



The Inflation Rate Is Falling, but Prices Are Not

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GLOSSARY

Consumer price index (CPI): A measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

Deflation: A general, sustained downward movement of prices for goods and services in an economy.

Disinflation: A decrease in the inflation rate or a slowdown in the upward movement of prices for goods and services in the economy.

Inflation: A general, sustained upward movement of prices for goods and services in an economy.

Inflation rate: The percentage increase in the average price level of goods and services over a period of time.

Price level: The weighted average of the prices of all the final goods and services produced in an economy.

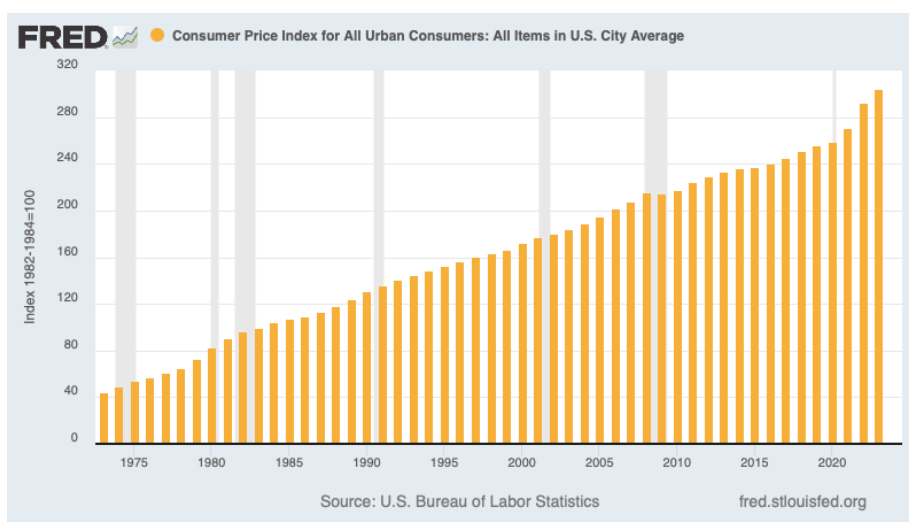
Has this scenario ever happened to you? You're in the grocery store reaching for a gallon of milk, and you notice that the price has increased since the last time you bought some. But you also recently read in the news that the inflation rate has fallen from 8% to 4%. How can that be? This article will explain why a falling inflation rate does not mean falling prices.

Inflation Is an Increase in an Economy's Price Level

Inflation is an increase in the price level, or average level of prices, of goods and services. The **price level** can either increase or decrease. When an economy's price level increases, we call it inflation; when it decreases, we call it **deflation**.

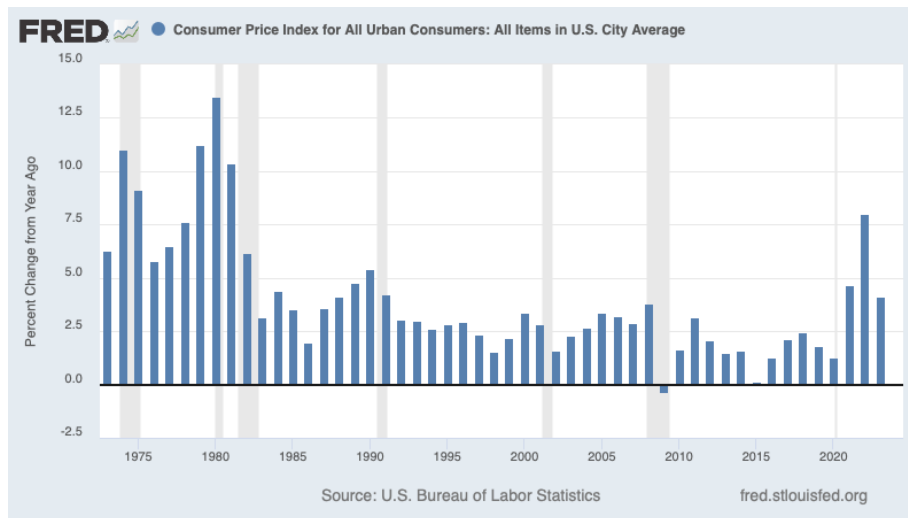
Figure 1 displays the average level of prices in the United States over the past five decades, as measured by the **consumer price index (CPI)**—that is, a market basket of about 80,000 household goods and services that the Bureau of Labor Statistics tracks the prices of over time. As you can see, in most years, the price level is rising.

