

# The Return of Inflation

If lately you feel like everything is more expensive, you might be experiencing the current bout of inflation. Inflation is a sustained and progressive increase in the prices of a basket of goods and services <sup>[1-2]</sup>. Understanding inflation is vital, because it erodes your purchasing power as additional spending is required to buy the same amount. It is important to point out that the increase is in prices in general and not only on a few items <sup>[1-2]</sup>.

Inflation is not new; inflation has been around for a long time <sup>[3]</sup>. Nevertheless, the last time the United States experienced high inflation was in the 70-80's, when prices skyrocketed, and the consumer price index reached double digits <sup>[1]</sup>. Since that was at least 40 years ago, here is a little refresher on inflation and its underpinnings.

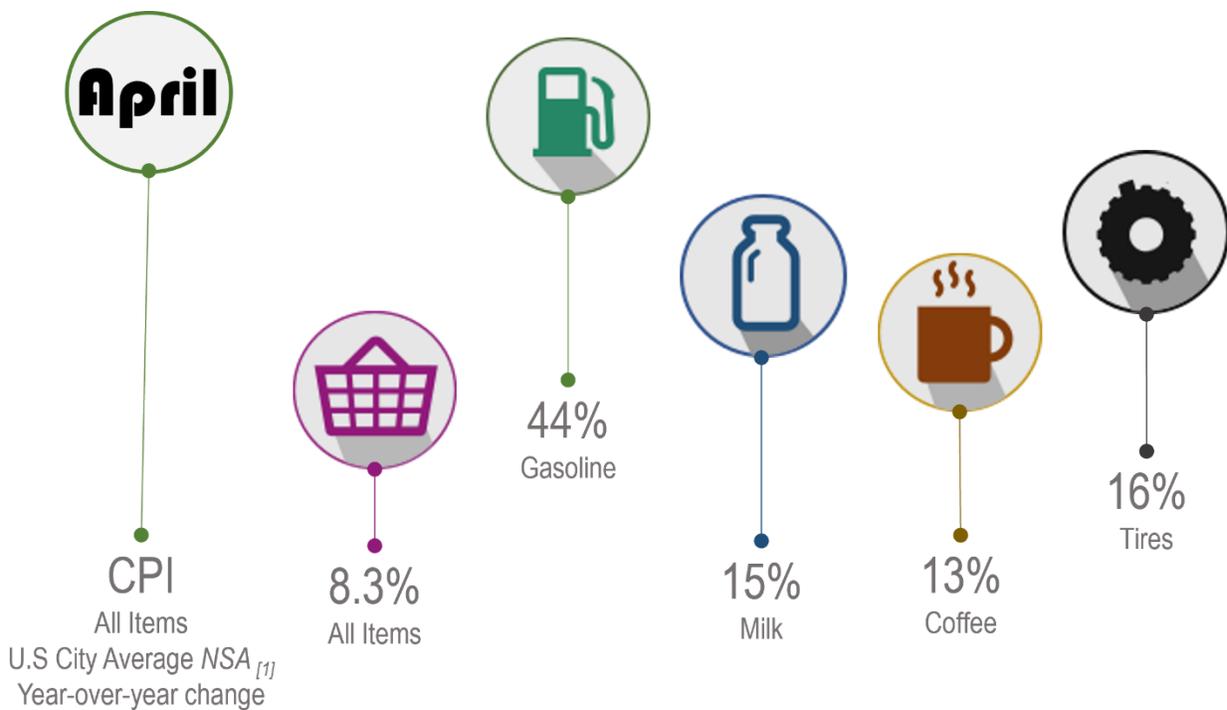
## **How is Inflation measured:**

Inflation can be tracked from the consumer's point of view or the producer's perspective. Below is a brief explanation of some of the most widely used indexes:

- The Consumer Price Index (CPI) measures the changes in prices from the consumer perspective. The CPI— collected by the Bureau of Labor and Statistics—compares the current prices in a basket of goods and services with their previous prices <sup>[1]</sup>.

