Inflation should be viewed as public enemy number 1: here's why

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Inflation is a process of sustained increases in the general price level over a period of time, typically 12 months.

Inflation can be calculated for a country, for specific regions in a country and for different income and demographic groups, for instance pensioners.

These different calculations are important because the spending patterns of regions and groups differ. That means that their rates of inflation also differ. It is therefore important for each household to have a clear understanding of its own inflation rate.

A number of countries allow for the development of this improved understanding. For example, South African households can use an Internet tool such as the personal inflation calculator of Statistics SA . A personal inflation calculator, based on the spending patterns of household, is also available for the Euro area, Canada and New Zealand.

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About us

The phrase describing inflation as 'enemy number one' is borrowed from the research done by South African businessman Dr Anton Rupert on the world-wide inflation problem suffered in the 1970s.

He described inflation this way due to its distortive impact on the economies of countries and the wealth and financial well-being of households.

But the word inflation has a much earlier origin. Its first use was in the US between 1830 and 1860, when the US dollar started losing value.

In short, people experience inflation as sustained price increases. Prices continue to increase and the same amount of money buys less goods and services over time.

Why is it so bad?

Inflation is bad because people on fixed incomes such as pensioners get poorer over time. The buying power of their money is eroded.

A further problem is that borrowers enjoy an advantage over savers. With high inflation, the capital value of savings is eroded, while the real burden of borrowing declines. It becomes easier to repay debt. Although interest rates increase with higher inflation, the real value of the amount borrowed that has to be repaid, declines as percentage of salaries that are adjusted for inflation.

Governments are the largest borrowers in the world. They are therefore the major beneficiaries of inflation, as the real value of their debt is eroded at the expense of the taxpayers in their countries. Tax collections increase with higher inflation and government debt becomes a smaller percentage of government revenue raised from taxes.

Who manages inflation and what instruments can they use?

Central banks have responsibility for containing inflation. They use the level of interest rates to contain inflation.

This responsibility for containing inflation is most noticeable in countries that use inflation targeting. In these countries, central banks adjust interest rates in line with the rate of inflation and its expected future level to contain it to the target range.

To contain inflation, central banks must keep interest rates above the inflation. This difference between the rate of inflation and the interest rate is called the real rate). When the rate of inflation accelerates and is expected to continue this trend, the central bank's policy response is a higher interest rate level (both nominal and real), commensurate with the change in the inflation trajectory.

What can go wrong?

Central banks can make wrong assumptions and use wrong projections in their assessment of future inflation. This can lead them to set interest rates at an inappropriate level.

An example is the recent acceleration in the inflation rate in the US to a level above 8%. At an average of around 3% per annum, the US inflation rate was at a very low level for the last four decades). Recently the rate accelerated to above 8%, without an appropriate policy response by the US Federal Reserve.

As a result, US inflation could become a persistent problem.

This unexpected acceleration in prices caught US households by surprise. Many households (for instance pensioners) who assumed that inflation would remain under control, are now faced with much higher expenses without a commensurate increase in income.

It is therefore important that central banks are constantly vigilant and respond to accelerating inflation. Inevitably, this implies setting interest rates at an appropriate real level above the rate of inflation.

The real rate of interest rates can be calculated in several ways. The simplest and easiest way to calculate is by deducting the rate of inflation from the nominal interest rate.

Some African countries suffer persistent inflation problems, with rates much higher than in developed economies. The Zimbabwean inflation rate for the year to April 2022 accelerated to 96.4% , while Ghana's inflation rate was 19.4% over the same period.

Countries suffering high inflation experience exchange rate pressure, with declining currency values. The exchange rate of the currency will remain under downward pressure as long as high inflation persists. Owing to high inflation, investment in the country becomes unattractive. The demand for the currency therefore declines, which puts the exchange rate of the country with high inflation under pressure.

The Ghanaian currency has already depreciated by 18% against the US dollar this year. A further value decline is expected for the rest of this year.

Over the past year, the Zimbabwean RTGS dollar has lost more than half its value against the US dollar).

Owing to sharp currency depreciation, the domestic prices of imported goods and services in countries like Ghana and Zimbabwe have increased sharply and continue to increase each time the currency depreciates.

Consumers in those countries who earn income in local currency experience increasing difficulty to afford imported goods and services.

The trust deficit

A problem in an environment of sustained inflation is that people do not trust the official published rate of inflation. Inflation rates are distrusted for several reasons. The first is a general distrust of government conduct. This results in a view that inflation rates are manipulated by government agencies responsible for their publication to report lower price increases than is actually the case.

Secondly, increased prices for goods such as fuel that receive considerable publicity, lead to perceptions of general price increases. This problem is linked to the fact that price increases are much more visible to consumers and attract more attention than price declines.

Lastly, inflation measures price increases on a cumulative basis, using each previous year's price level as the base for calculations. This implies that each previous year's inflated price level is used to measure the rate of inflation in the next year. Over time the cumulative effect of sustained inflation becomes quite large.

This can be explained in a different way. With a sustained inflation rate constant at 5% per annum, the intuitive perception is that prices will double every 20 years. In practice, however, under these conditions, prices will double every 14.4 years. Price increases therefore exceed the perceptions of consumers.

Given the negative impact of inflation, it is in the interest of all consumers that the authorities should always apply policies that prevent price increases or keep such increases to a minimum level.

Inflation does not make people wealthy, despite the fact the governments and borrowers enjoy benefits from inflation. Which is why the description that inflation is public enemy number 1 is so accurate.

1. **Jannie Rossouw**
Visiting Professor at the Business School, University of the Witwatersrand

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