What exactly is inflation and how does it directly affect my budget?

LOCAL

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Q: I see so much in the news about inflation. Can you explain what inflation is to me?

A: Monetary inflation is the process of losing purchasing power for your money. So, in the United States, when we have inflation, you will need more in dollars in the future to buy the same thing as today.

If inflation is running at about 3% a year, it means that (in general), you need around $1.03 to buy the same things you could buy for a dollar last year. You need more than $1.20 to buy the same things you could buy for a dollar five years ago as inflation compounds annually to diminish to value of your money. Understanding this is very important as we all hope to be spending our dollars in the distant future. A fixed stream of income will just gradually lose purchasing power (what you can buy with your money) due to inflation. You must consider at the very least “keeping up” with inflation to avoid becoming poorer.

Now, the amount of inflation on any given item or items varies widely. For example, buying a TV is generally cheaper over the last five years, while groceries have mostly skyrocketed. Different families buy different types of goods with their money, so that they each have a different exposure to inflation. Renters might be exposed to more inflation than homeowners, and even what type of food you like to eat exposes you to more variety in inflation. At this writing, beef prices have risen much more than most other food types — so vegetarians might come out ahead of their meat-eating neighbors. When the government reports the “inflation rate,” they are averaging the rise in cost of a large basket of goods.

Also, understand that the government inflation rate is adjusted for the presumed increase in quality and features a product might have over time (this is called a hedonic adjustment). Let’s turn back to buying televisions to understand this. Since a TV today has a better picture and other “smart” options compared to a TV from five years ago, any price increase in the current models will be adjusted downward in the inflation rate calculation by some obscure formula. So, the reported inflation rate is not just absolute price increases from the past.

The administration/Federal Reserve actually favors a low level of inflation rather than risking deflation (decreasing prices over time). Deflation often causes buyers to wait for prices to drop and may lead to an economic downturn/recession. A low level of inflation (the Fed wants 2%) is felt to be well tolerated and balanced by rising wages.

Most inflation is felt to come from the government printing too much money — and that is certainly a cause. In addition, supply and demand factors are important. Homes that are otherwise the same structure will have very different prices on them just because they may be in a desirable locale.

Practically speaking, we should understand the inflationary environment in order to preserve (or increase) our wealth. At this writing, the current rate of inflation is listed as 2.7% annually. If your investments could steadily grow right at the rate of inflation, then theoretically you'd retain your purchasing power over time. But we must also pay taxes on the growth of our money, even if it is just really keeping up with the inflation.

With today's inflation, most experts think you need to grow your assets at least 4 percent a year just to "stay even." If you cannot do this with some regularity, you lose.

