The Millennial Minute

Revisiting Millennial Budgeting Tips – Understanding the Impact of Inflation

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Inflation, often described as the silent thief, can significantly affect our financial well-being. It is a persistent economic phenomenon characterized by the gradual increase in the prices of goods and services over time. While moderate inflation is a sign of a healthy economy, it poses a challenge when it spirals out of control. **As we've seen in the last 12 months, inflation has a strong correlation with higher interest rates which diminishes our spending power;** and because our spending power is getting weaker, it becomes that much more important to look at the way we utilize our money.

We know now that inflation erodes the purchasing power of money. We see it in our grocery stores where two hundred dollars before 2020 got us eight or even nine bags of groceries, now we're only get 4 or 5 bags of the same items. We'll be faced with higher mortgage payments as our terms come due and we re-sign with sometimes more than triple the interest rate of our previous terms. This gradual reduction in the real value of money can have several consequences for individuals and the overall economy.

One of the primary consequences of rising inflation is these higher interest rates. Central banks use the interest rates as a tool to combat inflation by cooling off our spending and borrowing power. Higher interest rates make borrowing more expensive, which can slow down economic activity and keep inflation in check.

For consumers, this means that taking our loans, such as mortgages or car loans, becomes costlier. Additionally, credit card interest rates may rise, increasing the cost of carrying credit card balances. Savers, on the other hand, may benefit from higher interest rates on their savings accounts or other fixed-income investments. Be careful however, as these gains may not keep pace with the rate of inflation, resulting in diminished real returns.

As inflation reduces our spending power, people need to allocate a larger portion of their income to cover basic expenses like housing, food, and transportation. This leaves less money available for discretionary spending or saving. When people feel the pinch of reduced spending power, they may cut back on non-essential purchases, which can slow down economic growth.

So, what can we do? What is the answer to ease the financial burden?

The most helpful thing you can do for yourself and your money, is to re-evaluate your financial priorities. Take a look at your overall finances, your savings, your spending, your debts, and consider the best course forward. While saving money and paying down debt are both important to build your wealth and secure your financial future, **the weight of inflation can often tilt the scales in favour of debt reduction,** and here are a few reasons why:

1. **Real Interest Rates:** While we're currently seeing higher interest rates in low-risk savings products like GICs and Bonds, the current inflation is actually outpacing the interest earned on these savings vehicles, causing the Real (inflation-adjusted) Return on those savings to become negative. In essence, you're losing money in terms of purchasing power.
2. **Debt Burden:** On the other hand, if you have outstanding debt, especially high-interest debt like credit card balances or personal loans, inflation can be your ally – so long as you have locked in a fixed payment while interest rates were low. For example, lets assume you have a $10,000 loan that you negotiated a 4% fixed interest rate with your lender. If inflation spikes to 6%, you will continue to pay 4% despite the lender issuing new loans at much higher rates, and it actually decreases the value of your debt to $9,400 ($10,000 x (100% - 6%)).
   You could benefit even more if you locked in a low rate on a longer mortgage term. Let's assume you locked in a low, fixed 5-year rate. In this case, your payments will remain the same while your home's price rises, which in turn can boost your equity. (https://davidsklar.com/blog/how-does-inflation-affect-your-debt/)
3. **Paying Debt Now to Secure Future Financial Freedom:** Although we may want to focus harder on our savings and simply ride out the high interest rates on our debts by making only the minimum payments, reducing your debt can actually free up your financial resources for future investments and savings once inflation subsides.
   Let's take the current investment market for example – the prices on most stocks are wildly over-valued, making it hard to justify getting into investment products. However, the stock market is cyclical, meaning that the breaking point will come, and the prices will go down. Having less debt when the market drops can offer you an opportunity to buy into the market when prices are low with more money than you may have had if you had to put it towards outstanding debts at the same time.
   To put it plainly, concentrating on paying debts down when your money is worth less can be much more beneficial in the long run, as you can then (hopefully) put money back into savings when your money is worth more.
   Just like the stock market, it's all about the timing.

Inflation is an economic reality that affects individuals and nations alike. While it can be challenging to navigate, understanding its consequences can help individuals make informed financial decisions. When inflation rears its ugly head, higher interest rates and diminished spending power can squeeze household budgets. Therefore, **it's crucial to prioritize debt reduction over savings during periods of high inflation.** By doing so, you not only mitigate the impact of rising prices, but also position yourself for financial success in the long run.

Balancing your financial priorities in the face of inflation is key to achieving financial stability and securing your financial future.