

The Impact Of Inflation

Inflation is a general rise in prices - and it's the financial equivalent of rust. Just leave your money lying around, and watch inflation eat it!



If I hand you \$1,000 today, and inflation is running at 4%, my generous gift will be worth only \$962 this time next year. A ten-year wait, with the rate of inflation at 12%, will eat it down to a miserable \$322. Or, to put it more graphically still: suppose Grandma left a dollar under the mattress in 1900. Today, it's still a dollar. The difference is that in 1900 it could have bought dinner for two at a decent restaurant, and now it will just cover a cookie to go with that \$3 iced mocha.

Economics may be known as "the dismal science", but let's look on the bright side for a minute. We'll assume you kicked Grandma's bad habit of saving money at the Bank of Mattress. Instead, you put your extra cash to work - in a savings account, a CD, a mutual fund, stocks, whatever. However you do your saving, you are expecting some return on your investment. Absent of any inflation, its value may actually grow over time instead of shrinking; that, after all, is why people invest.

Back in the real world, there is almost always inflation. Sometimes a lot, sometimes just a little. It's measured monthly by the Department of Labor, which publishes the "Consumer Price Index," measuring changes in the prices of consumer goods and services like housing, food, and consumer durables. Historically in the U.S., a high inflation level was the 14-15% per year that we saw in the late 1940s and in 1980; a low inflation level is the 2-5% we saw through most of the 1990s.

You absolutely cannot rationally assess your investments, especially for retirement or any other long-term goal, without first estimating a probable rate of return on your investments and then adjusting for the probable rate of inflation.

Look again at that \$1,000 I gave you. Over ten years, if you are getting a 6.5% annual return on your investments, and there's a moderate (say 5.5%) rate of inflation, your balance will rise to \$1,877-but will be worth only \$1,152 when adjusted for inflation. On the other hand, with an aggressive stock portfolio in a rising market, you might make a 14% return; if the inflation rate is just 3%, then your \$1,000 turns into \$3,707 over the ten years - or \$2,759 when adjusted (of course, market conditions and inflation rates will vary).

Retirees, and others on a fixed income, should pay special attention to these calculations, and should not ignore the kind of scenario in which returns on investments don't keep pace with inflation. It has happened before and, it will probably happen again.

Before we finish, let's note one other place that inflation should loom large in your financial thinking and planning: figuring how much you should be saving. It's relatively easy to say, "I should save \$10,000 a year" and just keep doing so. But if inflation is running at 4%, the real value of what you're saving will decline every year. To compensate, and keep saving "the same" amount, you need to save \$10,000 the first year, \$10,400 ($10,000 \times 1.04$) the second year, \$10,816 ($10,400 \times 1.04$) the third year, and so on.

The rate of inflation is always changing. So is the investment climate, and with it the plausible rate of return on different kinds of investments. This means that returning to the financial calculator and running some numbers should be something you do at least once a year.

Think of it as a yearly application of rust inhibitor!