What Is Inflation And What Causes It?

Written by Sarah Foster

Inflation is when the dollars in your wallet lose their purchasing power — either because the money supply has dramatically increased or because prices have surged.

It's an economic phenomenon that has a nasty reputation among policymakers, investors and consumers alike. That's more so now than ever, with consumers spotting things like spikes in used car prices and pricy sporting tickets (both of which are up 10 percent from the prior month) and price surges at the gas pump.

Experts say as the coronavirus pandemic moves into the rearview mirror, there might be even more cause for concern. Pent-up consumers are ready to go big on the purchases they've been deprived of for more than a year, and adding to their wherewithal to spend are record-high savings rates thanks to three stimulus checks from Congress. Yet, shortages are preventing production and businesses aren't yet at full-capacity to match rising demand.

But price increases aren't always synonymous with inflation — and experts say a little bit of inflation is actually good for the economy and your wallet. Here's what you need to know about inflation, including what it is, how it works, how it's measured and when exactly it's a threat to your wallet.

What is inflation?

Inflation occurs when the cost of goods and services in the economy goes up over a sustained period of time. Yet, distinguishing actual inflation from just a price jump can get pretty tricky — because both are

different.

Inflation doesn’t happen overnight, and it also doesn’t happen when the cost of one particular good or service goes up. Say you go to the grocery store and buy a dozen eggs for $2. Then, the next week, that same product is now $4. That alone doesn’t count as inflation, as prices in the financial system constantly fluctuate.

From an economic perspective, inflation applies to the broader picture. So while prices on some items can definitely be inflated (think: college costs), it doesn’t equal what economists mean when they say inflation, even though your wallet can surely feel that squeeze.

“We may see prices rise on certain things like gas or milk, but it’s not necessarily inflation unless you see prices rising sort of across the board, across many different products and services,” says Jordan van Rijn, senior economist at the Credit Union National Association (CUNA).

How inflation is measured

The way you measure inflation depends on the gauge. For consumers, the most important price tracker tends to be the CPI index. Policymakers at the Federal Reserve, however, closely follow the Personal Consumption Expenditures (PCE) index, which is out of the Department of Commerce. They’re broadly similar and track the same trend, though CPI tends to be higher over time.

Generally speaking, both gauges follow a wide variety of consumer products, ones that reflect typical household purchases. That can be anything from appliances and furniture, to food, apparel and utilities.

Data collectors create an index that tracks the consumer staples’ costs and multiply it to get what’s called a “base period.” Then, they compare that index with different time periods to get what’s called the “inflation rate.” Quarter to quarter would provide a quarterly inflation rate; year to year would give an annual inflation rate.

But some categories tend to be more volatile than others. Food and energy, for example, experiences sharp swings month to month. Sometimes, it’s best to strip that from the data, in what’s called a “core” inflation rate, which helps eliminate some of the noise. Over time, however, both core and headline inflation tend to follow the same path.

Considering that households might spend most of their money on buying food and filling up their gas tanks, headline inflation might tend to reflect Americans’ everyday expenses. And even more complicated, some households might have a higher inflation rate than others, depending on what items they’re buying.

“If 50, 60, 70 percent of your money goes to paying a mortgage or rent and those prices are rising, you’re going to certainly be hit a lot harder,” van Rijn says. “Certainly people spending a lot of money on groceries and gasoline, they’re going to still feel the impact of a big increase in headline inflation.”

What causes inflation?

Economists like to lump the typical inflation causes into two categories: demand-pull and cost-push inflation. They sound wonky, but they reflect experiences that many Americans are familiar with.

Cost-push occurs when prices increase because production is more expensive; that can include rises in labor costs (wages) or material prices. Firms pass along those higher costs in the form of higher prices, which then cycles back into the cost of living.

On the flip side, demand-pull inflation generates price increases when consumers have resilient interest for a service or a good.

The demand could come from all different angles. Say joblessness is low, and consumers have more confidence. That gives them more interest to spend, leading to a higher demand for products and companies having to produce more to meet that demand. Perhaps the money or credit supply has jumped dramatically. Maybe consumers have been hunkered down in their homes, ready to do what some experts describe as "revenge spending."

A lot of times, however, companies aren't able to produce enough to match demand, meaning there's a shortage in the product, leading to a price surge. Or maybe demand is so sticky that it doesn't matter how much firms raise prices.

"All the liquidity that's been created, you could have an economy that revs up very quickly and you end up with demand-pull inflation, where there's too much money chasing too few goods and services," says Greg McBride, CFA, Bankrate chief financial analyst. "Cost-push is where input costs increase and that affects the price that businesses and consumers pay for goods and services. That could be rising commodity prices; it could be a declining dollar that increases the cost of imported goods, higher costs for transportation, wages — any or all of those inputs could produce higher inflation."

What's going on with inflation?

The cost of goods and services has steadily increased since World War II, when modern data collection was first made available. That's partially just because the economy has grown.

But economists like to think about price gains by tracking how much they've increased or decreased from the prior-year period. In recessions, the year-over-year inflation rate tends to fall, reflecting disinflationary pressures as millions of Americans remain out of work and demand is subdued. In recovery periods, the inflation rate tends to pick up, reflecting higher demand and wage gains as individuals find employment again.

