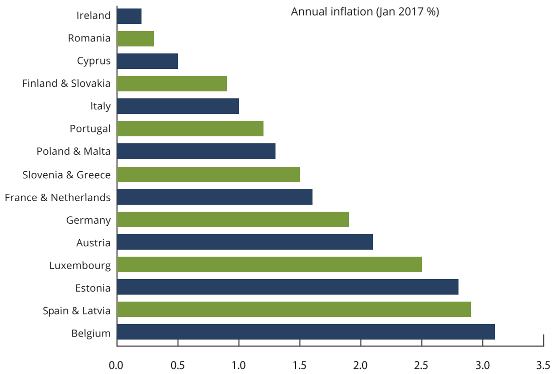
Inflation – why some may be needed

Richard White

Senior Investment Consultant

Richard White discusses the advantages and disadvantages of inflation.

For the first time since 2013, every Eurozone economy has recorded positive inflation. This is well aligned with the broad-based recovery seen in the composite Purchasing Managers Index, a gauge of economic activity, which according to data released in February is rising to the highest level in almost 6 years.



Source: Bloomberg

Inflation occurs when there is a sustained increase in the general price level. Traditionally, high inflation rates are considered to be damaging to an economy as they create uncertainty and can wipe away the value of savings. However, most Central Banks target an inflation rate of 2%, suggesting that low inflation can have various advantages to the economy.

Inflation and investors

Keeping a close eye on inflation is most important for fixed income investments (i.e. deposits and government bonds), as future income streams must be discounted by inflation to determine how much value today's money will have in the future. Inflation, whether real or anticipated, is what motivates stock market investors to take on the increased risk of investing in the hope of generating the highest real rates of return. Real returns are the returns on investment after taxes, inflation and other costs are taken into account.

So how much inflation is "too much"?

This question opens a huge debate argued around the world by Central Bankers and economists alike. There are those who insist that advanced economies should aim for zero inflation, or in other words, stable prices. However, the general consensus is that a little inflation is actually a good thing.

The strongest argument in favour of inflation is the case of salaries (labour costs). In a healthy economy market forces may require reductions in real wages (wages after inflation) to retain competitiveness. For example, a 2% wage increase during a year with 4% inflation has the same net effect as a 2% wage reduction in periods of zero inflation. This is the primary reason that most economists today agree that a small amount of inflation, about 1-2% a year, is more beneficial than detrimental to the economy.

Other advantages of inflation:

1. Deflation (a fall in prices – negative inflation) is very harmful. When prices are falling, people are reluctant to spend money because they are concerned that goods will be cheaper in the future. Deflation increases the real value of debt and reduces the disposable income of individuals who are struggling to pay off their debt.
2. Moderate inflation makes it easier to adjust relative prices. This is particularly important for a single currency area like the Eurozone where devaluation is not an option to regain competitiveness.
3. Inflation can boost growth. At times of very low inflation the economy may be stuck in a recession. Arguably targeting a higher rate of inflation can enable a boost in economic growth, however this view is controversial.

Other disadvantages of inflation:

1. Inflation leads to a fall in the value of money and makes savers worse off in real terms if inflation is higher than interest rates. High inflation can lead to a redistribution of income in society and often it is pensioners who lose out most during inflationary periods.
2. Inflationary growth tends to be unsustainable. It leads to a damaging period of boom and bust economic cycles. For example, the UK saw high inflation in the late 1980s, but this economic boom was unsustainable and when the government tried to reduce inflation, it led to the 1990-92 recession.
3. Inflation can make an economy uncompetitive. A relatively higher rate of inflation in a country can make their exports uncompetitive, leading to a current account deficit and lower economic growth. This is particularly important for countries in the Eurozone where devaluation is not an option.

To conclude, a modest level of inflation may be a good thing, or even necessary. However the return of inflation, albeit at a low level, is a reminder to investors, and in particular pension investors, of the need to maintain the real value of their savings.