



ARTICLE SERIES

EUROZONE INFLATION FALLS TO 1.1%—SO WHAT?

Most people are acutely aware of the impact inflation has on their spending power, but what causes it and how could it affect your personal finances—for better or worse?

Unpacking the macroeconomic forces behind the investment industry and helping make the latest global economic news relevant to all is one of the core purposes of the Investment Foundations from CFA Institute.

Applying terminology from the purposes of the CFA Institute Investment Foundations™ Program course of study, let's take a look at a recent article on inflation and its effect on the economy and households.

A Brief Introduction

In September 2013, the BBC reported that "consumer price inflation fell to an annual rate of 1.1% in September from 1.3% in August according to Europe's statistics agency Eurostat. A fall in energy prices helped to ease inflation. Price rises in food, alcohol and tobacco moderated, also helping."

Most householders are aware of the negative impact of inflation on their spending power, but what actually causes inflation and how might it affect your finances, for better or worse, through the investments you hold?

But What Is Inflation And What Causes It?

Inflation (*covered in Module 3 of the Investment Foundations Program*), defined as a general rise in prices for goods and services, is essentially an issue of supply versus demand. Among economists, there are two schools of thought that attempt to explain the forces that lead to inflation: the monetarist view and the resource slack view.

According to the monetarist view, if the supply of money into the economy is large, then more funds are chasing the same number of goods, pushing prices higher, and creating inflation. Monetarists believe that a central bank (for example, the European Central Bank or the US

Federal Reserve Board) can directly influence inflation by increasing or decreasing the money supply in the economy to increase or reduce inflation. But the monetarist view that there is a relationship between inflation and the amount of money in circulation cannot explain all inflationary episodes in history. It does not explain, for instance, inflation stemming from external sources, such as a large and prolonged oil price rise.

Now, let's take a look at the resource slack view. This school of economics argues that inflation is driven by the costs of production. The resource slack view focuses on the availability and utilisation of resources (also known as factors of production) and suggests that a shortage of resources, capital, or labour leads to increased production



costs. Higher costs for producers are eventually passed on to consumers in the form of higher prices, or inflation.

To summarise the differing viewpoints, the monetarist view is that the supply of money dictates demand for products and thus drives prices and inflation, whereas the resource slack view is that the availability of capital and labour dictate prices and inflation. In reality, both concepts are relevant—both the money supply and central bank activities, as well as supply and demand for production inputs, should be monitored to anticipate changes in the rate of inflation. If we relate these concepts to the BBC website item, then monetarists might argue that the fall in the European rate of inflation was caused by a reduction in the money supply, whereas proponents of the resource slack view might argue that the cause was a fall in production inputs.

What About The Measurement of Inflation?

How do we quantify the rate at which prices are rising or falling? The most common method is to measure the percentage change in an index from period to period. For example, a consumer price index (CPI) is constructed by determining the weight (or relative importance) of each good and service in a typical household's spending (referred to as a basket of goods) in a particular base year and then measuring the price change of the whole basket of goods with reference to the base year.

There are variants on that basket of goods that can lead to the reporting of different inflation measures. For example, economic policymakers are mainly concerned with core inflation, which excludes the effects of temporary volatility in the prices of commodities, such as food and energy. So, the inflation rate most relevant to households and producers, the CPI, may differ from the core inflation rate.

Inflation's Impact

Inflation does not just affect household spending; it affects many other parts of the economy, including financial investments. Consider bonds or other investments, which pay a fixed cash amount from the return. If an investment provides the same cash flow each year and prices are

increasing, then that amount of cash flow will be worth less each year in terms of spending power. This decrease can be a real problem for pensioners, for instance, who may have bought a retirement investment product that offers them a fixed return. If prices rise, that fixed return buys fewer goods over time and their standard of living suffers.

The impact of inflation on shares is more difficult to analyze. In some economic environments, shares provide some protection against inflation. For example, companies may be able to increase the selling prices of their goods or services as the costs of their inputs increase, and thus their profits and share price will not be negatively affected. But for some companies, raising selling prices may result in a fall in sales. If they want to stop that fall, they are forced to hold prices at their current levels, and thus their profits (and share price) decline.

Our Lesson In Clarity: Inflation

We can see that behind a news item that gives us an apparently simple piece of information lies an untold story. One of the aims of the Investment Foundations certificate program is to equip learners to be better able to make sense of the economic news they hear and read. So, when they hear that European consumer price inflation has fallen, they are able to understand why it has fallen, how that fall has been measured, and the relevance of the fall for consumers and their investments.