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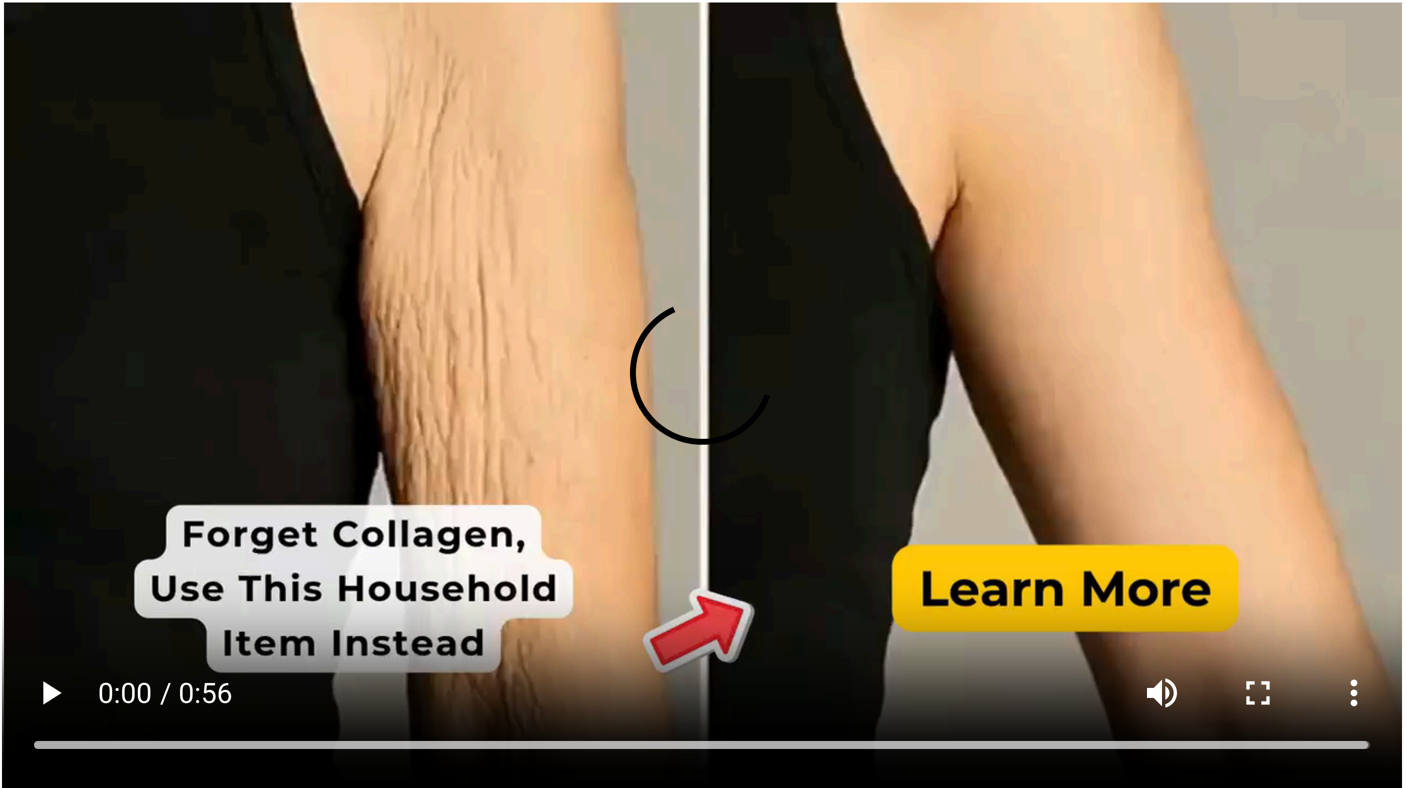
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