Knowledge Center

What Is Inflation?

Reading time: 4 minutes

Highlights:

- Inflation occurs when the prices of goods and services increase over a long period of time, causing your purchasing power to decrease.
- High inflation can occur as the result of a variety of factors. However, economists often divide the root causes into two categories: demand-pull inflation and cost-push inflation.
- Inflation is a complex issue, but understanding the root causes can help you better prepare for increased prices of goods and services such as housing, apparel, food, transportation and fuel.

Have you ever felt like your money doesn't stretch as far as it used to? Chances are, it's not your imagination. You're likely noticing the effects of inflation, an economic concept in which the costs of goods and services rise over time.

Inflation is a normal part of the world's economic cycles. Here's what you need to know about what inflation is, why it occurs and what you can do to help protect your finances as prices rise.

How does inflation work?

Inflation occurs when the prices of goods and services increase over a long period of time, causing your purchasing power, or the amount of goods and services you can buy with a single unit of currency, to decrease. In short, inflation means that your money may not be able to buy as much today as it could in the past.

It's important to understand that inflation is not the same as a price increase for a single good or service. Rather, inflation involves simultaneous and continued price increases of many of the things you buy regularly. So, it's not just your grocery bill — you'll see the cost of gas, utilities, travel and other expenses rise as well.

But why does inflation happen in the first place?

It often comes down to an imbalance between two different economic forces: supply and demand. Supply describes how much of a good or service is made and sold, and is driven by the businesses that are selling the good or service. Demand, on the other hand, refers to how much of a good or service is purchased at a specific price, and is driven by consumers. If demand outpaces supply, inflation tends to follow.

What are the types of inflation?

High inflation can occur as the result of a variety of factors. However, economists often divide the root causes into two categories: demand-pull inflation and cost-push inflation.

Demand-pull inflation is driven by an increase in total consumer demand. If consumers suddenly start spending more money than usual, businesses may find themselves selling more goods and services than they anticipated. If these businesses are unable to keep up with the increased consumer demand, their remaining stock becomes more valuable, and prices may rise.

This kind of inflation tends to happen during periods of high consumer confidence, such as when unemployment rates are low and wages are high.

Cost-push inflation occurs when production costs rise. Unrelated to consumer demand, these increased production costs may lead to a decrease in total supply and a subsequent increase in prices to compensate.

This kind of inflation is commonly observed when the price of oil increases, making manufacturing operations more expensive. For example, the 1970s energy crisis was largely responsible for the cost-push inflation that occurred during that time period.

It's also possible for inflation to result from factors unrelated to the economy. Natural disasters or major world events can disrupt supply chains and reduce the amount of goods available, driving up prices on the stock that remains. It's also possible for a combination of these factors to occur simultaneously or for one to occur as the result of another.

How is inflation measured?

Economists measure inflation with something called a price index, which tracks price changes across a specific set of goods and services. The two primary indexes are the Consumer Price Index (CPI) and the Personal Consumption Expenditures (PCE) Price Index.

Both serve the same purpose: showing the average change in price of everyday goods and services that American households purchase regularly. This rate is expressed as a percentage — any increase higher than 2% is typically cause for concern.

How does inflation affect interest rates?

Inflation is a complex issue, but one way to control it is through federal monetary policy.

When the Federal Reserve — America's central banking system, also known as the Fed — detects rising inflation rates, it responds by raising the federal funds rate. This is a special interest rate related to lending between commercial banks.

An increase in the federal funds rate causes a corresponding rise in interest rates on auto loans, mortgages and other types of credit, making it more expensive to borrow money. Increases in the cost of borrowing money can help to slow down consumer and business spending, allowing supply chains to catch up to the production of goods and services, which can in turn lead to a drop in prices.

Ideally, this curbs inflation and stabilizes supply and demand without longer-term consequences such as a recession. When inflation is low once again, the Fed may decide to decrease interest rates, making it easier to borrow money and encouraging spending.

4 ways to prepare for inflation

Once you understand the economic principles of inflation, you'll be better equipped to protect your finances against its effects. During periods of high inflation, consider the following.

- **Review your budget for opportunities to scale back spending.** Rising prices mean that your necessities will become much more expensive. A detailed review of your budget, including all your regular expenses, will help you find more room for a higher utility bill and more expensive groceries.
- **Continue saving when you're able.** Be sure to maintain an emergency savings fund in case of financial hardship — enough to cover expenses for three to six months. For the best return, consider high-yield savings accounts, which usually have better interest rates than a standard savings account.
- **Delay expensive purchases.** It's probably not cost-effective to take out a big loan like a mortgage when inflation is high. If you can, postpone house or car purchases until the economy stabilizes.
- **Continue to invest.** It may be tempting to pause regular investments to save money in the short term, but don't! It's important to continue contributions to any retirement accounts if at all possible.

Periods of inflation can be stressful for consumers but try not to fret. They're typically temporary and understanding the root causes can help you better prepare for rising costs.

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