How Inflation Affects Your Savings

You must take a little risk to avoid losing a lot of money over time

By Poonkulali Thangavelu Updated Jan 21, 2019

The national average cost of a movie ticket in 2005 was $6.41. By 2018, it was $9.14. That's the work of inflation. The price of a movie ticket, a house, or a semester in college tends to rise over time, sometimes quickly and at other times slowly. That fact has great relevance to your personal savings plan.

How Inflation Shrinks Savings

Let's say you have $100 in a savings account that pays a 1% interest rate. After a year, you will have $101 in your account. But if the rate of inflation is running at 2%, you would need $102 to have the same buying power that you started with.

You've gained a dollar but lost buying power. Any time your savings don't grow at the same rate as inflation you will effectively lose money.

If you are a retiree living on your savings, you can't keep up the same standard of living if inflation cuts into your purchasing power with every passing year. This is especially true in the U.S. where medical costs tend to rise at a greater rate than many other costs.

Inflation can hurt well before retirement. If you are steadily saving money with a goal in mind, such as a college fund for your children or a down payment on a home, the purchasing power of your money may decline while you're saving it.

What's Behind Inflation?

Inflation occurs as demand for goods and services grows. As the total money supply in an economy rises, there is likely to be more demand for goods and services from consumers. As more people buy more goods, sellers hike their prices.

Inflation is caused by other factors, many of them temporary and limited in their scope. A winter frost can damage the orange crop, causing a shortage of oranges and an increase in their cost that season. An automaker may be forced to pay more for parts and will pass that increase along to the consumer.

Measuring inflation

How do you measure the effect of inflation on your savings? The government measures it for you and publishes the results regularly. The Consumer Price Index (CPI) tracks the prices of a variety of consumer goods and services, including transportation, medical care, and housing. The index is published monthly.

Inflation in the U.S.

Believe it or not, inflation can be too low. In the wake of the 2008 financial crisis and the great recession, the central banks in the U.S., Japan, and Europe were worried that inflation could go below zero, meaning deflation, or falling prices. In fact, the U.S. did experience deflation in housing prices lasting several years in many markets.

During the worst of the crisis, the Federal Reserve targeted a 2% annual growth in inflation to return the economy to health. The bank initiated various stimulus measures that were intended to boost the economy and encourage job creation, therefore putting more money in consumers' hands.

Back in the late 1970s, the Fed was fighting double-digit rates of inflation and had to deploy monetary tightening measures to combat possible runaway inflation.

Economists will probably never stop debating whether the Fed's measures, in the 1970s or the 2000s, were the right ones.

How to Safeguard Your Income

If you are a retiree who gets a Social Security payment, you may see an increase in your monthly check from one year to the next, as the government adjusts the payments based on the cost of living as measured by the Consumer Price Index.

However, that increase requires approval by Congress. An increase of 2.8% was approved for 2019, and an increase of 2% for 2018. But the increase was .3% for 2017, and zero for 2016. Those numbers were based on the Consumer Price Index, but advocates for retirees argued that price categories which most affect the elderly, such as health costs, rose more rapidly than the overall index.

How to Safeguard Your Savings

The primary way to beat the effect of inflation is to invest your savings for a better return than you can get in money market accounts or savings accounts. Investing in virtually anything else inevitably involves greater risk than an FDIC-insured account. But you can choose investments that have a level of risk you can tolerate.

For example, retirees might want to consider Treasury Inflation-Protected Securities, or TIPS. These securities adjust the interest payouts you get based on changes in the CPI, and the principal payment you get back will also be adjusted for inflation. Even if prices go down over your investment period, you will at least get back your original principal.

Returns on stock investments generally tend to beat inflation. Investors who want to avoid the volatility associated with individual stocks might opt for mutual funds, which are professionally managed and aim to provide a good return over time.

A mutual fund that follows a passive indexing approach might be even better since it is not dependent on the stock-picking abilities of any particular fund manager. The stock market overall tends to go up over time. You will also pay less in fees with an indexing approach.

The Bottom Line

Inflation tends to cut into a consumer's purchasing power over time. Fortunately, there are ways of preserving the purchasing power of your savings. That means investing, but keeping your level of risk moderate.