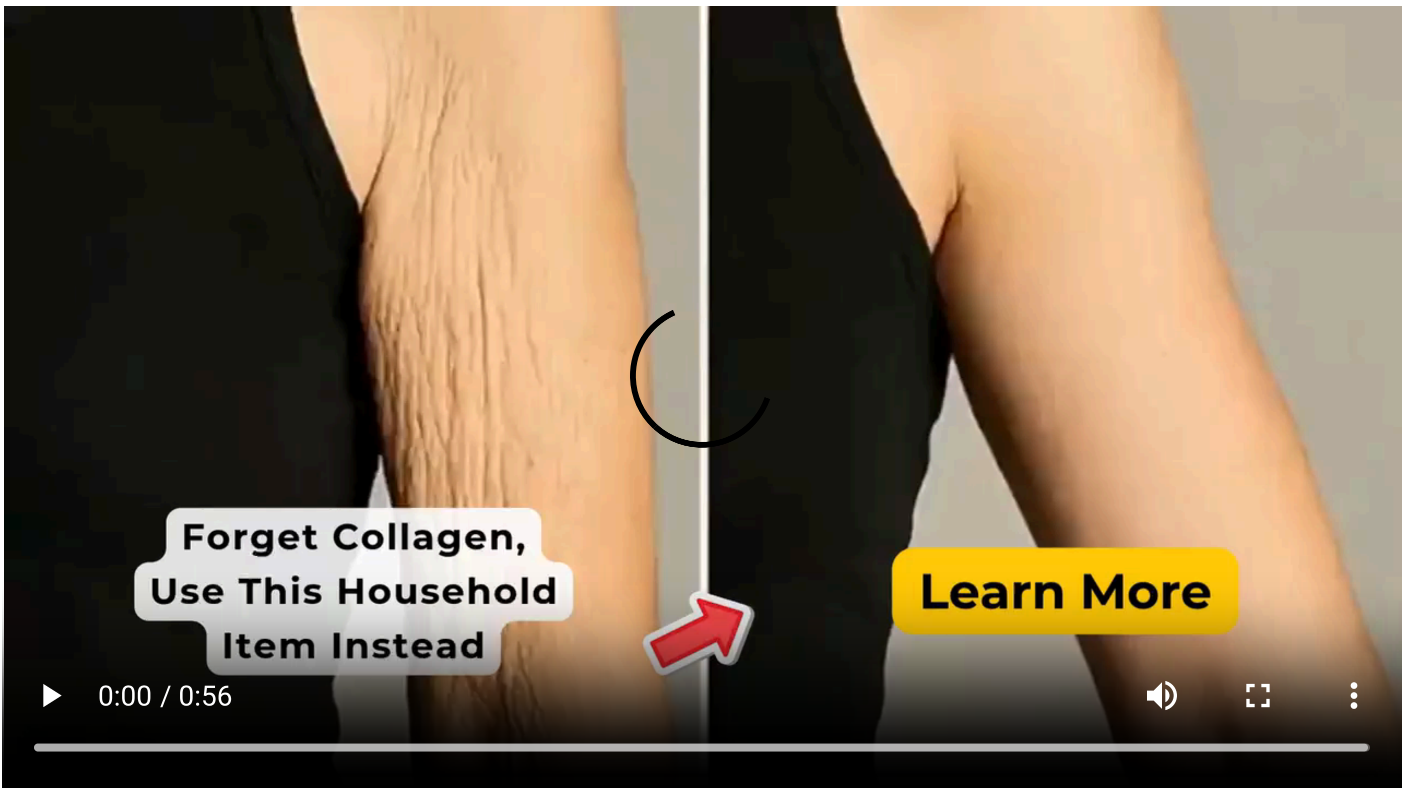
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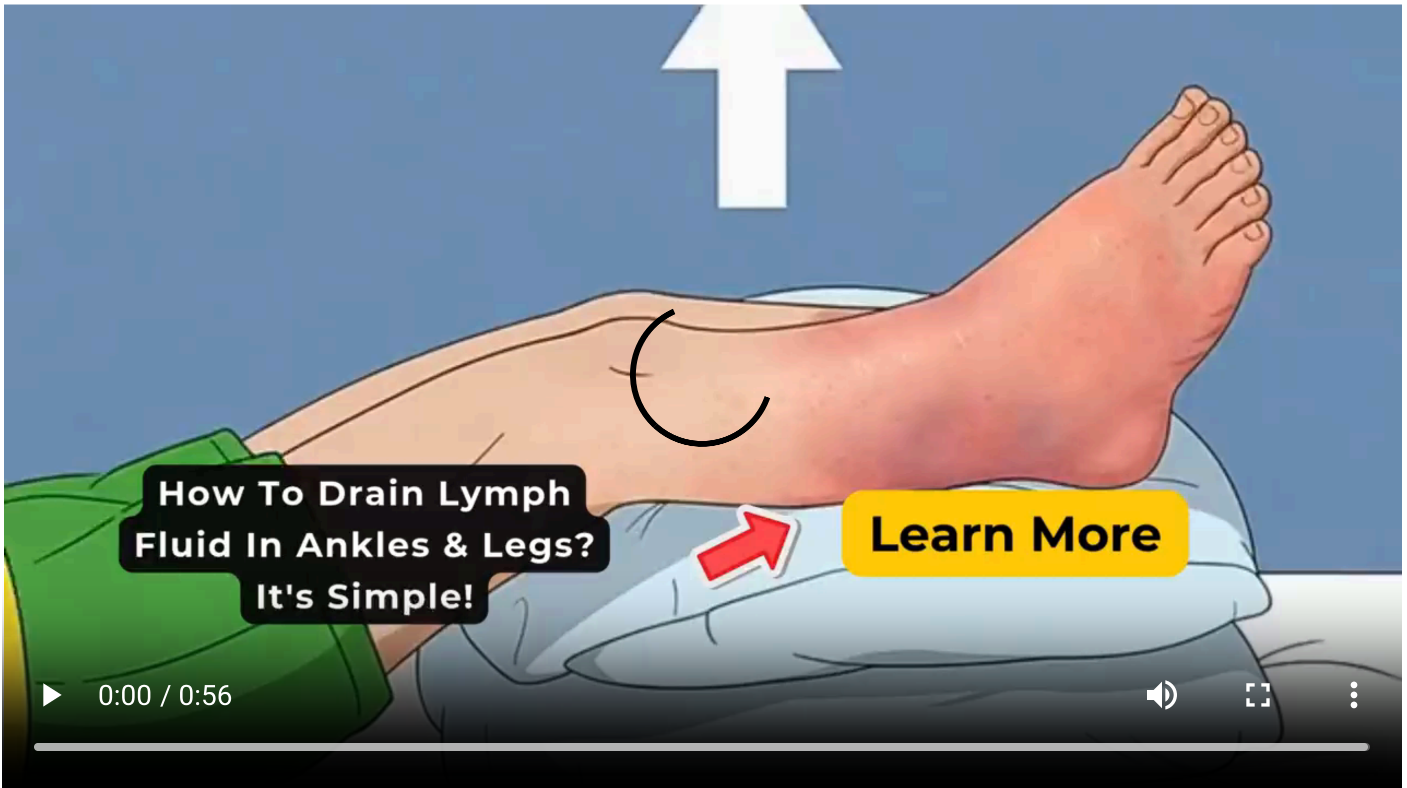
