2-9-2022

Inflation: Just How Bad Is It?

Timothy Meyers

AGRICULTURAL ECONOMICS

February 9, 2022

agecon.unl.edu/cornhuskereconomics

Cornhusker Economics

Inflation: Just How Bad Is It?

Amidst the chaotic news cycle of politics, the pandemic, and global affairs, a new topic is making headlines—inflation. To some, rising inflation causes greater fear than the other headlines combined; to others, it is nothing more than a minor nuisance. This article will explain why people's divisive attitudes toward inflation are likely justified.

What *is* Inflation?

Rising home prices, increasing fuel costs, and $10 bacon feel like inflation. Each of these has a unique market dynamic that can explain the upward price movement. It is important to note that a price going up is not necessarily illustrative of inflation. Inflation is when the overall price level rises. If there is inflation, it does not mean all prices are rising, but it does mean that on average, a trip to the store will cost more than it did previously. Economists use the terminology "market basket" to describe the tens of thousands of items tracked by the National Bureau of Economic Research. To the rest of us, the basket could be the one we use at Hy-Vee or Super Saver. Filled with the same items as last year, when the final tally is noticeably higher, *that* is inflation.

Causes of Inflation

The causes of inflation are numerous, but all fit into one of two categories. The first category, demand-pull inflation, is the type of inflation that is symptomatic of a revved-up economy. Direct payments from programs like the CARES act or enhanced and advanced child tax credit payments are policies that can lead to upward pressure on prices. Demand-pull inflation does not have to be caused by policy. As Keynes would say, the "animal spirits" of society could become more positive with regards to the future, resulting in more current spending, and rising prices.

While demand-pull inflation can be viewed positively, cost-push inflation has no obvious upside. Like the name implies, cost-push inflation results when the price of a productive resource increases. Labor, fuel, transportation, inputs from abroad, and taxes are inputs that have a widespread impact.

When an economy faces demand-pull inflation, prices rise, but the real output does as well (a good thing). When cost-push is the culprit, the prices rise and output declines -- a negative double whammy. Without a doubt, current inflation is the result of both demand-pull, and cost-push sources. Luckily, record low unemployment and GDP growth would indicate demand-pull inflation is the greater force.

Why *is* inflation bad?

This simple truth is that when prices rise, but our incomes do not, our purchasing power declines. Paying for rent, food, and entertainment becomes more expensive. One hopes incomes catch up to inflation and the unpleasantness is short-lived. When an economy experiences low and predictable inflation, there is little cause for concern. When inflation is unanticipated or high, the economic hardship is much more serious.

Losing purchasing power is a consequence of inflation that is directly related to how much cash an individual holds. Investments held in interest-bearing accounts, equity, or real estate will grow with inflation. Cash, on the other hand, will lose exactly the value of inflation. This loss is sometimes called the "inflation tax." This hardship is especially unfair to retirees on fixed incomes, who often have mitigated risk by increasing the relative cash positions of their retirement portfolios.

Secondly, unanticipated inflation causes randomness in the market and arbitrary winners and losers. This is not how capitalistic economies are supposed to work. Firms putting scarce resources together to best satisfy consumer preferences should be rewarded with profit. Likewise, lending institutions identifying these businesses and supplying them with financial capital should be rewarded with profit as well. Unanticipated inflation puts these capitalistic tenets at risk.

Imagine you have $100,000 in liquid funds. An acquaintance approaches you with an investment opportunity. You agree the opportunity is sound and agree to lend them money at 5% interest for one year. Over the course of the year inflation spikes to 6%. Fortunately, your acquaintance's business is a success and they are able to pay back your investment plus $5,000. Sadly, the $105,000 is worthless in real terms than the $100,000 you started the year with. (For argument's sake, imagine you were going to buy a tractor for $100,000 at the beginning of the year, and now its price is $106,000 -- you're $1,000 short). If your acquaintance asked for another loan, you may be willing, but at a much higher rate. Enough higher that the relationship breaks down.

The stock market reinforces the idea that inflation isn't that bad if we see it coming. More often than not, negative earnings reports and Federal Reserve rate hikes have little impact on the market. This is because the market anticipates these negative news events. It is only when earnings are lower than estimates, or rate hikes are higher than anticipated that the market responds negatively.

The third way inflation can cause pain in an economy is when it is high. "High" in this case means it is high enough that people start doing things to circumvent the negative outcomes of inflation. These activities, such as increased use of barter or constant contract negotiation, are a burden on the economy. If output (as measured by GDP) is the ultimate performance metric, inflation-beating activities are sure to be a drag on GDP as they simply waste the economic resource of time. If people are busy negotiating because they fear holding cash, they're wasting time they could spend producing more goods and services.

At present, there are few signs of this type of activity, but there are some. Super Bowl-bound LA Rams receiver Odell Beckham Jr. took his entire 2021 paycheck and invested it in Bitcoin, and we know how that turned out. Inflation rates of 4-7% do not sound scary, but compounding is real. Just 3 years of 6% inflation would result in a real income loss of 19% for someone with a static income.

What can be done?

Collectively, faith in our institutions and a historically inflation-fighting federal reserve should ease our inflation anxiety. Thus far, our Federal Reserve chairperson has effectively insulated decision-making from any outside influence (namely politicians.)

Consumers can "beat" inflation by substituting products. If our typical "basket" of goods has increased price by 20%, consumers should consider alternatives that have not increased in price as much. Bacon, for example, could be substituted with ham, sausage, or even eggs.

Agricultural producers face a bigger challenge. Rising fuel costs, equipment prices, and labor cannot be avoided. Commodity prices, on the other hand, may not increase with inflation, potentially squeezing already-thin margins. Effective marketing, product diversification, and long-run planning are all techniques producers can use to weather the current inflation storm.

Timothy Meyer
Associate Professor of Practice
Department of Agricultural Economics
University of Nebraska – Lincoln
tmeyer19@unl.edu
402-472-2314