Inflation and purchasing power

Joseph McGarrity
Economics professor

Inflation is the percentage change in the average price level. When there is inflation, dollars become less valuable. Here is why that matters: if the price level goes up but your income stays the same, your salary can't buy as much stuff, so your standard of living will decline. Fortunately, inflation rates typically run at about 3 percent in the U.S., which is pretty low by international standards. Even more fortunately, the inflation rate has been exceptionally low in recent years. From 2012 to 2020, it was always less than 3 percent; from 2013 to 2016 it was always less than 2 percent; and in 2015 it was only 0.1 percent. Given these historically low inflation rates, many people did not even notice the upward trend in average prices.

Even though Americans usually experience low inflation rates, once in a while high levels of inflation break out and the country suffers. From 1979 to 1981 the annual inflation rate was always over 10 percent. Over the three-year period, each dollar became 39 percent less valuable. Think about this. People, with fixed incomes and who held their savings in checking accounts, lost almost 40 percent of their purchasing power in just three years. People noticed these changes. People were losing purchasing power so quickly that some of them probably felt like they were being robbed.

Recent Bureau of Labor Statistic news releases suggest that our period of low inflation may be over. Over the last 12 months, the inflation rate was 5.3 percent, which is higher than average. But what does it mean to say that the average price level has increased by 5.3 percent? It certainly does not mean that the prices of all goods and services increased by 5.3 percent. Some items saw large price increases, others saw small price increases, and although you may find it hard to believe, some prices even decreased.

The largest price increases occurred in just a few areas of the economy, but these price increases were large enough to drive up the inflation numbers. To be more specific, over the past 12 months, energy and transportation prices drastically increased. Gasoline prices increased by 42.7 percent and natural gas prices increased by 21.1 percent. New vehicle prices increased by 7.6 percent and used car and truck prices increased by 31.9 percent. If you recently bought an expensive used car and used more energy than most people, you felt the pain of inflation and the 5.3 percent inflation rate probably underestimated your pain.

On the other hand, if you did not buy any cars and kept your energy purchases low, you may have avoided most of the downside that came with a higher average price level. The 5.3 percent inflation rate may overestimate how much less you can buy with your dollars. There are plenty of other things besides energy and cars that you can purchase and the prices of these other things did not increase substantially. Over the last 12 months, food prices at grocery stores increased by 3 percent, which remember is the typical increase in the average price level. The price of medical care only increased by 1 percent and the prices of medical commodities decreased by 2.5%.

It is worth remembering that inflation is a measure of the change in the average price level. It just gives us the average decline in the purchasing power of the dollars that Americans use to buy the goods and services that they typically purchase. However, if people are strategic – spending less on energy and transportation and more on medicine and groceries – they can avoid some of the loss in purchasing power that comes with inflation.