**Inflation: Why do prices rise and fall?**

[CBC News](http://www.cbc.ca/news/cbc-news-online-news-staff-list-1.1294364)Posted: Jul 17, 2009 12:45 PM ETLast Updated: Jul 17, 2009 12:52 PM ET

At its most basic, inflation simply refers to the upward price movement of goods and services — in other words, the rise in the cost of living. The rate at which prices move up is one of the most closely watched economic indicators.

When prices rise, the purchasing power of money drops. The expectation that prices will continue to rise leads to workers demanding more pay to prevent themselves from falling behind.

**What causes inflation?**

Depends which economist you ask. Some argue there's a strong link between inflation and the supply of money. If the amount of money in circulation rises, so will prices. Some economists warn that higher inflation than what we've been used to for the past 15 years could return as a result of all the economic stimulus that governments have been injecting to try to deal with the recession of 2008-2009. Others point to an overall demand in the economy: if demand for products exceeds the capacity of factories to build them, prices will rise. Prices fall if fewer and fewer people want to buy those products.

**How is inflation measured in Canada?**

Statistics Canada tracks inflation through the consumer price index (CPI), a basket of about 600 goods and services the average Canadian household consumes. Most prices are checked during monthly visits to major retailers. Other prices are checked by phone or on the internet. Nationally, about 650,000 prices are checked each year. Prices are weighted by their importance in the total budget, so a 10 per cent increase in rent would have a bigger impact on the CPI than a similar increase in the price of bread. The CPI is measured against a base year, which is currently 2002. So, if Statistics Canada reports that the "all-items" CPI hit 115.3, it means that it would take $115.30 to pay for a typical basket of goods and services that cost $100 in 2002. In June 2009, the all-items index was 115.1, down from 115.4 in June 2008. The index would have gone up if it weren't for falling gasoline prices. The transportation index dropped 7.7 per cent from June 2008. Transportation makes up 19.88 per cent of the all-items index. That's second only to shelter, which makes up 26.62 per cent of the index.

**What is the rate of inflation?**

It's the number we pay the most attention to. When Statistics Canada reports that the annual rate of inflation was 2.1 per cent one month, it means that its representative basket of goods and services costs 2.1 per cent more than it did a year earlier. If the following month's rate of inflation is lower, it does not mean that prices fell. It just means the rate at which prices increased, slowed down. In June 2009, the rate of inflation was minus 0.3 per cent. That's the first time the rate has been negative since 1994. But take out the impact of falling gasoline prices and the rate would have been 2.1 per cent.

**What is the core rate of inflation?**

The core rate of inflation measures price changes in that same basket of goods - but without the most volatile elements (fruit, vegetables, gasoline, fuel oil, natural gas, mortgage interest, intercity transportation and tobacco products). It's the rate the Bank of Canada takes most note of. Since 1991, the central bank and the federal government have set inflation targets. The Bank of Canada currently tries to keep the rate of inflation between one and three per cent and aims for a 2 per cent target midpoint. The central bank uses interest rates to try to keep the rate within its target. When inflation is at the low end of that band, the bank has the freedom to cut interest rates. However, if the inflation rate starts heading toward the upper end of the target, the bank may raise interest rates. Higher interest rates tend to reduce demand for certain goods and services. For instance, you'll be less likely to buy a car or a house when rates are higher and it's more expensive to borrow to finance the purchase.

**Has the government used other methods to try to control inflation?**

In 1975, the government of Prime Minister Pierre Trudeau set up the Anti-inflation Board (AIB) in its efforts to combat inflation. The government introduced wage and price controls, which were administered by the AIB. It was the first time that the government used wage and price controls in peacetime. The wage and price controls applied to the public sector and to private companies with 500 or more employees. Wage increases were capped at 10 per cent in the first year of the anti-inflation program, eight per cent in the second year, and six per cent in the third year. The program was very good at keeping a lid on wage increases. But by the early 1980s, inflation had hit 12.5 per cent.

**What is deflation?**

It's the opposition of inflation. When prices fall you have deflation. Most governments don't want to see prices fall. If people believe it will cost less to buy something in a month, they'll put off that purchase. If enough people do that, then prices will come down. That can pick up momentum to the point that there's a downward spiral in prices, companies stop producing products as demand falls and people lose their jobs.

But deflation is not always a bad thing. If falling prices are caused by faster productivity growth, as in the Industrial Revolution of the late 19th century, then it can go hand in hand with strong growth. However, if deflation reflects excess capacity and a slump in demand, it can be dangerous, as it was in the Great Depression of the 1930s. Prices tumbled and millions of jobs disappeared.

While Canada technically experienced deflation in June 2009, economists don't expect it to be a trend - or anything to worry about. Again, if you take out the effect of falling gasoline prices, the rest of the basket of goods and services Statistics Canada measures came in 2.1 per cent higher than in June 2008. Gasoline prices hit record highs of more than $1.30 a litre in the summer of 2008 before declining to around 76.5 cents a litre in December. So lower gasoline prices could lead to a few months of "deflation" in 2009.

**What is stagflation?**

With stagflation, prices are rising even while the economy is stagnating. In North America, this last happened in the late 1970s. Rising oil prices hit the economy hard - forcing up prices for many goods and services even as people were losing their jobs. Purchasing power in North America fell as wealth was transferred from oil consuming countries to oil producing countries.

**What is hyperinflation?**

Pretty much the worst of all worlds. Most economists describe hyperinflation as "an inflationary cycle without any tendency toward equilibrium." It's a vicious circle of constantly — and rapidly — rising prices. Many factors can lead to hyperinflation, but the direct cause is an unchecked increase in the money supply. Some governments have occasionally resorted to printing more and more money to meet their expenses. This increase in the supply of currency without any matching increase in demand, leads to a drop in the value of the currency.

Extreme examples of hyperinflation include:

* Germany in the early 1920s, when the rate of inflation hit 3.25 million per cent per month.
* Greece in the mid-1940s with 8.55 billion per cent per month.
* Hungary mid-1940s at 4.19 quintillion per cent per month.

By late 1923, the Weimar Republic of Germany was issuing 50-million-mark banknotes. The National Bank of Yugoslavia issued the largest banknote ever in 1993: 500 billion dinars.

In 2008, Zimbabwe recorded among the highest rates of inflation the world had ever seen. In December 2008, the official inflation rate was 516 quintillion per cent. That's 516 followed by 18 zeros.

**Questions (answer in your notebooks in complete sentences)**

1. What is inflation?
2. What happens when prices fall?
3. What are the two potential causes of inflation?
4. How does Statistics Canada track prices and therefore, determine the rate of inflation?
5. List some items that you might think would be included in the basket of goods and services that is used by Statistics Canada.
6. If the CPI was 120 in April 2010, what does this tell us about the cost of the typical basket of goods compared to 2002?
7. How are the rate of inflation and the core rate of inflation different?
8. What is the rate of inflation that the Bank of Canada targets and what does it do to ensure that the inflation rate meets this target?
9. Which do you think is worse – deflation, stagflation or hyperinflation?