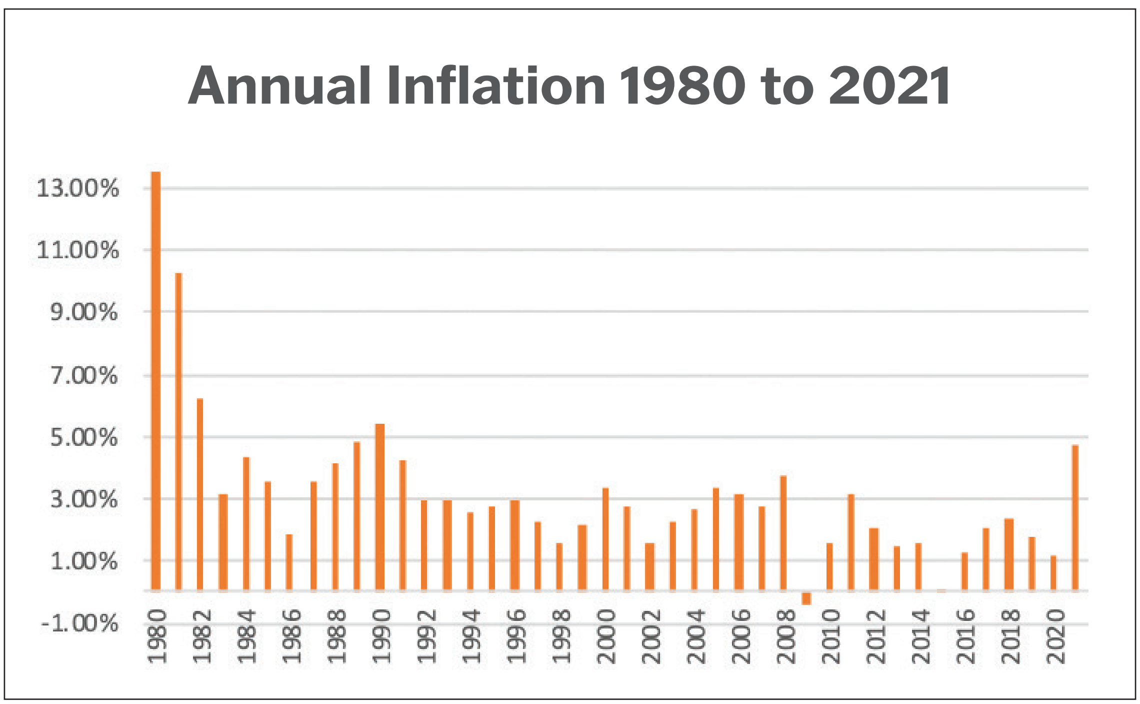
Minimizing the Impact of Inflation on the Budget

After nearly 30 years of inflation rarely exceeding 3.5%, over the past year inflation has been over 4%. Inflation is impacting family budgets, and to explain how, it helps to have a definition for inflation. Introductory economics courses teach that inflation is calculated by tracking and measuring the cost of a basket of everyday goods and services. The basket of goods contains groceries, housing costs, gasoline, haircuts, tires and hundreds of other common items. The graph shows annual inflation rates from 1980 to 2021. The 4.7% inflation rate in 2021 was at the highest annual rate since 1990 but significantly below the inflation rates of the early 1980s.

Inflation in general terms is out of the control of the average individual. However, an individual can take some actions to minimize the impact of inflation on their finances. The first step is to create a budget. A budget can help to understand where money is spent each month. With an understanding of where money is spent, it is easier to identify areas where inflation is causing the biggest impact. Inflation often does not affect all goods and services equally. For example, the price of apples might rise faster than the price of bananas or the price of pork might rise slower than the price of chicken. Due to these differences, a consumer who purchases pork chops instead of chicken breasts for dinner might reduce the overall impact of inflation on their monthly grocery bill. In economic terms this is called substitution. Some products are easy for consumers to substitute, while other products are much more difficult to substitute with an alternative. For example, many households have multiple vehicles, each of which have different fuel economy. A household might have



https://www.bls.gov/cpi/tables/supplemental-files/historical-cpi-u-202204.pdf a pickup that gets 16 miles per gallon (mpg), an SUV that gets 24 mpg and a car that gets 37 mpg. When gas prices rise, it is relatively easy to choose to drive the fuel-efficient vehicles more and drive the least fuel-efficient vehicle less. However, it's probably not so easy to stop driving to work or to pull a trailer with the car. Each individual will find areas in their budget where substitutions can be an effective tool to help limit the impacts of inflation, but they will also find areas where substitution won't be able to help. A detailed budget can be helpful in identifying areas for improvement.

