Forbes

Where Does Inflation Come From? A Not So Brief History Of Inflationary Markets

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The causes of inflation, as well as the severity with which inflation influences consumer behavior vary, and have traditionally sparked a lot of discussion among analysts. But where does inflation come from? Inflation can come from government spending, supply chain issues that impact supply and demand, a rise in money supply, and more.

It is essential to know not only what inflation is but why inflation in the U.S. is so high right now. It is also important to know how to invest during periods of high inflation.

Key Takeaways

- While many people dislike inflation, it is a fact of life and investing. As the economy expands and contracts, inflation is a normal byproduct.
- The overall goal with regard to inflation is to keep it around 2-3% annually.
- Government spending, along with stimulus, flooded the economy with new cash to buy goods and services, which were in short supply.

What Is Inflation?

Inflation is the rate of increase of prices over a given period of time. The price increase, usually stated as a percentage, signifies that a unit of money buys fewer items than previously. For example, if inflation is 3%, the things you currently buy for $1.00 will cost you $1.03 in the future.

While many people dislike inflation, it is a fact of life. As the economy expands and contracts, inflation is a byproduct. The key is controlling it so it doesn't get out of hand. There are two extremes to inflation: deflation and hyperinflation.

Deflation is when prices fall but buying power rises. Hyperinflation is when prices rise by 50% or more per month. Recently, consumers have started to notice "shrinkflation" as well. This is when companies reduce product sizes but keep the price the same.

Current Inflation in the U.S.

To understand the current inflation rate in the U.S., we must first understand the most common measure of inflation, the Consumer Price Index (CPI).

The Consumer Price Index (CPI) is a monthly indicator that tracks the fluctuation in average prices paid by American buyers. The Bureau of Labor Statistics calculates the Consumer Price Index as a weighted average of the price levels for a basket of services and goods reflective of total U.S. market expenditure.

For 2022, inflation has been running well above the 2% that the Federal Reserve would like. In April, inflation increased to 8.3%. At the time, many experts believed this to be the peak. However, inflation rose to 8.6% in May, followed by another increase to 9.1% in June. There was some relief in July, finally, as inflation fell back to 8.5%.

However, this decrease is misleading because of the reduction in the cost of gas. Oil prices fell dramatically, which offset price increases in rent and food. Because of the large drop in oil prices, the CPI report showed inflation slowing, when in reality, many costs consumers face are still increasing.

The question many people have is, how did inflation get out of control? Let's explore some of the factors contributing to our current situation. There are various reasons for these, each contributing to our current situation.

COVID Bailouts

COVID-19 wreaked havoc on the economy in unimaginable ways. The U.S. Government's reaction and the Federal Reserve played a role regarding inflation today. The government approved multiple bailout programs.

The $32 billion Payroll Support Program for the airline industry and the $659 billion Paycheck Protection Program for small businesses.

In addition, the government sent Economic Impact Payments, commonly called stimulus checks, to millions of Americans. There were three rounds of checks, and the payments totaled $803 billion:

- CARES Act (March 2020) included $1,200 per income tax filer, $500 per child.
- Consolidated Appropriations Act (December 2020) doled out $600 per income tax filer, $600 per child.
- American Rescue Plan Act (March 2021) provided $1,400 per income tax filer, $1,400 per child.

Also approved were rent and student loan payment moratoriums, allowing people to stop paying these monthly bills. Both programs began in March 2020, and while the rent moratorium has ended, the student loan suspension continues until December 31, 2022. There was also mortgage forbearance for many homeowners that allowed some relief from paying down mortgages for a period of time.

Extended Unemployment Benefits

During the pandemic, unemployment benefits were given to a broader range of people, including those who are self-employed. The time one could collect unemployment was also extended from the usual 26 weeks to 39 weeks.

There was also the Federal Pandemic Unemployment Compensation program, which gave the unemployed an additional $600 per week from the Federal government. This was eventually reduced to $300 per week when benefits were extended in 2021.

Supply Chain Issues

As a result of lockdowns across the globe, there have been shortages of many items. For example, many people who purchased furniture in 2021 had to wait six months or more for delivery. Dealerships were selling new vehicles without working radios because of semiconductor chip shortages.