- The Personal Consumption Expenditure Index (PCE) is like the CPI, but the underpinnings behind these two indexes are different. The PCE not only tracks changes in prices in all products that were purchased, but also the changes in consumer behavior due to those price changes [4].
- The Gross Domestic Product Price Index, tracks price changes for products and services produced in the United States [4].
- Producer Price Index (PPI) reports the changes in selling prices, which is said to be the seller's perspective [1].

While all these indexes can provide an insight into what prices are doing, some economists prefer to use core inflation, which is basically a price index minus food and energy [4]. Food and energy tend to move around due to different factors such as weather. By excluding these two categories' economists believe they can have a better picture of what is happening and a better gauge of future inflation [1,4].

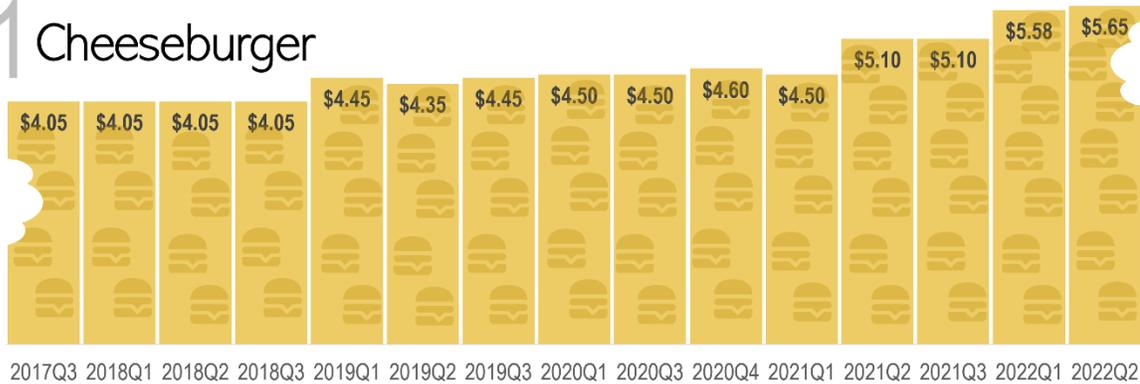


### Feeling the pinch:

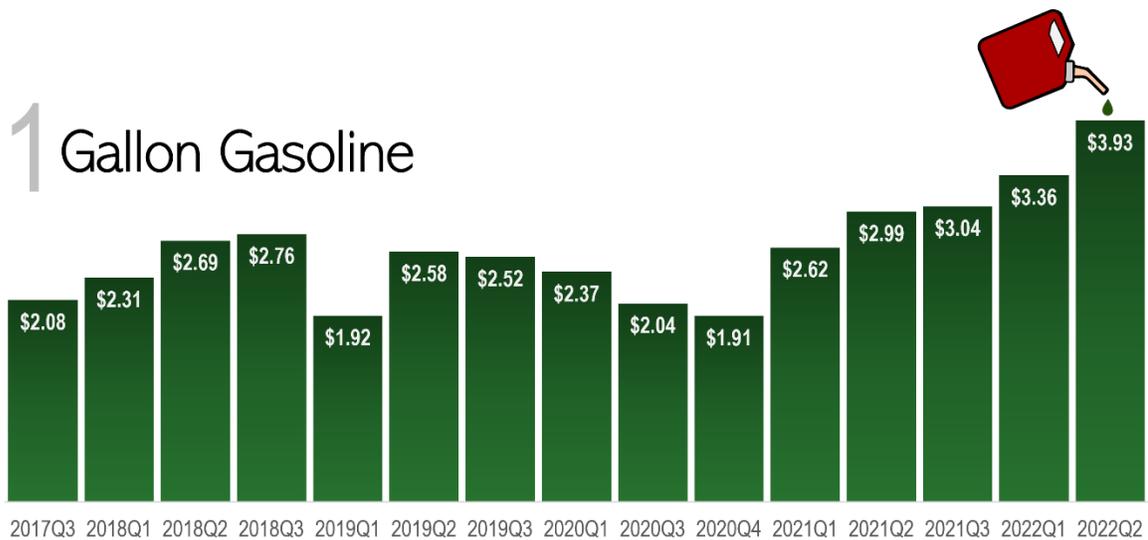
Look how the average price\* for a cheeseburger, 1 gallon of unleaded gasoline, and a dozen eggs have changed over the last few years in the City of Las Cruces [5]. During the second quarter of 2021 you would have paid 12% more— approximately an additional \$8—to fill up your 23-gallon gas tank; eat a cheeseburger; and buy a dozen eggs, as compared to the second quarter of 2018. Now, if we compared Q2 2022 to Q2 2018, you are paying \$31 more for the cheeseburger, the 23 gallons of gasoline, and the dozen eggs.

