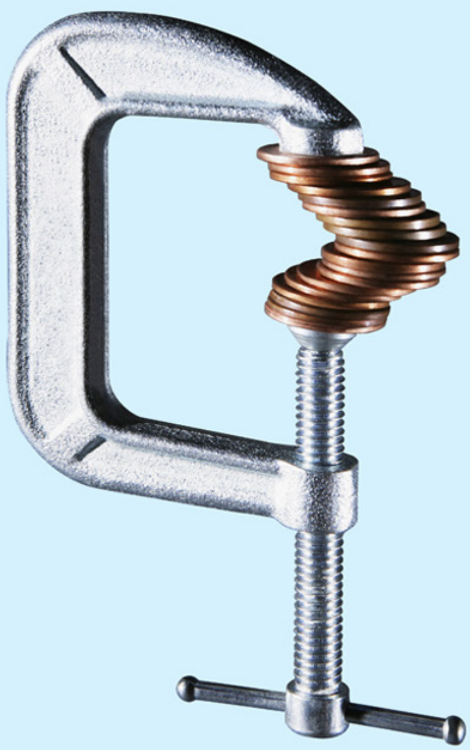
McKinsey & Company

McKinsey Explainers

What is inflation?

Inflation is the gradual loss of purchasing power, reflected in a broad rise in prices for goods and services.



August 2022

Inflation refers to a broad rise in the prices of goods and services across the economy over time, eroding purchasing power for both consumers and businesses. In other words, your dollar (or whatever currency you use for purchases) will not go as far today as it did yesterday. To understand the effects of inflation, take a commonly consumed item and compare its price from one period with another. For example, in 1970, the average cup of coffee cost 25 cents; by 2019, it had climbed to $1.59. So for $5, you would have been able to buy about three cups of coffee in 2019, versus 20 cups in 1970. That's inflation, and it isn't limited to price spikes for any single item or service; it refers to increases in prices across a sector, such as retail or automotive—and, ultimately, a country's economy.

In a healthy economy, annual inflation is typically in the range of two percentage points, which is what economists consider a signal of pricing stability. And there can be positive effects of inflation when it's within range: for instance, it can stimulate spending, and thus spur demand and productivity, when the economy is slowing down and needs a boost. Conversely, when inflation begins to surpass wage growth, it can be a warning sign of a struggling economy.

Inflation affects consumers most directly, but businesses can also feel the impact. Here's a quick explanation of the differences in how inflation affects consumers and companies:

— Households, or consumers, lose purchasing power when the prices of items they buy, such as food, utilities, and gasoline, increase.

— Companies lose purchasing power, and risk seeing their margins decline, when prices increase for inputs used in production, such as raw materials like coal and crude oil, intermediate products such as flour and steel, and finished machinery. In response, companies typically raise the prices of their products or services to offset inflation, meaning consumers absorb these price increases. For many companies, the trick is to strike a balance between raising prices to make up for input cost increases while simultaneously ensuring that they don't rise so much that it suppresses demand, which is touched on later in this article.

How is inflation measured?

Statistical agencies measure inflation by first determining the current value of a "basket" of various goods and services consumed by households, referred to as a price index. To calculate the rate of inflation, or percentage change, over time, agencies compare the value of the index over one period to another, such as month to month, which gives a monthly rate of inflation, or year to year, which gives an annual rate of inflation.

For example, in the United States, that country's Bureau of Labor Statistics publishes its Consumer Price Index (CPI), which measures the cost of items that urban consumers buy out of pocket. The CPI is broken down by regions and is reported for the country as a whole. The Personal Consumption Expenditures (PCE) price index—published by the US government's Bureau of Economic Analysis—takes into account a broader range of consumers' expenditures, including healthcare. It is also weighted by data acquired through business surveys.

What are the main causes of inflation?

There are two primary types, or causes, of inflation:

— *Demand-pull inflation* occurs when the demand for goods and services in the economy exceeds the economy's ability to produce them. For example, when demand for new cars recovered more quickly than anticipated from its sharp dip at the beginning of the COVID-19 pandemic, an intervening shortage in the supply of semiconductors made it hard for the automotive industry to keep up with this renewed demand. The subsequent shortage of new vehicles resulted in a spike in prices for new and used cars.

— *Cost-push inflation* occurs when the rising price of input goods and services increases the price of final goods and services. For example, commodity prices spiked sharply during the pandemic as a result of radical shifts in demand, buying patterns, cost to serve, and perceived value across sectors and value chains. To offset inflation and minimize impact on financial performance, industrial companies were forced to consider price increases that would be passed on to their end consumers.

How does inflation today differ from historical inflation?

In January 2022, inflation in the United States accelerated to 7.5 percent, its highest level since February 1982, as a result of soaring energy costs, labor mismatches, and supply disruptions. But inflation is not a new phenomenon; countries have weathered inflation throughout history.

A common comparison to the current inflationary period is with that of the post–World War II era, when price controls, supply problems, and extraordinary demand fueled double-digit inflation gains—peaking at 20 percent in 1947—before subsiding at the end of the decade, according to the US Bureau of Labor Statistics. Consumption patterns today have been similarly distorted, and supply chains have been disrupted by the pandemic.

