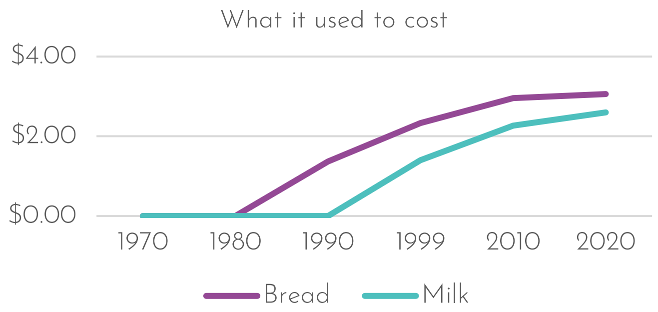
talk money with Ecstra Foundation

Finance facts:
Inflation

What is inflation?

Inflation is the rate at which prices for the things we buy keep going up, meaning you need more money to buy these things. Over time, you generally need more money to buy the same things you could buy with less money in the past. For example, bread cost 21 cents in 1970 and milk cost 19 cents, and now bread is about $3.06, and milk is $2.60 (or more). This chart shows the increase in the price of bread and milk over 60 years.



Source: State Library Victoria–What it used to cost

How is inflation measured?

It's important to monitor the price increases in goods and services because as a society, we don't want prices increasing too quickly. We want prices to rise slowly and steadily, as this means our economy is growing, and it gives some time for our incomes to catch up so we can afford to buy about the same number of things.

The government measures the price rises using a tool called the Consumer Price Index (CPI) every three months. They survey the cost of many items we use, but not everything, to provide a percentage of increase that we can use to compare across time.

Prices can rise for various reasons. If the demand for goods and services rises (more people want to buy things), or the supply of goods and services falls (there are issues with manufacturing or weather events have ruined food harvests), then the prices will go up.

A recent example is the COVID-19 pandemic, that caused mass disruption to the production of goods around the world. Consequently, Australia and other countries have experienced higher than normal price rises (inflation). In Australia, the CPI peaked at 7.8% in December 2022.

The Reserve Bank of Australia (RBA), who is responsible for measuring inflation, tries to keep the overall inflation rate between 2% to 3% to maintain a slow and steady rate of increase.

The RBA has strategies to influence inflation, called monetary policy. They can influence the interest rates bank's charge to business and individual customers to change spending behaviour. If they want to lower inflation, they can do things to influence banks to raise interest rates, causing people with loans to spend less on other things in the economy. They do the opposite to increase inflation, to bring it within the 2–3% range.

Let's look at a simple example of how inflation is calculated on one item in the CPI basket.

Case Study: Inflation

Joelle is 10 years old, and a keen runner and her parents buy her a new pair of sneakers every year for her birthday. Last year, the sneakers cost $50.00 and this year they cost $57.00. How much did the price of her sneakers go up by?

$$\text{Inflation} = \frac{\text{Price in year 2} - \text{Price in year 1}}{\text{Price in year 1}} \times 100$$

$$\frac{\$57.00\ (\text{year 2}) - \$50.00\ (\text{year 1})}{\$50.00\ (\text{year 1})} \times 100$$

Price increase (inflation) = 14%

The sneakers would fit in the 'clothing and footwear' category in the CPI basket. The other categories in the basket include

- housing
- food and non-alcoholic beverages
- recreation and culture
- transport
- furnishings, household equipment and services
- alcohol and tobacco
- health
- insurance and financial services
- education
- communication

A 14% increase in price over one year is a big change for one item. Other items might not have had such a big increase or may have even become cheaper.

Finance facts: **Inflation**

Did you know?

Occasionally, the government can create inflation simply by printing more cash. Venezuela did this between 2013 and 2019, creating **hyperinflation**, and its money effectively became worthless. People needed a wheelbarrow of money to pay for a meal out!

Prices going backwards is not a good thing either. Decreasing prices are a sign of lower demand and people being afraid to spend, which reduces the number of jobs and activity in an economy and is known as **deflation**.

Maintaining a target rate of inflation is good for an economy. If inflation is too high, the cost-of-living increases but if it's too low, the lack of spending and demand causes job losses, also making it hard to earn a living.

How does it impact you?

Inflation affects your purchasing power or how much you can buy with your money. When prices rise due to inflation, it reduces the number of things each dollar can buy. For example, $2.00 today will buy a chocolate bar, but in five years' time it might be more difficult to buy one for $2.00. Consider how this issue multiplies when thinking about a whole trolley of groceries.

The real problem for people is that when prices are rising fast it's hard for wages to keep up. Employers don't increase workers' wages every time the price of groceries or energy bills go up. People on low incomes and fixed incomes, like government payments, are much worse off. During periods of high inflation, it is common to see people cutting back on spending and going out.

When looking for work, a job that increases your salary each year by the rate of inflation will help you manage a difficult period of high inflation. Not all jobs have such benefits.

When investing, you should look for investments with rates of return that are above the rate of inflation. If the rate of return is not above the inflation rate, your money is losing purchasing power.

Glossary

Purchasing Power	is the financial ability to buy goods and services
Hyperinflation	means rapid, excessive and out-of-control price increases in an economy
Deflation	means a general decline in prices for goods and services in an economy
Reserve Bank of Australia (RBA)	is Australia's central bank that maintains a strong financial system and issues the Australian currency. There are many activities it undertakes to make sure we have an efficient payments system and that risks are managed for the benefit of all Australians.
Monetary policy	describes the method the RBA uses to affect interest rates. The RBA uses its trading of government bonds to change the supply of money in the economy, in order to bring about changes in the cash rate. When the supply of money is reduced, the price of money in the overnight market, called the cash rate, rises. This means that cash is more expensive for banks to buy and they pass on interest rate rises to their customers. When interest rates for loans are high, business customers and individual customers are reluctant to take out new loans and they have less money to spend in the economy. The opposite happens when the supply of money is increased.

Related Talk Money fact sheets

- Budgeting
- Investments
- Starting a job
- Financial risk

Links

Historical Data about the Cost of Living by Year in Australia

The Reserve Bank of Australia: Inflation

About Talk Money with Ecstra Foundation: Talk Money with Ecstra Foundation is designed to help Australian students learn money lessons for life, to be confident talking about money and to make informed financial decisions. We offer facilitator led workshops for Years 5-10 students and additional resources to reinforce learnings. The program is provided at no cost to schools, enabling more students across Australia to access financial education at key life stages.

About Ecstra: Ecstra Foundation is an independent charitable foundation committed to building the financial wellbeing of Australians within a fair financial system. Ecstra launched Talk Money in February 2022.

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