Inflation and Purchasing Power

Before 1991, Russia was a part of the Soviet Union. The Soviet Union had a command economy, a system in which the government owns the means of production, such as factories and farms, and makes all decisions about using them. The Soviet government decided what each factory and farm would produce and set prices for each product.

When the Soviet Union broke apart in 1991, Russia faced many economic problems left over from the Soviet era. To improve the economy, Russian leaders introduced reforms to change to a market economy. A market economy is a system in which individuals own factories and farms and decide what and how to produce.

The economy struggled as it adjusted to these major changes. One symptom of a struggling economy is high inflation. Inflation is a prolonged rise in average prices. The inflation rate is the percentage change in average prices from one time period to the next. For example, a 3 percent inflation rate in 2006 would mean that average prices in 2006 rose by 3 percent over 2005 prices. It is important to understand that the inflation rate measures the rise in average prices. The price of some items might rise more; others, less.

Purchasing power is the value of money in terms of the products it can buy. When prices rise, purchasing power falls. For example, $10 can rent two videos at $5 each, but only one video if the price rises to $8.

High inflation can cause hardship for a nation's citizens. For example, the graph below shows the inflation rate in Russia as 84 percent in 1998 and 86 percent in 1999. Study the table on the next page to see the effects of these severe inflation rates on purchasing power. An item purchased for 100 rubles at the beginning of 1998 would cost Russians 342.24 rubles at the end of 1999!

Russia has made great progress toward a market economy. However, high inflation continues to make it difficult for many Russians to afford the necessities of life.
Geography and Economics Activity
continued

✓ Thinking Economically

Directions: Examine the information and graph on the previous page and the table below. Then answer the questions that follow.

Loss of Purchasing Power in Russia

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
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</thead>
<tbody>
<tr>
<td>Price at beginning of year:</td>
<td>100 rubles</td>
<td>184 rubles</td>
</tr>
<tr>
<td>Inflation rate:</td>
<td>84%</td>
<td>86%</td>
</tr>
<tr>
<td>Price increase that year:</td>
<td>100 \times .84 = 84 rubles</td>
<td>184 \times .86 = 158.24 rubles</td>
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<tr>
<td>Price at end of year:</td>
<td>100 + 84 = 184 rubles</td>
<td>184 + 158.24 = 342.24 rubles</td>
</tr>
</tbody>
</table>

1. **Identifying** Who owns the factories and farms in a command economy?

2. **Identifying** Who owns the factories and farms in a market economy?

3. **Defining** What is inflation?

4. **Analyzing** How does inflation affect purchasing power?

5. For the years shown in the graph, did U.S. dollars or Russian rubles lose more purchasing power? Explain how you know.

6. **Identifying** In what years were Russia's inflation rates at least 20 percent?

7. **Calculating** Suppose your family wants to buy a car for $20,000. Assume that the car’s price will rise at the inflation rate of 6 percent. How much would you have to pay for the car if you wait a year? Show your work.