The Stan Clark Financial Team's

PERSPECTIVES

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Asset Allocation

What is inflation/deflation – and how does it affect you? (Part 1)

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We often hear about the economic term *inflation* and even sometimes *deflation*. Let's look at what these terms mean – and how they affect you.

Inflation is the general increase in prices of goods and services over time. When prices go up, your money can't buy as much. In technical terms, inflation results in a reduction of the purchasing power of money.

We experience inflation almost all the time. Sometimes it's hard to notice, year to year. But if we think back over longer time periods, we do notice that we can't buy the same things we used to with the same amount of money. Today, for example, a Snickers chocolate bar costs $2 at the corner store. Twenty years ago, that same Snickers, at the same corner store, cost 50. You can see how the dollar's purchasing power has declined over time – and its significant effect on all of us. A dollar from 20 years ago could buy two Snickers bars. Today it would only buy half a Snickers! In this example, the inflation rate works out to about seven percent per year. That means the dollar is eroding at seven percent per year. So, each year, a dollar is able to buy seven percent less.

This is just a simple example, but it shows very clearly the effects of inflation and how it is calculated. In the real world, as expected, things are a lot more complicated and unclear. In Canada, inflation is measured by the Consumer Price Index, or CPI. The Bank of Canada calculates CPI every month by collecting 70,000 price quotes on about 600 goods and services across the Canadian economy. This "basket" is comprised of things like food, shelter and transportation. So, every month, the Bank of Canada will review the prices of, say, bread, rent and gas to see how much the prices have changed.

That's a lot of work. But it actually gets even more complicated. For example, if we're at the grocery store and notice the price of beef is up but chicken remained the same, we might buy chicken over beef. In this case, the reported inflation rate will be higher than it should be because many people avoided higher prices by substituting chicken. There are lots of other reasons that make calculating CPI difficult, but we won't get into them here. Our point is that measuring inflation and the actual rise in the cost of living is complex and will never be completely accurate.

There are two types of inflation figures that are published: *headline* and *core*. Headline inflation is based on the entire basket of goods. Core inflation excludes the most volatile items, such as fruit, vegetables and gas. Core inflation is meant to exclude the noise of short-term price fluctuations and focus more on persistent long-term trends. The Bank of Canada focuses more on core inflation. The reason is that it doesn't make sense to change monetary policy, only to unchange it soon after because of some volatile prices. On the other hand, too much attention on one number also has its drawbacks. So, it's important to know how things are calculated, always keeping the big picture in mind.

Deflation is the opposite of inflation, meaning a general reduction in prices. This might sound like a good thing at first, because we all like lower prices. While mild deflation might be welcome, it can create disincentives that can lead to bigger problems for the economy.

We haven't experienced many deflationary periods in Canada. But there were two significant periods that proved to be quite vicious: the early 1920s and the Great Depression in the 1930s. In each period, prices were down around 20 to 25 percent, leading to lower profits, shrinking incomes and higher unemployment. Since then, Canadians have mostly experienced inflation, ranging up to 15 percent. But for the last 25 years, inflation has been quite stable and moderate, around the two-percent range.

In the next issue, we will continue our look at the effects of inflation and deflation.

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