

# Inflation and salaries

A married couple, who had a household income of \$100,000 last year, was happy to learn that they were both getting a 2 percent raise, which would bring their combined income up to \$102,000. Unfortunately, their joy was misplaced. Because of inflation, they will probably be worse off financially this year than they were last year.

Inflation is the erosion of the purchasing power of money. If the inflation rate over the next year is 2 percent, the average price level will increase by 2 percent, so our couple would need \$102,000 this year to purchase the same goods and services that \$100,000 enabled them to purchase a year ago. If the inflation rate will be 3 percent, the couple will need \$103,000. Worse still, if the inflation rate is 5 percent this upcoming year, the couple would need \$105,000 just to keep up with inflation. Unfortunately, it looks like inflation will be greater than 2 percent over the next year. As a result, the married couple, even after their raises, will see their standard of living decline.

**Joe McGarrity**



It is hard to accurately predict what the inflation rate will be over the next 12 months. The inflation rate from last June to this June was 5.4 percent. If this inflation rate continued, the couple would be 3.4 percent poorer in terms of their purchasing power (2 percent-5.4 percent). Luckily, the inflation rate will probably be less than 5.4 percent for two reasons. First, over the last year, we saw the prices of some items spike because of supply shortages. For instance, car companies shut down their production plants because they could not get enough computer chips. With so few new cars available, a car dealership could charge high prices because customers wanted more cars than were available. Car companies will not be able to continue to charge such high prices. As companies expand their production of computer chips, car companies will be able to produce more new cars.

With additional cars available, any one car dealership will be unable to sell cars at high prices because customers will find plenty of other dealerships that will sell them cars at lower prices. The second reason the inflation rate might soon be lower than 5.4 percent is that last year some companies, such as airlines and hotels, dropped their prices to make some sales during a pandemic-induced economic slowdown. As the economy has been recovering, these companies have been increasing their prices back to their previous levels. This type of price hike should only continue until the prices reach their pre-pandemic levels.

Even so, economists generally forecast that the inflation rate over the next year will be more than 2 percent. 3 percent is a reasonable forecast. If it is correct, the married couple we have been discussing will be 1 percent poorer in terms of what their combined salary can purchase. It will be hard for them to get their heads around the idea that they are poorer even though they are making 2,000 more dollars.