*\*Note: The prices might have a margin of error. 2022 is preliminary (subject to change).*

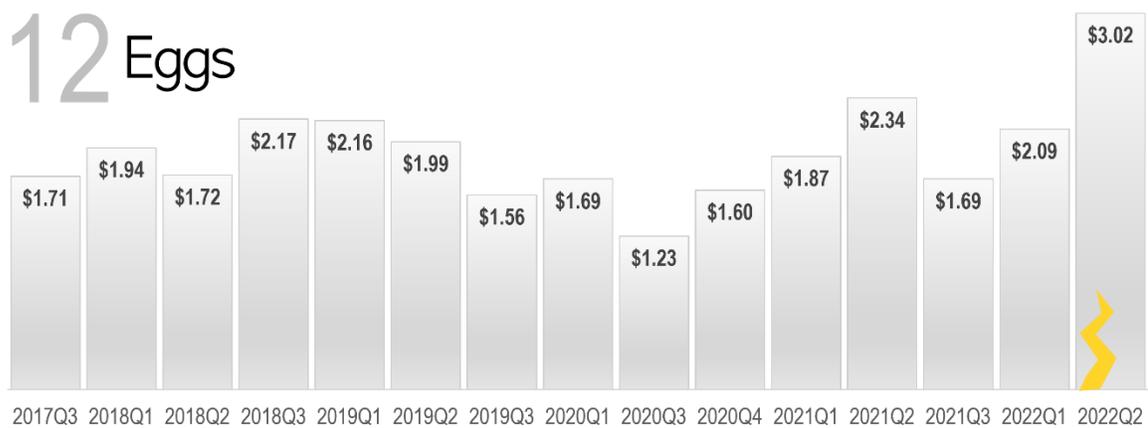
# 1 Cheeseburger



# 1 Gallon Gasoline



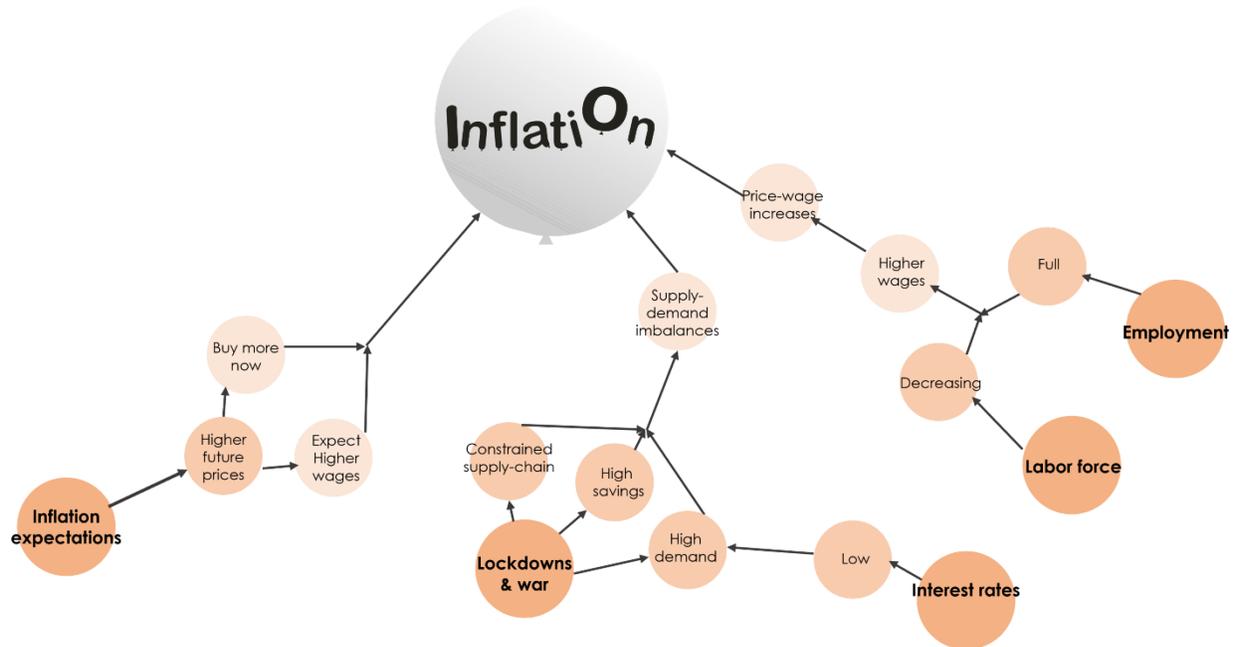
# 12 Eggs



How much it costs [5]?

## What causes inflation

The famous Nobel laureate Milton Friedman stated that inflation was a monetary problem, in other words “Too many dollars chasing too few goods” [6]. Independently from the school of thought, inflation is a complex subject in which many variables can play a role. Some things that could have contributed to the latest surge of inflation are:



- *Labor force and employment:* It is believed that a shrinking labor force combined with full employment can have an inflationary effect as workers have higher bargaining power on wages which can lead to price increases.
- *Supply-demand imbalances:* Supply-demand imbalances can occur by several factors; a good example is the recent lockdowns. The business closures during the pandemic had two dramatic consequences. One, they interrupted production, creating backlogs, and disrupting supply-chains. Two, consumers stuck at home were not only able to save more money (enhanced by stimulus money), but probably realized that their homes needed some upgrading or that they needed a new home, etc. Thus, they engaged in a buying spree, new furniture, remodeling projects, etc. This coupled with the lack of available products and fueled by low interest rates, could have contributed to the price increases we are experiencing.
- *Geopolitical factors:* What would have happened if Russia had not invaded Ukraine? This unleashed another set of complications, from additional supply-chain constraints to a decline in food production (e.g., wheat, sunflower oil, etc.), and an increase in commodity prices. [7]

- *Low interest rates:* When interest rates are low, business and consumers are more likely to borrow money to make big purchases. The opposite tends to happen when interest rates are high because borrowing is more expensive [8].
- *Inflation expectations:* It is believed that when people expect prices to continue to increase, they will buy more today or request higher wages today to make ends meet, which leads to rising wages and prices (known as the price-wage spiral) [9-10].

