Investment Primer: Inflation

"A nickel ain't worth a dime anymore." When describing inflation, New York Yankees legend Yogi Berra perhaps said it best. In the simplest of terms, inflation makes cash worth less tomorrow than it does today.

Expressed as an annual percentage, inflation is an important measure of the purchasing power of the currency of a nation and has implications on the cost of living of individuals and the overall pace of economic growth.

In this Investment Primer, we take a look at some of the key effects of inflation on individuals, businesses and the economy.

1. Erodes Purchasing Power

Inflation is a measure of the rate at which the price of goods and services in an economy increases over a period of time. The most familiar problem posed by inflation is the erosion of purchasing power. As inflation occurs and commonly purchased household goods become more expensive, a single unit of currency loses value as it buys fewer goods and services. This impacts the cost of living for individuals, who would then buy fewer items. As fewer items are purchased, this leads to a deceleration of economic growth.

2. Increases Spending & Lowers Saving

For consumers, inflation provides an incentive to spend money now rather than later. For businesses, it can spur capital investment that might have been done at a later time. In doing so, this can distort spending activity by pulling future demand into the present. Encouraging consumers and businesses to spend can be positive for the economy, but it's a delicate balancing act. With too much incentive, this behaviour can produce a feedback loop that can cause more inflation. In extreme cases, it can result in shortages of goods due to hoarding and a rotation from financial assets into real assets like real estate and commodities.

3. Lowers Real Return

For savers and investors, inflation erodes the purchasing power of their investable assets. This is especially true of cash. An under the mattress approach to saving would mean $100 today would only be worth $97.09 next year, at a 3% inflation rate. Over time, the impact of inflation is greatly amplified, with that same $100 worth only $74.41 ten years out. Using a very conservative approach, anyone saving to purchase a home, fund their children's education or retirement will almost certainly find that the real return on their investment won't keep pace with the increased cost to fund their goal. Practically speaking, this means investors need to save more or achieve a higher rate of return on their investments to offset inflation.

The nominal return is the actual percentage return earned.
The real return is the nominal return minus the rate of inflation.
The real return shows the actual increase in buying power.

4. Increases Long-Term Costs

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Inflation can have a significant impact on costs that will be realized years in the future. For younger investors with a long time horizon, inflation has many years to compound, with the cost of living increasing with it. As an example, if inflation were 3% every year, a cup of coffee that costs $2 today would cost $2.69 in 10 years, $3.61 in 20 years, and $4.85 in 30 years. Using the same example with an annual inflation rate of 5%, that same cup of coffee would cost $3.26 in 10 years, $5.31 in 20 years, and $8.64 in 30 years. It should come as no surprise then that they will need much more money in the future compared to today, just to maintain the same standard of living.

Amplifies Planning Uncertainty

Both consumers and businesses rely on stability to make long-term plans or budgets. Inflation undermines these efforts, as it makes it difficult to accurately predict prices in the future, particularly if you're looking out several years. While inflation also provides incentive to spend money now, it lowers the accuracy of capital spending decisions, as companies have reduced visibility, and are less likely to make precise projections.

Depreciates Currency

Inflation is associated with a depreciating currency, although it's both cause and effect. When there is high inflation in a given country, investors will transfer their money into other countries to invest there, in order to preserve the value of their capital. This activity will act to lower the value of the home currency relative to other currencies. As the home currency depreciates, consumers must pay more for imported goods in local currency terms, even without a price increase in the currency of the exporting country.

Lowers the Cost of Borrowing

Since inflation makes money worth less in the future than it is now in terms of purchasing power, it makes the cost of borrowing today cheaper. The real interest rate of a loan is the nominal rate, minus the rate of inflation. If the rate of inflation is equal to the interest rate on a loan, the cost to borrow is essentially free. This provides an incentive to borrow and spend money, which can contribute to further inflation.

Raises Interest Rates

Although governments can control inflation through both fiscal policy (taxing and spending) and monetary policy (control of interest rates and the money supply), it is the latter that is most customarily used to manage rising prices. This is usually done by increasing interest rates to reduce the money supply. When rates rise, fewer companies and individuals seek loans. This is the mechanism by which central banks act to slow down an overheating economy, bringing stability and reducing inflation. Conversely, central banks can do the opposite, lowering rates in order to stimulate the economy, as it will encourage more individuals and businesses to borrow money.

Central banks such as the Bank of Canada or the U.S. Federal Reserve attempt to maintain economic stability by keeping inflation at a low, steady rate. Neither inflation nor deflation is the goal, but rather, a steady and predictable situation. Central banks generally target an inflation rate of about 2%.

Measuring Inflation

Economists attempt to measure inflation through methods such as the Consumer Price Index (CPI). The CPI establishes the price of a basket of goods purchased by typical consumers, such as food, housing, shoes, and clothing, and measures the change in the price for the basket of goods over time. The percentage change in the price of the basket is used as an estimate of the amount of inflation in the economy overall. The Headline number includes the CPI components that exhibit larger month to month price swings, such as food and energy. The Core inflation number removes some of the "noise" of these more volatile goods by stripping them out.

Contact your Financial Advisor to learn more.

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