Figure 1
Average Level of Prices in the US, 1973-2023



SOURCE: US Bureau of Labor Statistics via FRED®, Federal Reserve Bank of St. Louis;
<https://fred.stlouisfed.org/graph/?g=1gFwr>.

Figure 2
Annual Inflation Rate in the US, 1973-2023



SOURCE: US Bureau of Labor Statistics via FRED®, Federal Reserve Bank of St. Louis;
<https://fred.stlouisfed.org/graph/?g=1gFwI>.

The Inflation Rate Tells You How Quickly the Price Level Is Rising

The **inflation rate** is just that, the rate at which the price level is rising. So, the inflation rate might be higher, such as 8%, or it might be lower, such as 2%. But in both cases the price level is increasing; one rate of increase is simply higher than the other. When the inflation rate falls, say from 8% to 4%, we call it **disinflation**, meaning the price level is rising at a slower rate.

So, any positive inflation rate number means inflation is occurring and the price level is rising. It's not until the inflation rate becomes negative that deflation is occurring.

You might think of it as riding in a vehicle: The driver can go faster (accelerate to 60 mph) or slower (coast at around 45 mph); but in both cases, you're moving forward, just at different rates.

Figure 2 shows that the highest annual inflation rate occurred in 1980 when the price level increased by 13.5%. The annual inflation rate has been positive in every year since 1973, meaning that the price level has risen almost continuously over the past five decades. The only exception is in 2009, when the inflation rate was slightly negative. In this brief instance, the price level decreased, so the US economy experienced slight deflation.

Let's return to the scenario at the start of this article. The increasing price of milk, even as the inflation rate fell from 8% to 4%, is consistent with what we would expect to occur. That is, when the annual inflation rate is 4%, the average level of prices still increases by 4% that year. So, the average level of prices continues to increase even though the rate at which those prices are increasing has fallen from the previous year.

Inflation Is an Increase in the Average Level of Prices, not all Prices

Finally, it's important to note that not all prices necessarily increase when there is inflation. Recall that inflation is an increase in the average level of prices. If the price level is increasing, the prices of many of the items counted in the CPI are increasing—but not all of them. Some prices are surely decreasing, and some prices are staying the same. The price level has increased, but not the price of every single good or service in the CPI basket or the economy.

Conclusion

There are two important points to help make sense of the prices you encounter. First, when the inflation rate decreases, prices do not. It's the rate at which the price level is increasing that has slowed, and we call this disinflation. If the inflation rate is positive, then the price level is increasing. In the rare instance when the inflation rate is negative, it means the price level has fallen and an economy experiences deflation.

Second, inflation is an increase in the average level of prices, not an increase in all prices in the economy. You can use these facts to understand how the prices you see at the store relate to the statistics you see in the news. ■

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Name _____ Period _____

Federal Reserve Bank of St. Louis *Page One Economics*®:
"The Inflation Rate Is Falling, but Prices Are Not"



1. According to the graph, the annual US inflation rate in 2009 was approximately
 - a. -2%
 - b. 0%
 - c. 2%
 - d. Unknown
2. When the inflation rate is 12% in year 1 and 15% the following year, the price level is
 - a. increasing.
 - b. decreasing.
 - c. staying the same.
 - d. indeterminate.
3. When the inflation rate is 12% in year 1 and 9% the following year, the price level is
 - a. increasing.
 - b. decreasing.
 - c. staying the same.
 - d. unknown.
4. When the inflation rate is 12% in year 1 and 12% the following year, the price level is
 - a. increasing.
 - b. decreasing.
 - c. staying the same.
 - d. unknown.

5. The price level in year 1, as measured by the CPI, is 100. The price level in the following year is 95. This is an example of
 - a. inflation.
 - b. hyperinflation.
 - c. disinflation.
 - d. deflation.

6. The price level in year 1, as measured by the CPI, is 100. The price level in the following year is 105. This is an example of
 - a. inflation.
 - b. hyperinflation.
 - c. disinflation.
 - d. deflation.

7. The inflation rate is calculated using
 - a. the deflation rate.
 - b. the consumer price index.
 - c. the labor force participation rate.
 - d. the consumer sentiment index.

8. The inflation rate falls from 12% to 9%. This is an example of
 - a. stagflation.
 - b. hyperinflation.
 - c. disinflation.
 - d. deflation.

9. If the inflation rate is 3%, it means that all prices are increasing by 3%.
 - a. True
 - b. False