What About Inflation?

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Want a lesson straight from economics 101 on the importance of not saving for the future? This video is definitely not endorsed by anybody in the financial services profession.

Another entertaining clip can be found in this video, showing individuals how they too can replicate the success of Goldman Sachs. All it takes is a little bail-out money, higher fees, issuance of common stock, and more risky bets.

Now, let us get to the real important topic: inflation. Some of you may remember the day when a loaf of bread was 20 cents and a ticket to the movies was 50 cents. The "day" I am referring to is actually 1962 and a gallon of gas was only 31 cents and a fancy new car was only $2,500. Of course, the median income was only $6,000 a year compared to the $55,000 that it is today.

If we step back a little further in time, we can see that even these "low" prices seemed awfully expensive to the generation who was able to remember 1916 when bread was only 5 cents, sugar was 8 cents, 10 lbs of potatoes were 27 cents, and a pound of navy beans was 11 cents.

Our point is that inflation can significantly decrease the purchasing power of individuals living on fixed income. It would not be unheard of to see the cost of living rise by two or three fold over the years you spend in retirement while your fixed income remains fixed.

After 2008, most investors were probably more worried about the volatile ups and downs of the market and were not so concerned with the slowly eroding value of their dollar. In fact, there was even some deflation in that period of time increasing our purchasing power. This does not appear to the be the case anymore and we are once again hearing about the threats of inflation. It is mind boggling to think that the government could put over a trillion dollars into circulation via emergency rescue packages and that there would not eventually be some inflation. The fear is that the small "leak" that is occurring now may not stay so little in the future. Just think about it. What has Ben Bernanke, the Federal Reserve Chairman, stated publicly that he is attempting to do? Generate a bit more inflation. How often have we heard economists say that the easiest way out from under our debt is to simply print more money and pay our creditors with money that is worth less? A weaker dollar would also help U.S. exports and decrease our imports which improves our overall trade balance.

Take a look at this chart from the St. Louis Federal Reserve. We can see that in 2008 and 2009, the government was injecting money into the system at an unprecedented rate. The government acknowledges that the M1 money supply (currency, traveler's checks, and demand deposits) has risen by 10% over the 12 months ending February 2011. The M2 money supply (sum of M1 and savings accounts and money market funds) grew at 4.1% rate and is 18% higher than it was at the end of 2007. The most recent count shows nearly $8.9 trillion dollars in the global economy. A quick look at that chart reveals that it was only $1.5 trillion in 1980.

The relationship between the money supply and future inflation is more complicated than simply saying when one goes up the other goes up. The two measures are definitely correlated but it is difficult to say which one causes the other, or, to say whether or not not another factor causes both. A look at the CPI Indexfrom 1981-2011 suggests that inflation has not risen as quickly as the money supply in the last 30 years.

Inflation could be caused by an increase in labor costs which are completely under control at the present time given the slack in the employment picture and the outsourcing of labor to lower wage countries. The "velocity of money" (how often a dollar is reused in the economy in a year) is also down. Economists have suggested that this has helped slow inflation in recent years as banks refused to lend even as the Federal Reserve flooded the banking system with cash. You can stuff an infinite amount of money in a bank, but if the bank refuses to lend that money then the general economy will never see inflation from it.

An economist at PIMCO, Mihir Worah, is currently projecting inflation rates that are pretty low when compared to historical averages. His estimates of 1% to 1.5% are likely to be realistic until the velocity of money increases to catch up with the increase in the money supply. At this point, inflation could be reasonably expected to rise at a significant amount and we will be subject to trusting the Federal Reserve to raise interest rates even while the government is looking at record deficit levels.

It is interesting to view the past and compare those situations to the ones we are experiencing today. There is a website that offers multiple wasy to calculate the changes in costs over time. You may find it interesting to note that $25,000 paid to George Washing annualy to serve as President of the United States in 1789 is equivalent to about $585,000 today. This is not a far cry from the $400,000 that our President currently receives.

Not everything has maintained the same pace as the rate of inflation (including the aforementioned presidential salary). In 1925, a new Model T car was $290. That would equal $3,500 at today's prices. In 1930 and 1931, the famous Yankee Babe Ruth earned a salary of $80,000. This is the equivalent of $1 million today and is about the amount that the .214 hitter sitting at the far end of the bench makes playing for the Yankees today.

The one thing to keep in mind as prices rise is that quality typically does too. Remember our first computers that took up an entire room, cost enormous sums of money, and whose computing power could be reasonably measured in kilobytes and megabytes? Now, we have computers in our phones that cost a fraction of what those computers used to and they can compute exponentially more information at faster speeds while fitting into our pockets. Also, the Model T mentioned earlier probably would not compare to the cars today in luxury, safety, and performance capability. This is simply something to keep in mind as the rate of inflation suggests prices are rising, but with that, you are also getting rising quality.

Sources:

Median Income

Federal Reserve measure of M1 and M2

PIMCO viewpoint

Food Timeline