These supply chain issues are still happening today with China resuming lockdowns as the number of positive COVID-19 cases ebbs and flows.

Increased Wage Pressures

Increased salaries are another critical factor in the rise of inflation. Many businesses began to re-hire workers after states started opening for business again. At the same time, many workers were choosing not to come back to work. Critics argue that this was due to the stimulus money people received and the rent and student loan payment halts.

With fewer workers and many job openings, businesses had to offer higher starting salaries to attract candidates.

Tax Cuts and Jobs Act

The 2017 Tax Cuts and Jobs Act (TCJA) was among the most extensive and far-reaching tax-law reforms that U.S. taxpayers have seen. Both individuals and businesses benefited from lower income tax rates. Families saw an increase in the child tax credit and the standard deduction.

With lower taxes, Americans have more money to spend, increasing demand.

Low Interest Rates

One other factor in the rise of inflation is the low-interest-rate environment. The Federal Reserve kept the Federal Funds Rate between zero and 25 basis points from March 2020 until June 2022. Low interest rates allowed businesses to borrow money cheaply, fueling more growth.

At the same time, the influx of money from the various pandemic policies and low mortgage rates fueled a hot housing market.

Where We Are Today

All of these policies have led to the situation we are in now with inflation. Government spending, along with the stimulus money to Americans, flooded the economy with new cash to buy goods and services, which were in short supply. At times, and in certain consumer product categories, very short supply.

Many bought houses, making the real estate market hot. Had the Federal Reserve acted sooner to raise rates, inflation might not be as high as it is. However, the Federal Reserve believed that inflation was transitory, meaning it would quickly pass, so they decided not to act.

History of Hyperinflation

Very few economists believe the U.S. is headed for hyperinflation since the Federal Reserve is actively working on reducing the supply of money.

Hyperinflation is a phrase that characterizes an economy's quick, unsustainable, and uncontrollable price spikes. While inflation quantifies the rate at which the cost of items and commodities rises, hyperinflation is extremely high inflation that generally exceeds 50% monthly. The U.S. is nowhere near this rate of growth.

Phases of hyperinflation have taken place throughout history in nations all over the globe as a consequence of governmental cost overruns, conflicts, corruption, and excessive currency printing to the point where paper is itself more valuable than currency.

Hyperinflation can destabilize a society, and the ensuing economic catastrophe can result in food scarcity and riots. Here are a few examples of hyperinflation.

Zimbabwe

Zimbabwe's background, along with the nation's hyperinflation, is complicated. However, hyperinflation can be traced back to governmental actions and supply constraints. In 2006, the country produced a large quantity of its money, the Zimbabwean Dollar (ZWD), to settle IMF loans and then again the following year to compensate government workers.

In accordance with the CATO Institute, the nation's economic difficulties became so intense that inflation reached 79,000,000,000% in 2008, resulting in the second-worst case of hyperinflation in written history.

Sadly, although there have been specific changes, Zimbabwe's economic system continues to deteriorate, with hyperinflation exceeding 300% as recently as 2019.

Germany

The German hyperinflation of the 1920s can be dated directly to its defeat in World War I. Following the war, the Versailles Agreement levied a tremendous load of reparation debt, prompting the government of Germany to issue increasing amounts of its currency, causing it to devalue.

Per the CATO Institute, Germany's rate of inflation per month hit 29,500% by October 1923 after it defaulted on a payment in fall 1922.

For example, bread cost 250 German Papiermarks in January 1923. By the end of the calendar year, the cost had exceeded 200 million German Papiermarks, as reported by the BBC. After Germany substituted the Deutsche Papiermark with the Rentenmark, the economy started to stabilize.

Asian Currency Crisis

The Asian currency crisis was a massive worldwide economic collapse that destabilized the Asian and, subsequently, global economies towards the close of the 1990s.

The crisis originated in Thailand and swiftly extended to surrounding nations. It started as a currency collapse after Bangkok unpegged its Thai Baht from the United States Dollar, triggering several currency depreciations and large capital outflows.

