Perpetual Equity Investment Company Limited

# Perpetual knowledge bank series: inflation

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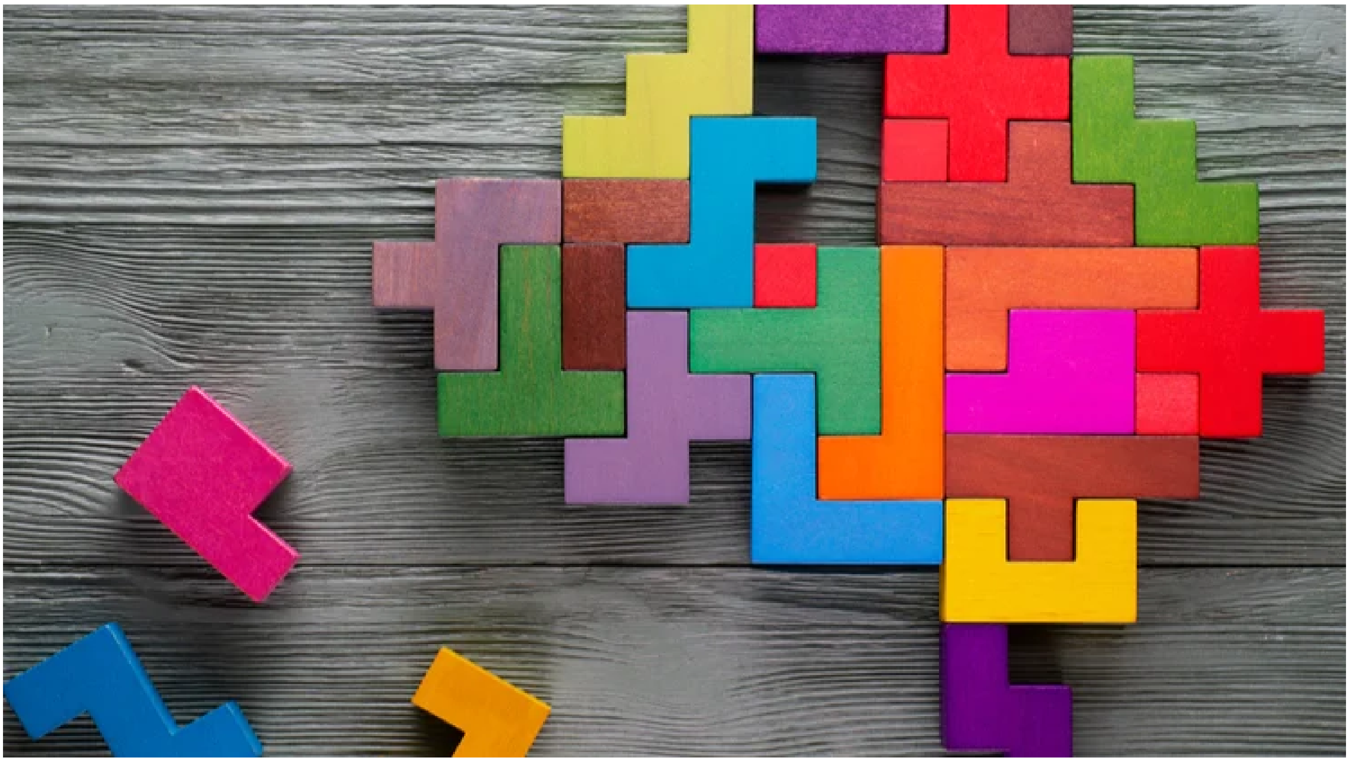

Inflation refers to the general increase in the price of goods and services that households or businesses buy over a period of time. This means as the general price of goods and services increases, each unit of currency (for example, one Australian dollar) will buy less goods and services, which results in a decline in purchasing power.

Inflation can be measured by the Consumer Price Index (CPI), the most commonly used indicator of inflation. CPI calculates the price changes for a basket of consumer goods and services that dominates spending in households. This comprises items such as food, alcohol and tobacco, clothing, housing, household equipment and transportation.

Inflation that is too high can led to unconstrained price pressures and wage growth which can have a number of negative effects on an economy. Conversely, the increase in supply of goods and services or lack of credit can lead to prices being adjusted downward. While this low inflation or even deflation can benefit consumers through lower priced goods, it can also be associated with a contraction in the economy. For example, an economy that has been fuelled with debt may come under pressure if there is a decrease in the supply of money and credit.

In Australia, inflation is monitored by the Reserve Bank of Australia (RBA). The RBA have a target to keep inflation between 2 and 3 percent over an economic cycle. At these levels, inflation is low enough that it contributes to sustainable economic growth and does not significantly influence economic decisions. If inflation becomes too high or too low, the RBA can adjust monetary policy to keep inflation at target levels. This is primarily though adjusting interest rates which is considered by the RBA each month.

**Causes of Inflation**

The causes of inflation can be categorised into two different types: demand-pull inflation and cost push-inflation.

Demand-pull inflation occurs when the supply of money grows faster than the production of goods and services. The increase in the supply of money spurs overall demand for goods and services, and when demand exceeds supply, this leads to an increase in prices.

Cost-push inflation occurs when prices increase due to an increase in production costs, such as raw materials or labour costs. For example, if the price of oil rises, this would lead to higher petrol prices and increased transportation costs. Any sectors in the economy that rely on oil would face an increase in production costs. Companies generally combat the increase in their production costs by increasing prices.

**Investing with inflation in mind**

Investors can be fearful of inflation, as it may erode purchasing power and reduce real investment returns. Investment returns generally must keep pace with or exceed the rate of inflation to produce a positive return. For example, an investment that returned 2% in an economy where inflation is at 3% will actually produce a negative return of -1% after adjusting for inflation.

Equities have historically been a good investment relative to inflation over the long term, with commodities traditionally a good hedge against inflation. Investors should consider companies and sectors which are able to raise their prices when their costs increase in an inflationary environment as this may translate into higher earnings and therefore higher share prices.