

Practice Quiz 6: Inflation

1. This year, Amy spent about \$2,000 on clothes. If inflation is 2% per year, how much will it cost her to purchase the same amount of clothes in four years? How about in ten years? Alternatively, if she still spends \$2,000 on clothes in ten years, how much clothes will she be able to buy in ten years compared to today? (Assume Amy buys similar clothes in the future, and that the price changes of clothes are in line with inflation.)
2. Back in 1990, Rich earned \$45,000 per year as salesman at his town's local hardware store (specializing in lawn mowers). Twenty years later, in 2010, Rich remains in the same position, but now commands a salary of \$65,000 per year, and attributes this increase to his employer's acknowledgement of his first-class salesmanship. Rich also noticed that a standard lawn mower increased in price from about \$150 to \$200 over this period. This confuses Rich, because he thoroughly understands the lawn mower industry and knows that lawn mower manufacturers have become more efficient over this time period, and based on his understanding of economics, thinks that the lawn mower prices should have fallen because of this. Inflation has averaged 2.5% during these twenty years. Calculate Rich's *real* wage growth between 1990 and 2010. Can Rich afford to buy more with his new salary? What is the price today of a lawn mower in 1990 dollars? Has the cost of a lawn mower risen or fallen in *real* terms?
3. In 2001, Janice invested \$15,000 in the stock market. Over a twelve year period, she realized returns of 13% per year on her investment. Inflation over the same period averaged 2.4% per year. What was the *real* return on her investment? How much are her stocks worth after 12 years? How much are they worth in 2001 dollars?
4. John is helping his parents, who plan to retire in 20 years, plan for their retirement. The couple currently has \$120,000 in retirement savings, and expects to earn about \$20,000 per year from Social Security benefits. They would like to augment their Social Security benefits with withdrawals of another \$20,000 per year from their savings, and would like to know how much to contribute each year to be able to do so. John explains that, while Social Security is adjusted for inflation, their withdrawals are not, so they will actually want to save enough to withdraw greater than \$20,000 per year after they retire to be able to maintain their target standard of living. Assuming his parents can earn 8% on their investments per year for the next 20 years and 4% during retirement, an inflation rate of 2%, and that they wish to save enough to withdraw today's equivalent of \$20,000 per year for 30 years, how much must they contribute each year in *today's* dollars? How large must their contribution be in ten years (in nominal dollars)? How much must they withdraw during their first year of retirement? How about their fifth year of retirement? (Assume all cash flows occur at the end of the year.)