Purchasing Power

Purchasing power is the value of a currency expressed in terms of the amount of goods or services that one unit of money can buy. Purchasing power is important because, all else being equal, inflation decreases the amount of goods or services you would be able to purchase.

In investment terms, purchasing power is the dollar amount of credit available to a customer to buy additional securities against the existing marginable securities in the brokerage account.

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BREAKING DOWN 'Purchasing Power'

To measure purchasing power in the traditional economic sense, you would compare the price of a good or service against a price index such as the Consumer Price Index (CPI). One way to think about purchasing power is to imagine if you made the same salary as your grandfather 40 years ago. Today you would need a much greater salary just to maintain the same quality of living. By the same token, a homebuyer looking for homes 10 years ago in the $300,000 to 350,000 price range had more options to consider than people have now.

Purchasing Power in Context

Purchasing power affects every aspect of economics, from consumers buying goods to investors and stock prices to a country's economic prosperity. When a currency's purchasing power decreases due to excessive inflation, serious negative economic consequences arise, including rising costs of goods and services contributing to a high cost of living, as well as high interest rates that affect the global market, and falling credit ratings as a result. All of these factors can contribute to an economic crisis.

As such, a country's government institutes policies and regulations to protect a currency's purchasing power and keep an economy healthy. One method to monitor purchasing power is through the Consumer Price Index. The U.S. Bureau of Labor Statistics (BLS) measures the weighted average of prices of consumer goods and services, in particular, transportation, food and medical care. The CPI is calculated by averaging these price changes and is used as a tool to measure changes in the cost of living, as well as considered a marker for determining rates of inflation and deflation.

A concept related to purchasing power is purchasing price parity (PPP). PPP is an economic theory that estimates the amount that needs to be adjusted to the price of an item, given two countries' exchange rates, in order for the exchange to match each currency's purchasing power. PPP can be used to compare countries' income levels and other relevant economic data concerning the cost of living, or possible rates of inflation and deflation.

The History of Purchasing Power

Historical examples of severe inflation and hyperinflation — or the destruction of a currency's purchasing power — have shown there are several causes of such a phenomenon. Often expensive, devastating wars will cause an economic collapse, in particular for the losing country, such as Germany during World War I (WWI). In the aftermath of WWI during the 1920s, Germany experienced extreme economic hardship and almost unprecedented hyperinflation, due in part to the enormous amount of reparations Germany had to pay. Unable to pay these reparations with the suspect German mark, Germany printed paper notes to buy foreign currencies, resulting in high inflation rates that rendered the German mark valueless with a nonexistent purchasing power.

Today, the effects of the loss of purchasing power are still felt in the aftermath of the 2008 global financial crisis and the European sovereign debt crisis. With increased globalization and the introduction of the euro, currencies are even more inextricably linked. As such, governments institute policies to control inflation, protect purchasing power and prevent recessions.

For example, in 2008 the U.S. Federal Reserve kept interest rates near zero and instituted a plan called quantitative easing. Quantitative easing, initially controversial, essentially saw the U.S. Federal Reserve buy government and other market securities to lower interest rates and increase money supply. The idea is that a market will then experience an increase in capital, which spurs increased lending and liquidity. The U.S. stopped its policy of quantitative easing once the economy stabilized, due in part to the above policy and a multitude of other complex factors.

The European Central Bank (ECB) also pursued quantitative easing to help stop deflation in the eurozone after the European sovereign debt crisis and bolster the euro's purchasing power. The European Economic and Monetary Union has also established strict regulations in the eurozone on accurately reporting sovereign debt, inflation and other financial data. As a general rule, countries attempt to keep inflation fixed at a rate of 2 percent as moderate levels of inflation are acceptable, with high levels of deflation leading to economic stagnation.

Purchasing Power Loss/Gain

Purchasing power loss/gain is an increase or decrease in how much consumers can buy with a given amount of money. Consumers lose purchasing power when prices increase, and gain purchasing power when prices decrease. Causes of purchasing power loss include government regulations, inflation and natural and manmade disasters. Causes of purchasing power gain include deflation and technological innovation.

One official measure of purchasing power is the Consumer Price Index, which shows how the prices of consumer goods and services change over time. As an example of purchasing power gain, if laptop computers cost $1,000 two years ago and today they cost $500, consumers have seen their purchasing power rise. In the absence of inflation, $1,000 will now buy a laptop plus an additional $500 worth of goods.

Which Securities Offer the Best Protection Against Purchasing Power Risk?

Retirees must be particularly aware of purchasing power loss since they are living off of a fixed amount of money. They must make sure that their investments earn a rate of return equal to or greater than the rate of inflation so that the value of their nest egg does not decrease each year.

Debt securities and investments that promise fixed rates of returns are the most susceptible to purchasing power risk or inflation. Fixed annuities, certificates of deposit (CDs) and Treasury bonds all fall under these categories.