free samples in the mail and giving out samples in a store. This form of advertising allows the customer to try the product. One form of direct advertising is direct sales. A salesperson goes door-to-door to give customers a catalog or to show them a product. Another method is holding a party to sell products to a group of friends. This approach takes the product directly to the consumer, using a person-to-person approach.

OTHER TYPES OF ADVERTISING
There are many other forms of advertising. Some are subtle and indirect, such as placing coupons in entertainment books. Others are up-front and bold, such as billboards. A brochure listing used cars or houses for sale is another method. Whatever the medium, ads catch the consumer's attention and stimulate interest in buying a product or service.

BUYING STRATEGIES

Sellers have strategies to encourage you to buy. You should have a plan to maximize your buying power. Some ideas to help you in your role as consumer are given in the following sections.

BEFORE YOU SHOP
Before going to the store, prepare a shopping list of the things you need. Base your list on well-thought-out ideas, such as a menu plan, so you can resist impulse buying. Decide ahead of time what you will buy and about how much you will spend. Also plan how you will pay for the items. Planning ahead will help you avoid overspending or buying items you do not need.
For major purchases, you may deal with a salesclerk who is paid on commission. The clerk may encourage you to spend more than you intended. Plan your strategy ahead of time. Before you leave home, decide what you want or need and how much you are willing to pay. Prepare questions to ask. Do not allow a salesclerk to convince you to spend more than you planned.

WHILE YOU SHOP

While at the store, stick to your list. Compute unit prices, and make sure you are getting the best deal for the products you are buying. Do not go grocery shopping when you are hungry—being hungry will affect your choices. If you have made decisions about how much you will spend for an item, stick with them. Do not make on-the-spot decisions that you may regret later or allow yourself to be pressured into buying. If necessary, take someone with you to give you support. Do not select last-minute purchases at the checkout line. These items are often high-priced, low-value purchases.

AFTER YOU BUY

Keep the receipts and warranties for all items purchased. Remove a product carefully from its packaging. If there is a box or bag, keep it until you are sure that you have all the pieces for the product and that it works properly. If you need to return an item, be sure all the pieces are back in the package. Evaluate your purchase. Are you satisfied with the product? Is it what you had intended to buy? Are you satisfied with the service you were given? Answering these questions will help you make better decisions in the future.

FOCUS ON: Price Gouging

Economic conditions can change quickly in times of emergency. For example, when a natural disaster occurs, there are inevitable shortages. If a flood occurs, people may desperately need clean water to drink. They may need gasoline, food, and other necessities. Businesses that have these essential goods have two choices—they can keep their prices the same, or they can raise their prices. If they raise prices to what is considered an unfair amount, this is known as price gouging. Some people think it is good business to raise prices when demand is high. They view this process as simply supply and demand forces at work. Others think that price gouging is unethical. They believe businesses are taking advantage of people who are unable to buy elsewhere or do without the product. Some states have laws against price gouging in times of declared civil emergencies. What can you do to avoid being a victim of price gouging? The best strategy is to plan ahead. Prepare for emergencies by having essential items on hand. Keep a supply of clean drinking water and food packaged to prevent spoilage to feed your family for several days. Gather blankets, flashlights, a portable radio, and batteries ready for use. Have a corded phone on hand. A cordless phone may not work if electrical power is out. Buying essential items ahead of time will allow you to avoid paying higher prices during an emergency.

Chapter Summary

- ***Inflation is an increase in general price levels for goods and services.***
- ***Inflation is measured by the U.S. government using the Consumer Price Index (CPI).***
- ***Deflation is a decrease in general price levels. It is the opposite of inflation.***
- ***Demand-pull inflation occurs when consumers want to buy more goods and services than producers supply. Cost-push inflation occurs when producers raise prices because their costs to create products are rising. Real-cost inflation is rising prices due to scarce resources that are diminishing or are harder to acquire.***
- ***There is a connection between inflation and employment. Higher inflation usually means that more people are employed.***
- ***Inflation reduces the value of money. As prices rise, money buys less.***
- ***Inflation affects the amount of money consumers may be able to spend, save, or invest.***
- ***In a market economy, prices are affected by producers, consumers, and other factors.***
- ***Cost-plus pricing adds the total cost of making a product to a profit margin. Value-based pricing sets a price that is as high as consumers will pay. Market-based pricing sets a price based on prices of similar products in the marketplace.***
- ***Consumers can economize (spend as little as possible) or optimize (spread dollars as far as they will go).***
- ***To sell products, businesses make shopping convenient, provide customer service, meet needs and wants, and create demand.***
- ***Advertising is an effective method for sellers to create and stimulate demand for products.***
- ***Consumers can use good buying strategies to spend money wisely.***
- ***Price gouging is charging unreasonably high prices for essential goods, such as food and fuel, at certain times when demand is high, such as in times of emergency.***