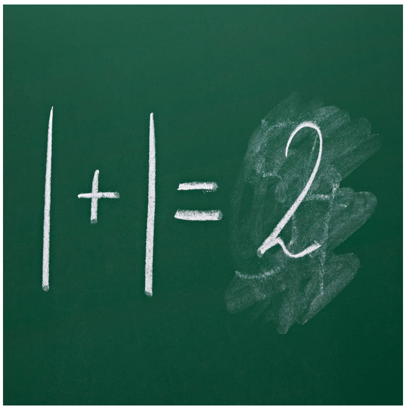

Inflation, put simply

Description

Inflation is a measure of the change of prices in an economy.

In an economy, we want to know how much “purchasing power” our money will have. That is, how much goods and services can we purchase with $1CAD. By tracking the change in prices over time, inflation can help us understand this.

You can think about it this way: Today, you can walk into a Starbucks today and buy a tall cafe latte for $3. Will the same hold true next year? If inflation is positive, the answer is “no”. As inflation rises, so will the price of your latte. If inflation is relatively low, you may not notice much of a difference — you might pay $3.06 next year. But that still means that your $1CAD now buys less coffee.

How is inflation measured?

Typically, and this is true of Canada, inflation is measured by tracking a “fixed basket of goods and services” over time.

The people responsible for tracking inflation take measures of the prices of a wide variety of things that consumers typically spend their money on. Each category is weighted based on how much the typical Canadian spends in that area. Taken all together, this basket makes up the Consumer Price Index (or CPI).

To get a bit more specific, the broad categories of the prices tracked in the CPI are:

- Food;
- shelter;
- household operations, furnishings and equipment
- clothing and footwear;
- transportation;
- health and personal care;
- recreation, education, and reading; and

- alcoholic beverages and tobacco products.

To get even more specific, within the category of “food”, the CPI tracks prices for the food you’d buy at the grocery store as well as what you order at a take-out or dine-in restaurant. Food overall accounts for around 16% of the CPI, while food purchased from dine-in restaurants, for example, accounts for about 3% of the entire index.

“Recreation, education, and reading”, meanwhile, breaks down further into categories like travel tours, school tuition fees, and multipurpose digital devices. So yes, when Apple raises prices on the new iPhone, that can increase the rate of inflation in Canada. (Though not by much, that category accounts for less than 1% of the CPI!)

The prices for all of these products and services are measured and weighted to make up the Consumer Price Index. The CPI as a whole is then compared to the CPI from prior periods, like last year or last quarter. That percentage change in the CPI over time is the inflation rate.

What causes inflation?

As we walked through above, from a technical sense, inflation is caused by rises in the Consumer Price Index. So when we ask “what causes inflation?” we might as well ask “what causes a rise in the CPI?” Or, maybe better still, “what causes consumer prices to rise?”

To answer that, we can look at two high-level causes for higher inflation, or a rise in consumer prices: demand-pull inflation and cost-push inflation.

Demand-pull inflation

Demand-pull inflation refers to when an increase in the demand for goods and services leads to a rise in prices. One example of how this can happen is if interest rates are low and those low rates encourage people to borrow a lot of money to buy things. Low interest rates (low mortgage rates) can encourage people to buy houses, which can drive higher housing prices. Low rates on auto loans can encourage people to buy more cars. And low rates on personal loans and credit cards, as well as 0% financing deals, can encourage people to do more spending on a lot of consumer goods.

If this increase in spending is faster than the increase in goods — that is, more houses being built, more cars being manufactured, and more TVs, smartphones, sneakers, refrigerators, and bicycles on the shelves — then prices for those goods will rise. And that’s how you end up with demand-pull inflation.

Cost-push inflation

On the other side, cost-push inflation results from rising costs of inputs to goods and services working their way through the system and leading to increases in the costs of the stuff that we buy. An example of this could be a shock to the supply of aluminum, leading to less aluminum being available and a higher price for aluminum. The higher price for aluminum could show up in a lot of places from cars and refrigerators to soda (aluminum cans!) and windows.

As prices rise for those goods that include aluminum, the CPI will rise. And, just like that, we'd see cost-push inflation.

How does inflation affect the economy?

The Bank of Canada targets an inflation rate between 1% and 3%, aiming for the midpoint of 2%. In other words, some inflation is not a bad thing. In fact, most economists believe that some inflation is good for an economy. They might say that it provides a lubricant for economic activity.

Just like ice cream, some inflation can be good, but too much just ain't.

When an economy has too much inflation, it can be a serious problem because it rapidly erodes the value of the currency. Remember the example of a Starbucks latte rising from $3 to $3.06 from one year to the next? Imagine of that latte rose from $3 to $8 the next year. That's a real problem. When an economy has inflation like that, it becomes increasingly hard for consumers and businesses to buy the things they need because prices are rising so quickly. It discourages saving because nobody wants to hold onto dollars that are going to be worth a lot less in the future. And it generally makes people and businesses uncertain and uneasy. And neither of those attributes leads to a healthy economy.

At the same time, deflation (negative inflation, or falling prices), isn't great for the economy either. When this happens, you have a different set of problems that come up. Now, instead of nobody wanting to save, nobody wants to spend! This happens because lot's of people look at the falling prices and think "Why buy that today when I may be able to buy it tomorrow for less?" Consumers don't buy things and businesses don't invest in growth.

Again, just like ice cream: too much is no good, but having none is bad too!

Why is inflation bad for the stock market?

The stock market usually doesn't do well when inflation is high. A big part of that is competition. Specifically, competition from bonds, savings accounts, and other fixed-income products.

A primary tool for central banks to fight inflation is to raise interest rates. When the central brank raises interest rates, that cascades through the banking system and leads to banks offering (and charging) higher rates. Higher interest rates encourage people to save money and spend less, which, ideally, cools off some of the pressure on prices.

But when an investor can get a high rate of return from a savings account or a bond, the attractiveness of stocks drops. Without going too far down the rabbit hole, investors are constantly weighing the return they can get from an investment against the risk they bear for owning that investment. Stocks typically have a higher rate of return compared to other investments, but also have a higher risk associated with them. A savings account or government bond generally have a lower rate of return, but also lower risk compared to stocks. So it's reasonable that when the rate of return on a low-risk savings account or bond rises, more and more investors will shift their funds from higher-risk stocks to lower-risk fixed-income.

PP NOTIFY USER

1. tmfkopp

Date
2025/08/19
Date Created
2021/03/17
Author
tmfkopp