The worth of the Indonesian Rupiah plummeted by 80%, the South Korean Won dropped by 50%, the Thai Baht fell by more than 50%, and the Malaysian Ringgit decreased by around 45%.

How the Federal Reserve Combats Inflation

There are several ways to control inflation. Although none are certain, some have shown to be more successful and have caused less harm than others. There are various monetary policy tools the central bank uses to influence the economy and fiscal policy respectively.

Contractionary Monetary Policy

A more widely used strategy for reducing inflation is contractionary monetary policy. A contractionary policy aims to shrink a country's money supply by raising interest rates.

This restricts economic development by increasing the cost of loans, which disincentives consumer and company expenditures.

Increases in interest rates on Treasury Bonds also limit growth by encouraging investors and lenders to buy bonds, which offer a fixed annual return, rather than more risky stock funds that profit from lower interest rates.

Open Market Operations

Reverse repurchase contracts are an example of open market operations, transactions wherein Treasury securities, including bills, notes, and bonds, are bought and sold.

OMOs are a mechanism the Federal Reserve uses to reduce the money supply and regulate interest rates. They do this by selling treasury bonds on the open market. As people invest their money, cash can no longer be used to buy goods or services.

The reverse is also true, as the Federal Reserve can increase the money supply. They do this by purchasing treasury bonds. The investors who sell now have the cash to buy other investments, goods, or services.

Federal Funds Rate

The federal funds rate is the overnight lending rate between financial institutions such as banks. The Federal Reserve does not immediately determine the federal funds rate. Instead, the Federal Open Market Committee (FOMC) establishes a realistic range for the federal funds rate and then modifies two additional interest rates, the overnight reverse repurchase agreement rate and the interest on reserves, to drive interbank exchange rates into the optimal federal funds range.

This impacts consumers through higher or lower interest rates on mortgages, credit cards, and auto loans. It also affects the interest you earn on savings products like certificates of deposit and savings accounts.

Discount Rate

The discount rate is the interest rate levied by the United States central bank on loans provided to financial organizations such as corporate banks. The boards of trustees of each commercial bank and the Federal Board of Governors establish the discount rate.

Price Controls

Finally, there are price controls. Price controls are pricing ceilings or floors imposed by the government, not the Federal Reserve, on specific items. Wage restrictions can be used with price caps to reduce wage inflation. Most economists agree that price controls are not a good method for lowering inflation as they can lead to more significant issues down the road, including shortages and surpluses of goods.

Inflation and Your Portfolio

As an investor, how should you react to periods of high inflation? The answer all depends on your investing goals and time horizon.

If you are nearing retirement or need income to fund your retirement years, you can shift money around to get the maximum return on your investment. This could mean investing in bank CDs or treasury inflation-protected securities. Q.ai has various fixed-income investment kits to help you meet these goals.

Suppose you are early in your investing career. In that case, you might want to stockpile cash and slowly purchase beaten-down technology and other stocks so that as inflation cools and the stock market rallies, you can realize a significant gain. Again, Q.ai has many Investment Kits that allow you to invest in a way that makes sense to you and supports your values.

What you should not do in either case is sell out of your holdings. The goal of investing is to make money, meaning sell high. Investors risk missing out when they give in to their emotions and sell when the market falls. Many times during stock market declines, the market will rally. These random days of large gains tremendously impact your long-term wealth.

For example, according to Putnam, if you invested $10,000 in the S&P 500 at the end of 2006 and stayed invested through the end of 2021, you would have close to $46,000. However, if you sold and missed the ten best days during this time, you would have less than $21,000. Even worse, if you missed the best 30 days, you would have lost money, ending with roughly $8,300. Since no one knows when these days will happen, it is best to stay invested at all times.

Bottom Line

Inflation is a fact of our society, given the global market examples above, it's crucial that inflation stays under control. In order to do just that, the Federal Reserve has various tools including monetary policy, open market operations, the federal funds rate, and the discount rate. The overall goal with regard to inflation is to keep it around 2-3% annually.

Currently, the U.S. is in an elevated state of inflation, which hurts consumers and businesses alike. Preparation, first and foremost, is the key to getting through high inflationary periods. Higher inflation will have little impact on you if you ensure your personal balance sheet is healthy.