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Inflation 101

Not since the time of former Fed Chairman Paul Volcker in the late 70s and early 80s did inflation been much of a factor in the Fed's monetary policy. High oil prices have compounded the slowdown in the global economy, already weakened by the US sub-prime and credit crises. The energy crunch further stoked inflation concerns, which have added to selling pressure in the global equities market.

Given the number of inquiries and questions we have been getting from our readers and investors with regard to the topic of inflation, we thought it would be helpful to discuss these as part of our continuing investor basics series.

The Consumer Price Index

Before we can even discuss inflation, we must first find out how it is derived using a price statistic such as the consumer price index (CPI). CPI is a price index measuring the average price of consumer goods and services purchased by the average consumer.

Two types of data are needed to construct the CPI: price data and weighting data. Price movements of the goods and services represented in the CPI are weighted according to the relative importance of commodities in the total expenditures of the consumers. Weights used in the current CPI were derived from the results of the Family Income and Expenditure Survey (FIES) conducted by the National Statistics Office (NSO).

CPI Basket

Commodity Group	Weight	Commodity Group	Weight	Commodity Group	Weight
All Items	**100.000**				
Food, beverages and tobacco	***50.031***	***Clothing***	***3.004***	***Services***	***15.889***
Food	46.584	Footwear	0.917	Educational	3.834
Cereals and cereal preparations	13.281	Ready-made, excluding footwear	2.031	Medical	2.100
Cereals	10.242	Custom clothes	0.056	Personal	2.056
Rice	9.362			Recreational	0.382
Corn	0.880	***Housing and repairs***	***16.796***	Transportation and communication	7.517
Cereal preparations	3.039	Minor repairs	1.024	Other services	0.000
Dairy products	2.334	Rentals	15.772		
Eggs	1.009			***Miscellaneous***	***7.330***
Fish	6.388	***Fuel, light, and water***	***6.950***	Household furnishing and equipment	1.758
Fruits and vegetables	5.303	Fuel	2.354	Household operations	1.230
Meat	7.629	Light	3.750	Personal care and effects	3.304
Miscellaneous	10.640	Water	0.846	Other miscellaneous items	1.038
Beverages	2.253				
Tobacco	1.194				

Source: National Statistics Office (NSO)

Inflation is then computed as the percentage change in CPI over a specific period (usually a month or a year). When inflation rate of 9.6 percent is cited by the media, this usually refers to the year-on-year inflation rate, which measures the changes of CPI for the month compared to the CPI of the same month of the previous year.

Other measures of price inflation

Aside from using CPI, the inflation rate can be calculated for other price indices, including:

- GDP deflator – measures the price of all goods and services included in the gross domestic product (GDP)
- Producer price index – measures the prices received by producers
- Commodity price index – measures the price of a selection of commodities
- Cost-of-living index – measures the cost of maintaining a certain "standard of living" in a particular geographical area

Effects of inflation on the economy

Inflation, in general, is not bad. Prices of goods and services naturally tend to increase over time. A small amount of inflation is viewed as having a beneficial effect on the economy as it encourages consumers and businesses to spend & borrow and to make long-term investments. In other words, moderate inflation tends to keep the economy active.

High and unpredictable inflation, however, is bad for the economy because of the following reasons:

- Rising inflation can induce a wage-spiral when workers demand higher wages to maintain their real standard of living. This can fuel more inflation especially if higher wages are over and above any gains in labor productivity.
- Uncertainty about the economy may discourage savings, especially if real interest rates are negative. This means that the rate of interest does not compensate for the increase in the general price level, thus favoring the borrowers and not the savers.
- Uncertainty about the future also makes business planning and budgeting difficult. This may have an adverse effect on the level of planned capital investments, which in turn damages long-run economic growth and productivity.
- Higher price of raw materials and other inputs can squeeze margins which can then feed through business investment decisions.
- Inflation reduces the real value of fixed income, thus affecting pensioners who rely on fixed pensions year after year.

Effects of inflation on stocks

Inflation is also closely watched by the stock market because a continued and prolonged rise in prices is usually accompanied by a hike in interest rates which is negative for stocks. In fact, the most significant development over the past few weeks is the sharp turn in central bank rhetoric. The Fed which has been aggressively cutting rates and stimulating growth since August of last year is making a sharp "U" turn in its assessment on growth versus inflation risks.

In their recent FOMC meeting, the Fed downplayed the risks to growth, but played up the inflation threat. The Fed left its benchmark rate at 2 percent, ending a series of seven reductions since September of 2007. This resulted in another sharp downturn in stocks last week with major stock indices such as the Dow Jones Industrial Average (DJIA) hitting new lows for the year.

The perception is that the latest Fed easing cycle has accelerated the drop in the dollar, which further encouraged the oil price surge. In effect, the Fed appears to be boxed-in and has seemingly lost its maneuvering room due to the threat of inflation.

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