Inflation is often only thought of in terms of prices paid for goods and services, but some cost increases are being driven by higher labor costs for producing and delivering goods. These higher labor costs are sometimes referred to as wage inflation. Workers may be the beneficiary of higher wages; if wages are rising faster than inflation, workers are generally going to be better off. However, if a worker's wages are not rising as fast as inflation, then a worker will have less buying power. Many retirees are often considered to be on a fixed income. This basically assumes their pension or social security payments don't change. In some cases this is true, but many of these income sources do have inflation adjustment mechanisms. However, the adjustments are often based on last year's inflation rate, so the adjustment lags inflation-impacted prices by a year. Inflation can be particularly challenging for retirees. The tight labor market and explosion of remote work options may provide opportunities for retirees to increase their monthly income with full time, part time or seasonal work. This might not be a good option for all retirees, but for those willing and able to rejoin the labor force, a new employer and the family budget may be glad they did. Interest rates also often rise when inflation increases. The low inflation environment over the past 20 years has driven interest rates for savings accounts and bonds to very low levels. Retirees investing in savings accounts, certificates of deposit, and bonds will likely see higher earnings on these investments if inflation continues to be higher than the average of recent years.

It is hard to predict a timeline for how long higher inflation will be part of our daily lives. Most consumers won't be able to change inflation. However, a thorough family budget can be a helpful tool to find expenses to manage and help limit the negative impacts of inflation on everyday purchases. It can also be a useful tool to help examine the opportunities that inflation may present to increase a family's income.

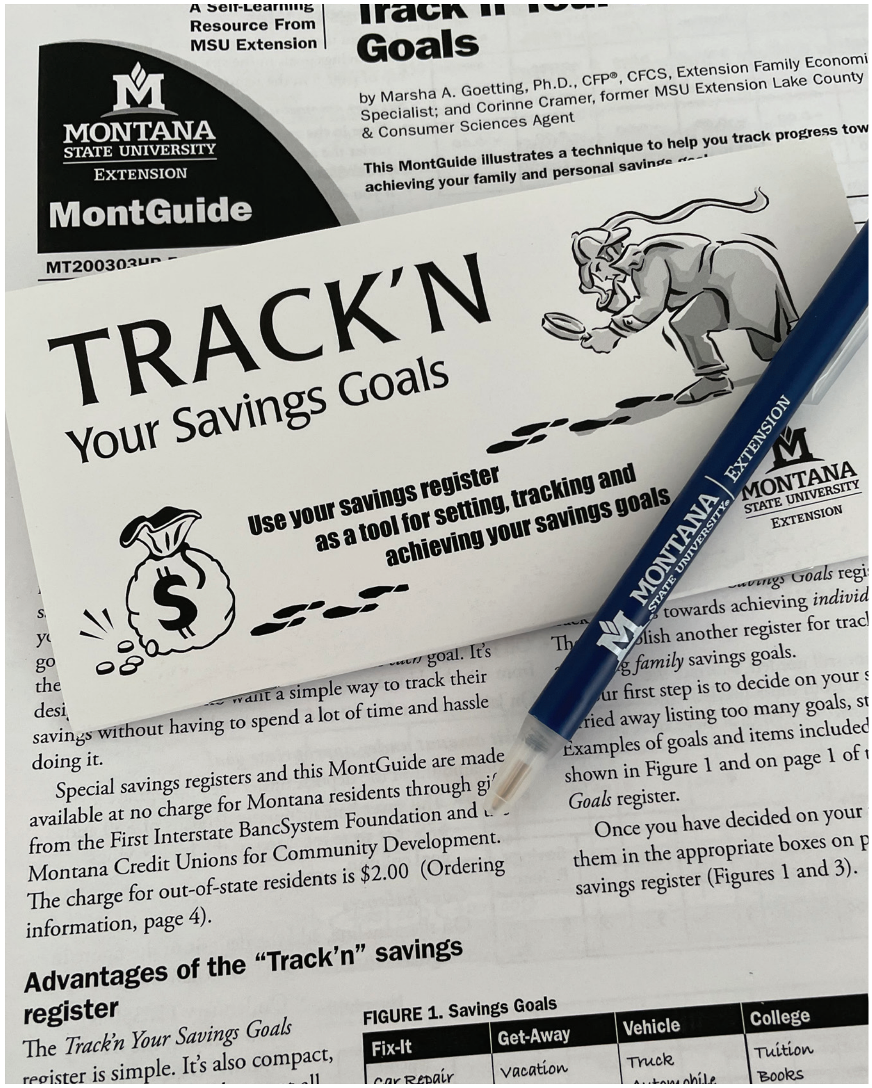


Photo: Erika Malo, MSU Extension

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