Real World Graduation: Question 7

Edward D. Duvall

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Question 7

A reputable economic research organization conducted a survey of prices in 2004. They found that median prices of the following items increased as follows:

1. Unleaded gasoline, from $1.59 per gallon to $1.88 per gallon; an increase of 18.23% [1]
2. Single-family homes, from $243,756 to $264,540; an increase of 8.52% [2]
3. Soybeans, from $6.08 per bushel to $7.56 per bushel; an increase of 24.34% [3]
4. Flour, 5-lb bag, from $1.55 to $1.65; an increase of 6.45% [4]

From these statistics, what is the approximate inflation rate from 2003 to 2004?

a) The inflation rate should include only the data for gasoline, soybeans, and flour, since those are common products that people use directly or indirectly every day; the inflation rate is approximately 16.3% = ((18.23 + 24.34 + 6.45)/3)

b) Only the data for single-family homes should be used, since homes are purchased on long-term mortgages (usually 30 years), and are therefore a better predictor of long-term inflation. The long-term inflation rate is the most important metric. Therefore the inflation rate for 2003-2004 is approximately 8.5%.

c) Only the data for unleaded gasoline should be used because it is the only one of these that most people have to buy directly. Most people do not buy homes every year, and the prices of soybeans and flour are not useful because they are only components in items purchased by most people (i.e., flour is used in making bread, but there are other costs besides flour that contribute to the increase price of bread, such as sugar, butter, and fuel). Therefore, the inflation rate for 2003 - 2004 is approximately 18.23%.

d) All of the data should be used, but not equally weighted, since some of these are purchased frequently, and some infrequently, and some are used more than others. For example, gasoline is purchased frequently, and homes infrequently. No data was provided on the pro-rated amount of usage, so the most that can be inferred about inflation during this period is that was somewhere between 6.45% and 24.34%.

e) Only the data for soybeans and sugar should be used, since they are basic commodities that are used in a large number of products, and represent structural trends in the economy. Therefore, the inflation rate was approximately 15.39% (the average of 24.34 and 6.45)

[1] Energy Information Administration
[2] Federal Housing Finance Board; see about.com/US Government info (The New York Times Company)
[3] farmdoc Project, College of Agricultural, Consumer and Environmental Sciences, University of Illinois at Urbana-Champaign
[4] Wisconsin Farm Bureau Federation

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http://edduvall.com
edward.d.duvall@gmail.com

Edward D. Duvall is the author of The Federalist Companion: A Guide to Understanding *The Federalist Papers* and *Can You Afford That Student Loan*.

Answer to Question 7

This is a trick question. All of the answers are false.

The question asks about the rate of inflation, but only gives data on the rise in prices. A rise in prices can come about by many different causes: a) an increase in demand with a fixed supply; b) a reduction in supply with fixed demand, c) buying by optimistic speculators; d) accident, hurricanes, floods, tornadoes, and droughts; e) increased cost due to new regulations; and many others. But natural prices also can decrease if: a) supply is greater than demand; b) demand drops in the presence of the same supply, or c) less capital is wasted in unnecessary regulations.

Inflation is an entirely different thing and has a different cause. Inflation is due to an expansion of the money supply in excess of the needs for production and clearing the market of that which is produced. It is not an increase in prices per se; it is the reduction in the buying power of the unit of currency, which means that, because each dollar is worth less, it takes more of them to buy a certain thing, and prices increase. The rise in prices of products is one symptom of inflation. Note the difference: a normal price increase is due to economic factors; inflation is due to government or central bank manipulation of the currency by printing more currency than is required for the economic exchange requirements of the economy. Only governments and central banks in control of the money supply can create inflation; inflation cannot be caused by industries, farmers, unions, workers, Wall Street, or any other economic participants, although the government would like you to blame any or all of them. The general, underlying rise in prices, which robs the working person, is always due to government and government-chartered banks, like the Federal Reserve.

True inflation is always marked by a general rise in all prices with the other natural effects upon prices added on to it. It is very difficult to separate out which part of a price change is due to true inflation of the currency, and which are induced by naturally-occurring economic effects. It is therefore easily camouflaged, and a great deal of ink and videotape is used to mask the fact that governments and their central banks are responsible for a reduction in the value of a dollar and the resulting reduction in the standard of living for the average worker. The most reliable indicator of true inflation was the publication of the "M-3" statistics by the Federal Reserve, which showed how much new currency was being printed. It has now been discontinued (care to guess why)?

So, there was insufficient data provided in the question to determine at what part of the increase in prices was due to inflation and which are due to other normal causes. Typically several year worth of data is required to estimate the monetary inflation rate. The main point here is: don't be confused by the much-advertised "Consumer Price Index". It is a measure of the increase in prices of an averaged composite of a mix of commodities, and cannot separate out the debasement of the currency from other normal causes.

http://edduvall.com
edward.d.duvall@gmail.com

Edward D. Duvall is the author of The Federalist Companion: A Guide to Understanding *The Federalist Papers* and *Can You Afford That Student Loan*.