Name ______________________________ Date ______________

CHAPTER **13** | CASE STUDY RESOURCES

Facing Economic Challenges

"What Inflation Means For…"

This article describes the impact inflation had on consumers in the mid-2000s.

Tensions are spiking in the Middle East, and so is the price of oil, which reached $77 per bbl. That's a record, and not a good one as far as motorists and investors are concerned. Nor is it happy news for inflation, which is already at a 16-year high largely because of surging fuel costs. Consumer prices of all stripes rose at an annualized rate of 5.2% in May—enough to take some of the fun out of shopping. But Ben Bernanke, Chairman of the Federal Reserve, is on the case. The Fed raised its benchmark interest rate by a quarter point last month, the 17th straight increase, in its efforts to gently brake the economy by reining in spending. Retail sales fell ever so slightly in June, according to a Commerce Department report, but consumers hoarding money just to pay for gas won't help the inflation fight. . . . Here's why you should care about what he has to say. . . .

…YOUR WALLET

While tame compared with the double-digit rises of the 1970s, oil prices are again the driving force behind inflation, with energy costs rising 31% at an annual rate so far in 2006. That ripples through the rest of the economy, showing up as fuel surcharges on services like airline tickets (up 7.9% so far this year) and higher prices on pretty much anything that travels before reaching a store. Even clothing has been inching up after months of deep discounting. "I wouldn't expect a lot of relief on gasoline prices," says Richard Berner, chief U.S. economist at Morgan Stanley. In addition to geopolitical tension, the hurricane season and its potential to disrupt refineries on the Gulf of Mexico lie ahead. And as we grudgingly get used to $3-per-gal. gasoline—it's been nearly two years since crude oil broke $50 a barrel—companies feel more comfortable passing along their own higher costs to customers.

…YOUR STOCKS

Oil, war and stocks don't mix. When consumers get pinched by higher prices and pay more to borrow, investors are worried that they'll have less to spend, thus lowering overall demand for goods and services. That's already begun to happen. After growing 5.6% in the first three months of the year, the economy is expected to expand only 3% the rest of the year. That—and the uncertainty created by the Middle East fighting—has helped batter the stock market; the S&P 500 is down 5% since early May. . . . Until the Fed gives clear signals that it will stop the cycle of rate hikes—Bernanke took a wait-and-see attitude last month—expect volatile times for stocks.

…YOUR BUSINESS

Like many small business owners, Tom Zimmerman is scrambling to absorb higher costs without scaring away his customers by raising prices too much. He owns Spectrum Automation, a Detroit-area firm that makes parts for factory equipment, and he's trying a bit of everything. He has raised his bids on contracts he competes for, deferred buying equipment to avoid debt and just recently shelved plans to add three jobs to his 20-person staff. "I wouldn't want to hire them if I couldn't keep them," he says. With a big new deal just signed and good news arriving from his health insurer (a 2% cut in costs), he may reconsider. But Zimmerman is certain about plans to overhaul his factory's heating and cooling system to make it more energy efficient—a move that puts him in a good position to handle future energy inflation. The companies that will thrive, economists say, are those that can deflect higher prices by boosting productivity.

...YOUR SALARY

One indicator that has lagged most others is the one attached to labor. Average weekly earnings rose 4% in May—not enough to keep pace with inflation. So even with a few extra dollars in their pockets, most workers have to cut corners to stay afloat. Believe it or not, economists consider this a good sign. If workers were successfully pressuring for higher wages, that would reflect an expectation of even more inflation to come and lead to a spiral of rising wages and prices. It's the job of the Fed, Bernanke has said, to use smart policy to keep those expectations in check by consistently taking action as soon as inflation starts to cut loose. "The Great Inflation of the 1970s," as he calls it, is "an example of what can happen when inflation expectations are not well anchored." So as long as we can stand a little lead in our pockets, relief may be in sight.

...YOUR DEBT

Every time the Fed ups interest rates in response to inflation, that takes a bite out of anyone carrying a lot of credit-card debt or holding an adjustable-rate mortgage—the tools that have fueled the housing boom, particularly in the big metro areas of California and South Florida. Ann Johnson, 57, a saleswoman in Kansas City, Mo., cringes thinking about what could happen to the mortgage that looked so appealing two years ago and wonders if she'll be able to sell her condo in a cooling market. "I tell my sister to keep that spare bedroom open for me," Johnson says. She also buys gas strategically on long trips to lower the cost of a tankful (hint: skip Kansas). Painful as it may be, that's exactly the effect that Bernanke is looking for. As consumers limit their spending, inflation follows suit and tapers off in turn.

From Thottam, Jyoti and Barbara Kiviat. "What Inflation Means For…," *Time*, July 24, 2006, p. 41.

MAIN IDEAS

1. What businesses besides the travel industry do rising oil prices affect?

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2. In what ways did businessman Tom Zimmerman worked to make his business continue despite inflation?

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3. How does limited spending by consumers lead to a tapering inflation rate?

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