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Inflation Could Make a Comeback

After a long period of dormancy, inflation may be heating up again. At the November 2007 reading, the consumer price index posted the largest monthly gain in two years. In the 12 months ending in November, the inflation rate was 4.3%, well above the 20–year average of 3.0%.[1,2]

The Federal Reserve has helped keep inflation fairly low for the better part of the past two decades: The last time the annual inflation rate rose above 4% for a calendar year was in 1990 (6.1%).[3] But current conditions have put the central bank in a bit of a pickle.

A New Conflict

When the economy grows too fast, inflation can occur if monetary policy is not adjusted correctly. The Fed normally responds to inflation by raising key short–term interest rates, which tightens the money supply and theoretically slows the economy. When economic growth appears to be slowing, the Fed cuts rates, which makes money more available. When these two challenges are balanced, it leaves interest rates alone.

The pickle is that during the fourth quarter of 2007, the economy appeared to be slowing (a reason to cut rates) and inflation appeared to be heating up (a reason to raise rates). The Fed responded by cutting interest rates, but only slightly, and probably less than the financial markets would have liked. When the Fed cut rates by a quarter point at its final meeting of 2007, the Dow Jones Industrial Average dropped sharply, closing down 294 points for the day.[4]

But then controlling inflation is a thankless task. When it is done effectively, no one really notices and it's no guarantee that the economy will grow. However, when inflation

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flares, it's almost guaranteed to make consumers yelp, and to have negative effects on the economy.

What Causes Inflation?
Believe it or not, inflation is a monetary phenomenon that reflects the supply and demand for currency created by central banks.[5] When supply gets too far out of line with demand, problems can occur.

When there is too much currency, its value is diluted, and vendors raise their prices to compensate. The late Nobel economist Milton Friedman described this condition as too many dollars chasing too few goods.

When there is not enough currency, the effect is like a brake on economic activity. It generally takes money to make money, so when there is not enough liquidity to support the demand for money, it becomes harder to obtain. In a sense, money becomes too valuable (the opposite of inflation) and may make consumers and businesses spend less freely.

Although inflation is primarily a reflection of monetary policy, there are some secondary causes. One of these causes is the fluctuating supply of important commodities, especially food and energy.

You may have heard economists make a distinction between inflation and "core" inflation. Economists arrive at core inflation by calculating the consumer price index after subtracting food and energy prices, because they tend to (1) be more volatile and (2) affect other prices. Economic growth could not occur in the absence of either food or energy, so when these prices rise, so does the cost of doing business, which typically leads to a rise in general prices.

Economists compare general inflation with core inflation to see whether food and energy are causing other prices to rise. It's not uncommon for food and energy prices to rise temporarily due to seasonal or other variables but then subside before merchants decide it's necessary to raise their prices to compensate for the higher costs.

Core inflation is important to economists and policy makers, but typically means very little to consumers. It may be of little comfort to hear that core inflation is under control when gasoline and groceries are consuming a greater share of your income, but it's far more preferable than hearing that core inflation is rising as fast as general inflation.

Inflation may be mostly a man–made phenomenon, but the problem is that man does not always know how to treat it. Until a better method is found to manage inflation, we can expect it to be an ever–present concern.

It's important to anticipate that inflation will gradually weaken the spending power of a dollar. By adjusting your long–term financial goals upward to reflect the expected effects of inflation, you may be able to avoid the possibility of reaching your goals only to discover that you didn't aim high enough. For more information and a review of your retirement plan and your overall financial plan, contact **Jason M. Woodward, MS, J.D.** today at (603) 264-7550 or financialattorney@gmail.com.

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1) Bureau of Labor Statistics, 2007
2–3) Thomson Financial, 2007. Consumer price index for the period 11/30/1987 to 11/30/2007
4) Yahoo! Finance, 2007. Dow Jones Industrial Average (total return) on 11/12/07. The performance of an unmanaged index is not indicative of the performance of any particular investment. Individuals cannot invest directly in an index. Past performance is no guarantee of future results.
5) *The Wall Street Journal*, December 18, 2007