What is Inflation and Why is it Important in Personal Finance?

Teaching Personal Finance Conference

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What is Inflation and Why is it Important in Personal Finance?

- A useful general perspective
- Wages, returns, etc.
- Measuring inflation; historical performance of inflation
- Inflation, interest rates, and the economy
- Recent performance and policy issues

Experiencing Inflation

- Inflation – Generally rising prices for many of the things we buy (and sell)
  - Can have a sizeable effect on personal finances
- Even if some of us teaching personal finance courses have not been heavily impacted by the surge in inflation over the last 2+ years, many of our students and their families likely have been and still are negatively impacted, some severely
  - Real average wages and real median income have fallen (although there is evidence of the beginning of a catch up, whether and how much that will continue remains to be seen, as does its effect on future inflation)

Experiencing Inflation

- Because inflation has generally been low since the early 1980s, no one under the age of 60 has experienced high inflation in the United States in their working life
  - No worker, no consumer, no manager, no policy maker
  - The last time inflation was high, your students' grandparents had just begun their working life!
  - The increase was far more rapid than in the last episode of high inflation in the 1970s – early 1980s
    - Disinflation: Slowing the rate of inflation
    - Deflation: Falling prices

What Is Most Relevant to You: What You Wind Up With as Command Over Real Purchasing Power

- Gross earnings minus federal income tax minus state income tax minus Social Security and Medicare tax **minus inflation**
  - Inflation was 6.5 percent in 2022 and reduced real after-tax wages by that amount
- Investments: gross return minus fees and commissions minus taxes **minus inflation**