The period from the mid-1960s through the early 1980s, sometimes called "The Great Inflation," saw some of the highest rates of inflation, with a peak of 14.8 percent in 1980. To combat this inflation, the Federal Reserve raised interest rates to nearly 20 percent. Some economists attribute this episode partially to monetary policy mistakes rather than to other purported causes, such as high oil prices. The Great Inflation signaled the need for public trust in the Federal Reserve's ability to lessen inflationary pressures.

How does inflation affect pricing?

When inflation occurs, companies typically pay more for input materials. One way for companies to offset losses and maintain gross margins is by raising prices for consumers, but if price increases are not executed thoughtfully, companies can damage customer relationships, depress sales, and hurt margins. An exposure matrix that assesses which categories are exposed to market forces, and whether the market is inflating or deflating, can help companies make more informed decisions.

Done the right way, recovering the cost of inflation for a given product can strengthen relationships and overall margins. There are five steps companies can take to ADAPT (Adjust, Develop, Accelerate, Plan, and Track) to inflation:

1. *Adjust discounting and promotions* and revisit other aspects of sales unrelated to the base price, such as lengthened production schedules or surcharges and delivery fees for rush or low-volume orders.

2. *Develop the art and science of price change.* Don't make across-the-board price changes; rather, tailor pricing actions to account for inflation exposure, customer willingness to pay, and product attributes.

3. *Accelerate decision making tenfold.* Establish an "inflation council" that includes dedicated cross-functional, inflation-focused decision makers who can act nimbly and quickly on customer feedback.

4. *Plan options beyond pricing to reduce costs.* Use "value engineering" to reimagine your portfolio and provide cost-reducing alternatives to price increases.

5. *Track execution relentlessly.* Create a central supporting team to address revenue leakage and to manage performance rigorously.

Beyond pricing, a variety of commercial and technical levers can help companies deal with price increases in an inflationary market, but other sectors may require a more tailored response to pricing. In the chemicals industry, for instance, category managers contending with soaring prices of commodities can make the following five moves to save their companies money:

1. *Gain a full understanding of supply–market dynamics and outlook*. Understand and track the elements that trigger price increases and rescind these increases once those drivers are no longer applicable.

2. *Ensure that suppliers can clearly articulate the impact that price increases in the market have on suppliers' prices*. In times of upward price pressure, sellers often overstate the share of raw materials in input costs, taking the opportunity to inflate their margins. Using cleansheet methodology to identify and challenge these situations is important.

3. *View unavoidable price increases as temporary surcharges, not the new future state*. This mechanism, partly psychological in nature, is very effective in dealing with the stickiness of price increases because it shifts the burden of proof to the supplier.

4. *Prioritize cross-functional initiatives*. When prices are high, the impact of yield improvements, waste reduction, or substitutions can be amplified. If any are available, now is the time to make them a priority.

5. *Work with sales to pass on price increases*. Category managers work closely with finance and commercial teams to shed light on pure market effects and their impact on the prices of goods sold, while ensuring that the right arguments are advanced to pass market-price increases to customers.

What is the difference between inflation and deflation?

If inflation is one extreme of the pricing spectrum, deflation is the other. Deflation occurs when the overall level of prices in an economy declines and the purchasing power of currency increases. It can be driven by growth in productivity and the abundance of goods and services, by a decrease in aggregate demand, or by a decline in the supply of money and credit.

Generally, moderate deflation positively affects consumers' pocketbooks, as they are able to purchase more with less money. However, deflation can be a sign of a weakening economy, leading to recessions and depressions. While inflation reduces purchasing power, it also reduces the value of debt. During a period of deflation, on the other hand, debt becomes more expensive. Additionally, consumers can protect themselves to an extent during periods of inflation. For instance, consumers who have allocated their money into investments can see their earnings grow faster than the rate of inflation. During episodes of deflation, however, investments, such as stocks, corporate bonds, and real-estate investments, become riskier.

A recent period of deflation in the United States occurred between 2007 and 2008, referred to by economists as the Great Recession. In December 2008, more than half of executives surveyed by McKinsey expected deflation in their countries, and 44 percent expected to decrease the size of their workforces.

When taken to their extremes, both inflation and deflation can significantly and negatively affect consumers, businesses, and investors.

Articles referenced include:

— "How business operations can respond to price increases: A CEO guide," March 11, 2022, Andreas Behrendt, Axel Karlsson, Tarek Kasah, and Daniel Swan

— "Five ways to ADAPT pricing to inflation," February 25, 2022, Alex Abdelnour, Eric

Bykowsky, Jesse Nading, Emily Reasor, and Ankit Sood

— “How COVID-19 is reshaping supply chains,” November 23, 2021, Knut Alicke, Ed Barriball, and Vera Trautwein

— “Navigating the labor mismatch in US logistics and supply chains,” December 10, 2021, Dilip Bhattacharjee, Felipe Bustamante, Andrew Curley, and Fernando Perez

— “Coping with the auto-semiconductor shortage: Strategies for success,” May 27, 2021, Ondrej Burkacky, Stephanie Lingemann, and Klaus Pototzky

Designed by McKinsey Global Publishing