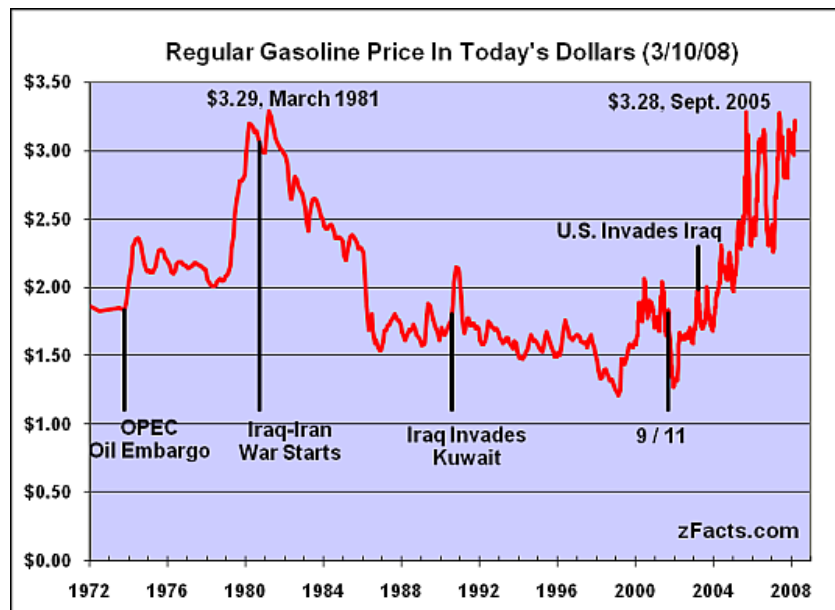


How Does Inflation Distort Costs?

Inflation is an increase in the general level of prices: Each dollar of income buys fewer goods and services than before. The Bureau of Labor Statistics (BLS) compiles the Consumer Price Index (CPI), based on survey information of consumer buying habits. GDP is a key measure of how well the economy is performing. Typically we think of GDP in terms of current year dollars—the dollars valued as of a given year based on what they will buy in that year. However, given that inflation occurs on an ongoing basis, the value of the dollar declines over time. Therefore, in order to make GDP comparisons between two years the GDP is usually expressed in constant year dollars, i.e., based on the value of a dollar in a given year. For example, the GDP in Billions for 1960 and 2007 was \$526 and \$13,841 respectively in current year dollars. The values are \$2,502 and \$11,567 respectively in constant year 2000 dollars.

Gasoline prices in constant, inflation adjusted dollars in 1980 (about \$1.20 per gallon at the time) were actually about the same in gasoline prices in real terms in 2007. In real terms, gasoline prices declined in the eighties and nineties—which may have explained our lack of interest in conservation until recently. Inflation tends to obscure the underlying economics. The 27 cents per gallon gas of 1955 actually cost \$2.16 per gallon in 4/08 dollars—and the 1955 cars got 14 mpg for a cost of 15 cents per mile. A car today at \$4.25 per gallon might get 22 mpg—a cost of 19 cents per mile. Hummers get less. Inflation can distort our perspective about costs. Increases in gas prices, adjusted for end use quality/efficiency have only recently become significant. Contributing to the gasoline pain is a major change in usage: we typically drive many more miles today than was the case in 1955.



The economy has shown the ability to respond to and adapt to changing gas prices. This type of economic change when put in perspective should not be a controlling reason for projecting long run problems: the economy has shown substantially resiliency.