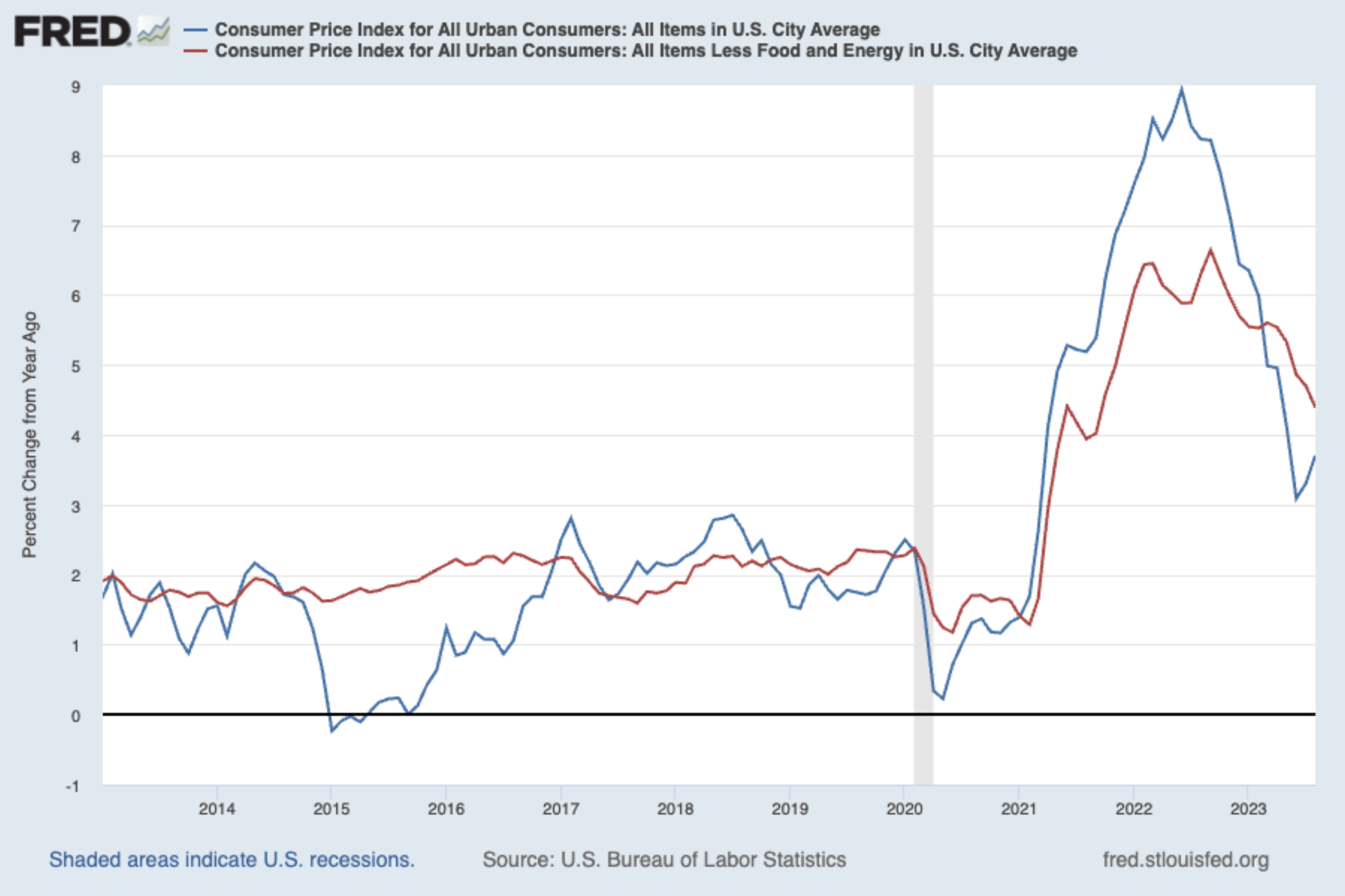
Measuring Inflation

- Inflation: General increases in prices of things we buy
- Price increases can vary a lot between (and within) goods and services (some may go up a lot, some a little, and some will fall)
  - Different goods and services are assigned weights to produce an overall measure called an index
    - So clearly the impact on different households will vary depending on the proportions of their budget (income) they spend on various goods and services.
      - Low-income households spend proportionally more on necessities like food and are especially hard hit when these prices rise most, and conversely

Measuring Inflation

- Food and energy prices are especially volatile, economists and central bankers focus on underlying (core) inflation ex energy and food in assessing medium-term trends
- There are two main measures of consumer inflation: the CPI and the PCE
  - They differ in the range of consumer spending and the relative weights given to each
  - The CPI is calculated monthly, the PCE quarterly
    - Consumer spending accounts for about 2/3 of total spending in the economy, the rest are investment spending, government spending, exports and imports; each has a corresponding price index used to calculate real GDP

Inflation



FRED
Consumer Price Index for All Urban Consumers: All Items in U.S. City Average
Consumer Price Index for All Urban Consumers: All Items Less Food and Energy in U.S. City Average
Percent Change from Year Ago
9
8
7
6
5
4
3
2
1
0
-1
2014
2015
2016
2017
2018
2019
2020
2021
2022
2023
Shaded areas indicate U.S. recessions.
Source: U.S. Bureau of Labor Statistics
fred.stlouisfed.org

Inflation and Interest Rates

- The interest rate(s) is among the most important prices in the economy affecting borrowing costs for everything from mortgages and auto loans to business investment and the income of lenders (and savers); and asset prices (bonds, equities, homes, etc.)
- The Fisher equation: $i = r + \pi$
  - The nominal interest rate equals the real interest rate plus inflation (more sophisticated, plus expected inflation)
    - Expected inflation is ascertained from the bond market and/or surveys of households and economic forecasters
    - Are expectations realized/accurate/approximately correct? Often, not always
      - Big misses: 1970s inflation, 1980s disinflation, 2008-2009 Fed funds

Stopping Inflation and Personal Protection Against Inflation

- Causes of inflation and stopping inflation
  - The fiscal versus monetary debate; cost-push or demand-pull?
- Historical examples: The Volcker Fed and the ends of hyperinflations
- The current Fed and other central banks' policies to curtal inflation: Soft landing?
- Fairly low inflation may not be too harmful over a short span, but compounding can make it very harmful over a long one; protecting against inflation with:
  - Equities?
  - Housing?
  - Commodities?
  - TIPS?

Broader Societal Implications of Inflation

- "The way to crush the bourgeoisie is to grind them between the millstones of taxation and inflation." – V.I. Lenin

- "By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. This "arbitrary rearrangements of riches" strikes at both the security and confidence that people have in the economic system." – J.M. Keynes