High inflation last posed a threat to the financial system during the 1970s and 1980s, after the federal government spent much of the 1960s spending big, two oil shocks hit the market and the central bank moved too slowly to adjust interest rates. That prompted swift Fed action, with former Fed Chair Paul Volcker leading the U.S. central bank to intentionally cause a recession by raising interest rates to get inflation back in line.

Ever since then, however, inflation hasn't proved to be much of a threat. In fact, price gains have been tepid at best. Overall, that's because of a variety of disinflationary factors, from globalization, fewer labor unions, technological innovations and overall stagnant wage growth.

The coronavirus pandemic, however, is proving to be a bit of a wildcard for the inflation outlook, causing prices to surge.

Some economists believe these price pressures might prove to be temporary, leveling out when supply balances back out with demand and the below-average inflation readings from during the coronavirus pandemic drop out of the picture.

Others, however, think transitory inflation could itself prove to be a transitory idea, with the federal government running record deficits to finance its emergency coronavirus spending and the Fed keeping interest rates ultra low for years to come to help the financial system bounce back from the virus.

"There's a tendency to think that it's a direct straight line back to 1981, but that's not the case," McBride says, referring to recent price pressures. "It's if inflation then continues to barrel higher on a sustained basis that it becomes economically problematic."

Consequences of inflation

The current consumer inflation rate as measured by CPI in April rose 4.2 percent from a year ago, the largest pace in more than a decade.

Americans and policymakers wouldn't be so fixated on inflation if it didn't prove to have consequences — both for individual consumers and the broader economy.

In a high-inflationary environment, there are few places to hide. Think about the money you have sitting in your wallet or in your bank account. In a high-inflationary environment, you wouldn't be able to buy as much with it as you used to. Taking into consideration the fact that two-thirds of U.S. economic growth is consumption, that could threaten the vibrancy of growth.

"If prices are rising faster than wages, which tends to occur in cases of high inflation, basically, that means people have less money to spend, less real purchasing power," van Rijn says. "It's almost like having a pay cut."

Pretend you're a retiree figuring out how to manage your portfolio. You would be hard-pressed to make a decent return without taking on some risk. Since you're not earning a salary anymore, you might also end up having to cut back on purchases to balance out your loss of income.

Retirees "at this moment in their lives they really want to reduce their exposure to risky assets and be in a bond portfolio," says John Cunnison, CFA, chief investment officer at Baker Boyer Bank. "But if inflation begins to run, those bond portfolios, they're really not going to perform well. They have very limited options in a period of high-sustained inflation."

Say you’re a business owner who’s trying to stay afloat. You’d most likely have to pass along higher prices to balance out how much more you’re having to pay to produce your products.

The cost of borrowing would also rise, making it harder for consumers to get a cheap mortgage, firms to borrow and invest and slowing down the economy overall.

How much inflation is too much inflation?

A little amount of inflation is actually a good thing. Typically, that’s thought of as a 2 percent increase year-over-year, at least in the minds of officials on the U.S. central bank.

That’s for two main reasons: One, it prevents a deflationary trap, which experts say can be even worse than deflation because money loses value. Another reason is that households make better financial decisions when they expect stable and low prices.

“A little bit of inflation is really a good thing,” Cunnsion says. “That basically gives the economy the ability to slowly raise prices. For companies, they can slowly increase people’s wages. You’re really looking at the goldilocks inflation, a not-too-little, not-too-much.”

But if increases in inflation are too drastic, the U.S. economy would be in a hard spot. Consumers’ purchasing power would be eroded, demand would be stifled, threatening profitability to firms, and the Fed would be forced to raise interest rates to cool down the economy.

Even the mere expectation of higher prices can be a bad prophecy. If consumers start expecting prices to pop, they’re more likely to start panic buying and demanding higher wages. Those two forces combined prompt companies to increase prices, creating the very phenomenon consumers were worried about.

“The tricky thing with inflation is, a lot of it is psychological; it depends on expectations of what inflation will be in the future,” van Rijn says. “If people think inflation will be high, prices are going to continue to rise. If you’re an executive setting wages at your company, that depends a little bit on your expectations for how much prices are going to increase next year. As wages go up, then the same thing happens with businesses — they’re going to start raising their prices.”

How to protect your money from inflation

Technically speaking, higher inflation should always be something that’s factored into your wallet, experts say. But another way of looking at it means periods of higher inflation shouldn’t change your strategy all that much, particularly if you’re an investor.

Equities tend to be a safe haven from inflation, given that companies can pass along their price increases. You generally want to avoid parking too much cash on the sidelines in fixed-income investments, such as government bonds. Experts typically recommend getting income from across your portfolio, including from dividend-paying stocks, preferred stocks and real estate investment trusts.

Another beneficial strategy can be incorporating inflation-indexed bonds, the most common being Treasury-

Inflation Protected Securities (TIPS). TIPS protect you from inflation by design. They pay a fixed interest rate every six months and an inflation adjustment on a semiannual basis, which applies to the bond’s face value, rather than its yield.

While higher inflation might seem like the wrong time to prioritize saving, building up an emergency fund of six to nine months’ worth of your expenses is still a wise idea, considering that economic uncertainty rises along with inflation. But after that, higher inflationary environments are a particularly important time to make sure that you start searching for a better return — especially for consumers, who are losing purchasing power.**Bankrate, posted on SouthFloridaReporter.com, May 25, 2021**

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