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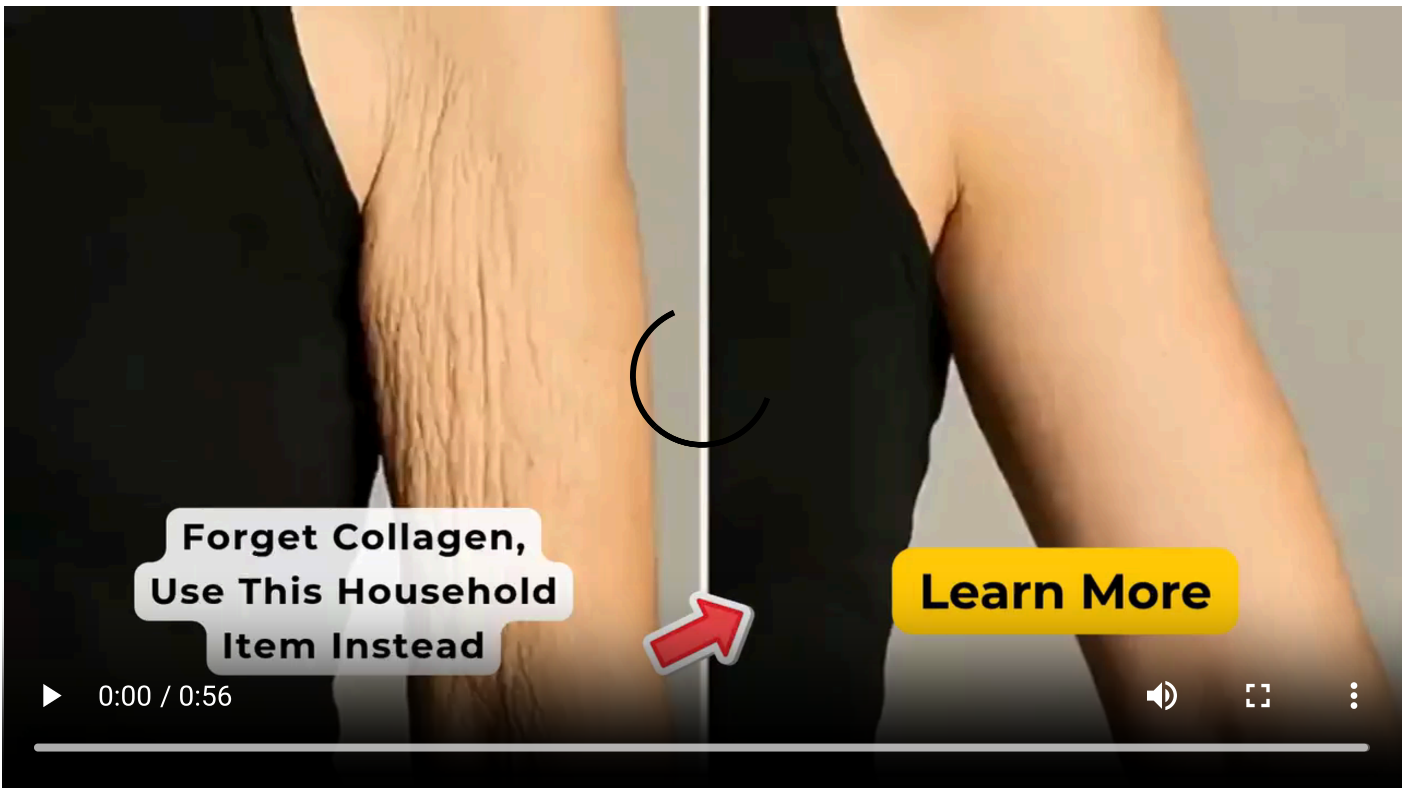
