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The Ravages of Inflation

By Mark G. Dotzour

Inflation is a term used to describe the economy when prices of virtually everything consumers buy — necessities and luxuries alike — are going up.

Sometimes inflation is low (1 to 2 percent per year), and we don't think about it. But at other times, the inflation genie gets out of the bottle, and prices rise quickly. In 2008, prices increased over 5 percent. Just for historical context, when inflation rose to over 6 percent, Richard Nixon imposed wage and price controls over the entire U.S. economy (Figure 1).

Inflation causes a general loss of purchasing power. Your money simply cannot buy as much as it did when inflation was not present.

Suppose you saved $1,000 to buy two plane tickets to Hawaii for your anniversary. After a year of saving, you call to buy the tickets and find that they now cost $1,200. Either you don't get to take the trip, or you have $200 less to spend on lodging, food and souvenirs when you get there.

When prices increase faster than income, quality of life for all Americans is diminished. You have less money left over after paying for necessities such as food, gasoline, electricity and property taxes. This was readily apparent in the past year, when gasoline and food prices rapidly increased. Consumers had less to spend at Starbucks, Applebee's, Men's Wearhouse, Ann Taylor and on trips to Las Vegas.

What Causes Inflation?

The basic cause of inflation in America is the federal government's pattern of spending more money than it takes in from taxes. American citizens cannot do that every year. Sooner or later, their debt gets so large that they cannot pay it back. Then they face bankruptcy.

State and local governments cannot do it either because they are usually required to develop a balanced budget each year. On rare occasions, even local governments cannot live within their means and are forced into bankruptcy.

The federal government is the ONLY entity that can spend more money than it collects every year.

How can Congress and the President continue to spend more money than they take in every year for decades? The answer is this: they own the printing presses of the U.S. Treasury and the Federal Reserve. They just print more money every year (Figure 2).

It must be great to control the largest economy on the planet and know that you can spend virtually any amount of money for any project you deem worthy. And it must be very easy to spend money that was earned through the hard work of others.

We can spend money to be the world's policeman in Korea, Afghanistan and Iraq. We can feed the world and support the United Nations. We can bail out huge global banks that made massive profits with subsequent bonuses of astronomical proportions in previous years. We can offer subsidies to large businesses. We can pay farmers not to plant crops.

We pay salaries to healthy people who choose not to work. We promise all Americans Social Security and Medicare benefits from an account that will be drained in the near future. Now, we are going to consider adding universal health care to the list. Why not? When you are on a spending spree at the mall with someone else's credit card, you might as well load up the shopping cart.

But let's not debate which of these programs are good or bad. The point is that all of these programs are examples of government promises that are not backed up with the money to pay for them.

The federal government has three options to pay for all this promised spending. First, it can raise taxes to try to pay for them. But raising taxes is not popular with the American public. Ever since the Boston Tea Party, Americans have resisted paying higher taxes.

Second, the government could change its policies and choose not to spend money it does not have. It could start living within its means. This is highly unlikely because it is difficult for politicians to stay in office when they promise people benefits and then change their minds.

The third alternative is for the government to print money to pay its bills. This option has been adopted by governments all over the world for thousands of years.

Who Loses?

Clearly, the biggest losers when inflation strikes are retired people on fixed incomes from their own savings and Social Security payments. They have no choice but to cut back on their lifestyle by buying less expensive food and taking fewer trips to see their kids and grandchildren. They may even take more drastic measures such as not buying their medicine. They don't have a printing press to print new money. They *have* to live within their means.

Well-meaning, hard-working Americans who prudently save money to provide for their futures also lose big from inflation. Each year the rate of inflation is higher than the interest they earn on their savings, their retirement quality of life declines.

Consider a person who deposited $1,000 into a savings account on Jan. 1, 2000. In July 2008, products that would have cost $1,000 at the beginning of the century cost about $1,300. This value difference would have to be compensated for by cutting back on spending in retirement.

Bad Behavior Encouraged

Inflation removes the incentive to save. Why save today, when your money will purchase less next year?

Inflation encourages consumers to borrow as much money as they can today, knowing that they will repay the loan with cheaper dollars in the future. Clearly, the American consumer is aware of this because the savings rate in the United States has been virtually zero for several years now.

Unfortunately, borrowing money to live beyond your means is a recipe for financial disaster. We are seeing plentiful evidence of this truth today as millions of families struggle to pay their mortgage and credit card debt.

