

# Inflation basics: What it means, how it happens and who it hurts

Everyone talks about inflation but few can really explain it

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As the economy recovers, talking heads will turn to the next economic fear — inflation.

But the talking heads rarely explain what inflation is, what causes it, why it's bad or who it hurts. Dr. Robert Premus knows. He's taught economics at Wright State University for more than 30 years.

"Inflation is a general rise in the money prices of goods and services that we buy," Premus said. He explained it's more helpful to know what inflation is not.

"Inflation is not a change in the relative prices of two or more goods," Premus said. "For example, if the price of apples rises and the price of oranges fall, oranges are now relatively more expensive, but this is not inflation since apples are relatively cheaper. The increased cost of oranges is offset by a decline in the cost of apples, so there is no increase in the aggregate cost of apples and oranges."

Inflation occurs when the government prints money faster than the economy grows.

The classic illustration of inflation is an island economy where there are 100 people using \$10,000 to carry out their economic activity. If \$20,000 washes up onshore, the islanders will feel richer — in the short term. But as the cash works its way into the island economy, prices triple and



the population feels as if its gotten nowhere.

In the example, the suitcase washing up onshore is the government printing too much money.

Premus said "inflation acts like a tax on the nation's money stock, decreasing its purchasing power," but not all islanders are hurt by it.

"People generally assume that they are always harmed by inflation," Premus said. "However, if one's wages rise faster than the price level, people will be better off. Even though they are paying more for goods and services the purchasing power of their wages is rising.

"Inflation hurts people on fixed incomes, such as retirees. Inflation also hurts those who hold money in their savings and checking accounts."

Premus predicts rising inflation beginning in 2010.

"The Fed pumped an enormous amount of new reserves into the banking system in order to head off a pending financial collapse," he said. "Although the banking system is now much more stable, the banks have the potential to expand the money supply at an accelerated rate. It is too late for the Fed to pull back on these reserves to avoid a rise in the inflation rate from the recent 1-2 percent rate to a 3-5 percent rate in the out years."