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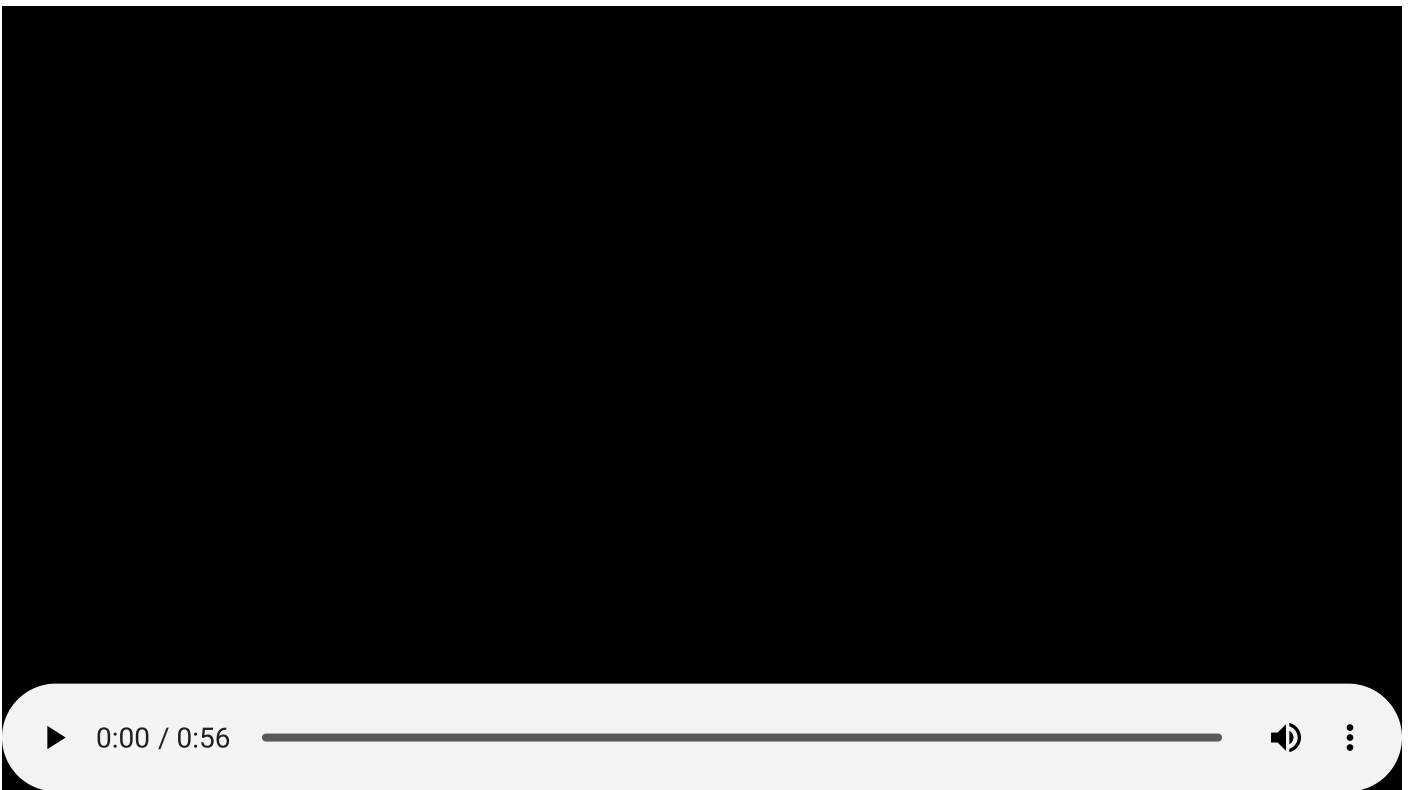

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