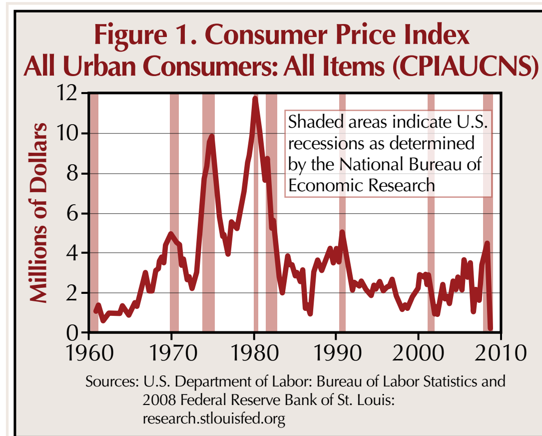

Figure 1. Consumer Price Index All Urban Consumers: All Items (CPIAUCNS)

Sources: U.S. Department of Labor: Bureau of Labor Statistics and 2008 Federal Reserve Bank of St. Louis: research.stlouisfed.org

What Can Past Teach Us?

History is full of examples of governments that have lived beyond their means and resorted to printing money and devaluing their currency. The hyperinflation in Germany in the 1920s is one of the most documented. Workers were paid twice a day because the currency was losing so much value in a 24-hour period. Children carted wheelbarrows full of money to pay the entrance fee to the public swimming pool.

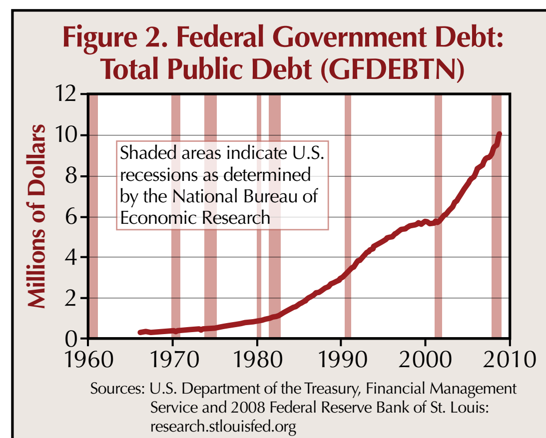

Figure 2. Federal Government Debt: Total Public Debt (GFDEBTN)

Sources: U.S. Department of the Treasury, Financial Management Service and 2008 Federal Reserve Bank of St. Louis: research.stlouisfed.org

Two decades later, Hungary was straddled with war debts it could not possibly pay, so they devalued their currency into oblivion in a matter of 18 months. More recently in 1993, when Slobodan Milosevic ruled Yugoslavia, he turned on the printing presses and forgot to turn them off. Local citizens who did not take precautions saw their life savings lost in a matter of months. The same thing is happening in Iceland today.

How Do Consumers Respond?

When consumers believe that inflation may spiral out of control, some get the urge to buy gold. These folks think gold is a hedge against inflation but, in reality, it is a speculative commodity and an extremely high-risk one at that. Just ask people who bought gold in 1981 at $700 per ounce and watched it fall to $300 per ounce a few years later.

Real estate also has traditionally been recognized as a hedge against inflation because real estate prices tend to increase along with other prices. This is only partially true. Quality real estate does tend to keep up with inflation. However, there are places in the United States where real estate prices have not increased for many years.

Areas where jobs are being created and population is growing are the best places to invest in real estate for the long-run protection against inflation. Farm land and quality commercial real estate tend to increase in value with inflation. Buying a single-family home in your own community for investment is another viable option.

Some people want to cash in their U.S. investments and buy assets in foreign countries with currencies they consider more stable. Most investors view the United States as a place safe from currency devaluation, but if our government continues to run trillion-dollar deficits that could change.

Another investment option is inflation-protected U.S. Treasury bonds. These are backed by the full faith and credit of the U.S. government, and each year the principal amount of the bonds increases with inflation. Consequently, if the consumer price index is up 7 percent in one year, the value of your bond also goes up 7 percent. Hence, the purchasing power of your savings is preserved.

What are the Odds?

Many economists expect no inflation in 2009. This is possible because gasoline was $4 a gallon in 2008 and is $1.50 a gallon in 2009. That is deflation. If retailers cut the prices of clothes, TVs and computers, that further adds to deflation.

But what about 2010 and beyond? If gasoline stays at $1.50 a gallon in 2009 and increases to $1.65 in 2010, that represents 10 percent fuel price inflation. Do you think your doctor, accountant, lawyer or local university will lower their prices or increase them each year?

Chances are that we could see deflation in 2009, followed by inflation in the years after. With the massive spending going on in the United States and China, the economies of both nations will strengthen soon. That's when the threat of inflation becomes more likely.

If you are concerned about runaway inflation, your safest long-term investment options are quality real estate properties and inflation-protected U.S. Treasuries, which offer protection without the enormous speculative risks associated with gold or other commodities.

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THE TAKEAWAY

When inflation strikes, consumers look to gold, real estate, foreign assets from countries with stable currencies, and inflation-protected U.S. Treasury bonds. But gold is always a high-risk investment. The best bets from this list are quality real estate properties and Treasury Inflation-Protected Securities.

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