



Why Does the Federal Reserve Have a 2% Inflation "Target"?

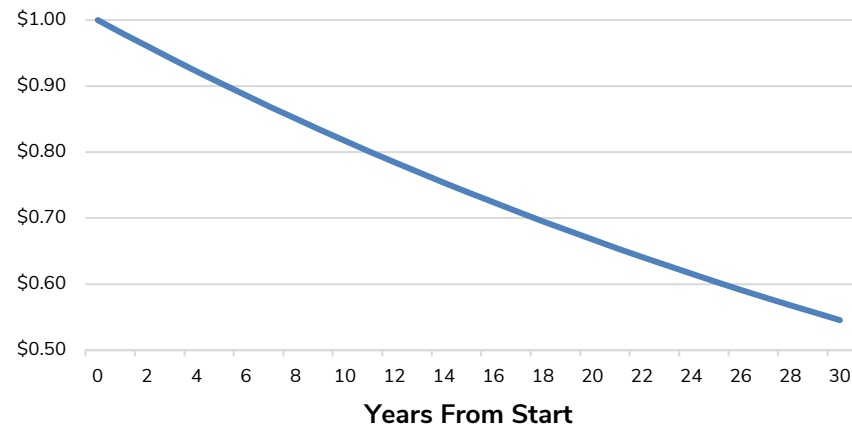
The Federal Reserve has stated its intention to keep the U.S. inflation rate in the low single digits. Specifically, it adopted a target inflation rate of 2% after the Great Recession, under former Chairman Ben Bernanke.

While it certainly sounds preferable to the current 4% rate of inflation, even inflation of 2% slowly and steadily diminishes the purchasing power of a dollar over time.

As shown to the right, this "target" inflation rate will decrease the actual goods and services that a dollar can buy by almost half after 30 years.

If, over this period, inflation is temporarily higher (like in the current environment), consumers' purchasing power is even more rapidly reduced.

Purchasing Power of \$1 With 2% Annual Inflation



So why does the Federal Reserve set this inflation target, if the net result is that the consumer loses ground over time?



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The primary reason is that central banks have concluded a little inflation is better than the opposite - deflation. During periods of deflation, the aggregate price of goods and services decreases. Initially, this might sound nice (who wouldn't like a new car costing 3% less next year), but the actual ramifications of sustained deflation could be devastating to a consumer-driven economy like that of the U.S.:

- In anticipation of lower prices, consumers would defer purchases, saving more.
- Companies would see revenues drop, forcing them to lay off workers.
- These laid off workers would then spend less.

This vicious cycle is what occurred during the Great Depression, when prices dropped an average of almost 7% each year from 1930-1933. Set off by a financial crisis, this drop in prices caused consumer spending to plummet, and it took massive government intervention and eventually a world war to finally kick the economy back into gear. More recently, Japan struggled with 20 years of deflation, during which time Japanese growth lagged that of the U.S. and most other nations. With these examples in mind, the Federal Reserve is dedicated to ensuring at least a little inflation over the long term.

Armed with this knowledge, investors should understand that storing their hard-earned cash under a mattress or in a low-yield savings account means watching the purchasing power of their funds slowly erode over time—an unacceptable outcome. Instead, investors' goals should include achieving returns that outpace or at least keep up with inflation.

A well-planned investment strategy, even conservative in nature, will aim at the very least to help one maintain one's purchasing power over time—an essential goal.

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