



# What you need to know about inflation

Inflation can be tricky — you might notice the grocery bill going up or see headline numbers about how it's the most inflation we've seen in nearly 30 years. But in order to understand the real risk of inflation, it's helpful to understand what inflation is and how it's measured.

## What is inflation?

Inflation is the rate at which prices change over time. For example, if something costs \$2 today and \$3 a year from today, its price increased 50%, or it has a 50% inflation rate.

In the real world, it's a bit more complicated than that, but not much. The government tracks inflation with the consumer price index, or CPI for short. CPI looks at a "basket of consumer goods and services" — things like food, personal care products, medical expenses, and the like.

The government bases what goes in the basket on actual reports from consumers, meaning there's a lag between when that survey happens and when CPI data is updated.

There are critics of CPI that say it isn't an accurate measure of inflation for various reasons, including its scope. For instance, the government surveys urban consumers, specifically, meaning prices may not reflect those in rural or suburban communities. It also ignores some major expenses like housing and health insurance premiums.

I don't talk to many clients who follow CPI numbers closely, but it's an important metric because it's the peg the government (and many businesses) use to make cost-of-living adjustments to salary. Which brings us to why these numbers are so important.

## Why does inflation matter?

Simply put, inflation tracks how much a dollar can buy. Sticking with our first example: If the price of something that costs \$2 today costs \$3 next year and you have a fixed \$2, you can no longer buy that item (or you'll need to save in order to afford it).

In economic terms, your money doesn't purchase as much; you've lost **purchasing power**.

Like with our \$2 example, this can be particularly challenging for anyone who has a preset amount of money — for instance a retiree living off a fixed income. Of course, there are things we do to try and ensure your assets keep track with inflation, even in retirement. For instance, we make sure clients keep a

part of their investment portfolio in stocks regardless of age to ensure we're always at least partly focused on growth.

We're not the only ones trying to ensure your income keeps pace with inflation. The government is aware of this need, as well, and adjusts Social Security payments accordingly. The yearly cost of living adjustment (COLA) is linked to CPI. (Another reason that metric is so important.)

Average inflation is roughly 3% per year, which is normal in an expanding economy. Consider the U.S. economy: Prices are inflated from what they were in 1950, but the economy grew significantly during that period.

For much of the 21<sup>st</sup> century, inflation was actually below that level, according to CPI. For instance, in 2019 and 2020 inflation was less than 2%. On the other side of the equation, in several key windows – 1974, 1979, 1980, and 1981 – CPI showed inflation higher than 10%.

It's because inflation numbers are so important to overall financial health – it affects everything from how much companies must pay employees to stay competitive to how much consumers can afford to buy. In fact, one of the primary jobs of the U.S. Central Bank is to keep inflation in check. (This is why you often hear inflation discussed in the context of the Federal Reserve, or "Fed," and monetary policy.)

## **When is inflation problematic?**

Considering a certain amount of inflation is normal, it's natural to wonder when inflation crosses into risky territory. If you ask an economist that question, they're likely to talk to you about stagflation.

Stagflation refers to inflation when the economy is stagnant, but inflation increases. If there's high unemployment or wages stagnate, and prices go up, people may not be able to afford those higher prices. Demand is likely to fall, and it can create an ongoing negative cycle.

It's also possible for prices to fall instead of increase, known as deflation. If something costs \$1 now and a year from today it costs \$0.50, there's been 50% deflation.

Deflation can occur for a few reasons. If technology improves and productivity increases, for example, prices can fall. Think about the price of a laptop computer in 2005 compared to today. We expect a certain amount of this type of positive deflation.

However, deflation at a large scale can be concerning. When that happens, it's often linked to shrinking demand, which tends to coincide with recession. As a point of reference, the last time the U.S. experienced deflation was in 2009 following the financial crisis: Consumer prices fell 0.4%.

Some of this is tied to interest rates since rates are the primary tool for bringing inflation in check. In fact, one of the primary mandates for the U.S. Central Bank is to keep prices stable. When the Federal Reserve hikes rates, this translates to higher consumer rates on things like credit cards. That increase often discourages people from buying products, which can bring demand (and therefore prices) back down. However, rising interest rates can have a number of other side effects – but that's a different topic for a different article.

If you have questions about our outlook for inflation, or how we factor inflation into investing and planning decisions, we can discuss at our next client meeting.

Sources: [Bureau of Labor Statistics](#), [Minneapolis Federal Reserve](#), [CME Group](#), [Investopedia](#), [Merriam-Webster](#), [The Library of Economics and Liberty](#), [The Borgen Project](#)