## **Good or bad, it all depends.**

Inflation is like everything in life, too much (hyperinflation) or too little (deflation) is not good. A moderate amount of inflation is said to be good because it works as a balance between producers and consumers. Consumers buy and businesses have leverage to adjust to changes and still make a profit [10-11]. Moreover, inflation does not affect people the same way, as the consumption basket and access to assets varies with income level [7,12].

High inflation can be especially hard for lower income earners because they cannot adjust their spending as easily as higher income earners, and because they are less likely to own diverse assets that can help hedge inflation [10]. Inflation can also add a challenge for retirees, owners of bonds, companies that cannot pass the additional costs to consumers and absorb the cost by reducing their profit margins. On the other hand, inflation could benefit the people with fixed-rate interest loans as your money today is more valuable than your money tomorrow.

## **What or who keeps inflation under control**

The Federal Reserve. The Fed as it is commonly known, is the central bank of the United States and one of its roles is to keep prices stable. To keep prices from rising too much, the Fed can affect consumer demand by increasing the fed-fund rate which is the rate banks lend money to each other, and the baseline that lenders use for interest rates on loans [8-13]. When interest rates increase, borrowing becomes more expensive and consumers and business are less likely to borrow, which in turn reduces demand, production, and employment [8,13-14]. It is important to keep in mind that the Fed's objective is to achieve a "soft landing", meaning slowdown the economy by increasing interest rates at a pace that will not cause a downturn [14]. Now, if the economy starts to decline at a faster pace than expected, lowering interest rates can help bring the economy up-to speed by promoting borrowing, and therefore purchasing, production, and thus employment [8].

## **Why it matters:**

Inflation is real, is back, and it hurts your wallet. That is why is important to understand its underpinnings and consequences.

## References

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