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The Money Illusion: How inflation threatens what today's money can buy in the future

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In their excellent book *Why Smart People Make Big Money Mistakes*, Gary Belsky and Thomas Gilovich look at how three people, Peter, Paul and Mary, each buy a house that costs $200,000. Then each sells their house after one year.

Let's follow what happens to all three in discussing how inflation threatens what today's money can buy in the future – what we call *the money illusion*.

In Peter's case, the country undergoes 25% deflation in that year, and he receives just $154,000 for his house, 23% less than he paid.

In Paul's case, a year later, inflation has risen by 25%. He can sell his house for $246,000, a 23% percent gain.

In the year Mary owns her house, the cost of living is flat. At the end of the year she sells it for $196,000, or 2% less than she paid.

Taking inflation and deflation into account, and assuming none carried debt, who was financially better off after selling their home?

I'll tell you the answer shortly. You may be surprised. But first here is another example to consider:

Let's say you set aside $100,000 cash in your safety deposit box. You leave it there for 10 years while inflation averages 3% a year. At the end of 10 years, you open the box and count your money, and there it is: your $100,000 sitting safely inside. Should you feel good about that?

Both examples above illustrate the money illusion – the tendency to focus on the face value of money and overlook the effects of inflation on its purchasing power. With the cash in your safety deposit box, sure, your original money is still there. But 10 years of inflation have cut its purchasing power by $26,000, to just $74,000.

In the housing example, most people feel Paul does best because he's made a $46,000 profit. But the real winner is Peter, even though he sold for a $46,000 loss. Why? Because of inflation, Paul's profit falls 2% short of the inflation rate, so his purchasing power is diminished. So is Mary's. But Peter, despite what seems like a sizeable loss, comes out with purchasing power 2% *greater* than inflation.

The point I'm making is this: Money is only good for what it can buy. So, what you can buy with your money is more important than the absolute quantity you have.

The money illusion has three major effects on people's financial planning.

First, they underestimate how much money they will need, especially after they retire. An average couple retiring today can expect at least one of them to live another 28 years. That's plenty of time for inflation to dramatically increase your costs, as it chips away at the purchasing power of fixed investment.

Second, people overestimate the value of fixed assets such as cash on hand, as shown in the cash example I described above.

Third, they overestimate the ability of real estate to keep them ahead of inflation.

Inflation averaged 3.2% over the past 100 years. Central banks around the world, such as the Bank of Canada and the U.S. Federal Reserve, seem determined to ensure we have similar inflation going forward.

The lesson here is: Be sure you consider inflation when planning your future and when comparing different investments. History shows that despite seeming risky, stocks are actually a good long-term inflation hedge. That's because company earnings generally rise with inflation, whereas fixed-rate investments don't. Incorporate inflation when doing your long-term financial planning. It won't make inflation go away, but at least it allows you to clearly see the effect it might have on your financial future. ■

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