Why is inflation bad?

In the first fact sheet in this series on the South African Reserve Bank (the Bank) it was pointed out that the Bank's mission is to protect the value of the rand, i.e. to combat inflation. This task has been assigned to the Bank in terms of the Constitution as well as the SA Reserve Bank Act. What does this imply and what is inflation? Why is inflation bad?

What is inflation?

Inflation is a process of continuous increase in the prices of most goods and services in a country. This does not necessarily mean that all prices increase. There may be some exceptions, such as computer prices which have actually declined in recent years. Inflation can therefore be described as a persistent *general* increase in prices.

How inflation is measured

Inflation is measured by defining a basket of goods and services used by a "typical" consumer and then keeping track of the cost of that basket. In the twelve months up to January 2007, the cost of that basket rose by 6 per cent. This increase of 6 per cent in the so-called consumer price index is referred to as the inflation rate. From 1974 to 1992 the South African inflation rate has ranged between 10 and 20 per cent. It has been brought down to less than 10 per cent per annum since 1993.

Why is inflation bad?

Inflation is regarded as a bad process because it leads to distortions and problems in an economy. A short list of the key disadvantages of inflation includes the following:

Losses to savers: If you save your money by hoarding cash, inflation erodes the purchasing power of the amount saved. For instance, R100 put underneath a mattress ten years ago can now purchase only one third of the goods and services that it could have done in 1987. (See Graph 1 on p.3.) Even if you save in the form of savings deposits which pay interest, the interest may not be enough to compensate you in full for inflation. This also applies to pension planning, where people may, for example, save for a pension during their entire working life, just to find at the end of their career that their savings have been eroded by inflation.

Losses to people with fixed incomes: People with fixed incomes (such as the interest on a fixed deposit, or a fixed salary) find that the purchasing power of their income diminishes over time. The wealthy, by contrast, can usually partly protect themselves against inflation by investing in assets, such as shares or property, which increase in value during periods of inflation. Inflation therefore leads to an increase in the disparity between the wealth of the "haves" and the "have-nots", or the rich and poor.

Losses to taxpayers: If your salary increases in line with inflation, and no adjustments are made to income tax, you will shift into a higher tax bracket and end up paying a larger share of your salary to the tax office. This means that government gains control over an increasing proportion of society's resources without formally getting the approval of Parliament to raise taxes.

Confusing price signals to producers and slower expansion of businesses: A higher price for a product would usually indicate that people want more of it, that more profits can now be made from it and that more resources should therefore be employed to produce it. In times of inflation, however, an increase in the price of a product can occur either simply as part of the regular inflation-related adjustments to prices, or because the demand for that product has risen permanently. Entrepreneurs, not knowing which of the two kinds of price increases have occurred, may wait much longer before expanding their businesses and employing more resources in reaction to a permanent increase in demand.

Speculation crowding out production: An environment of high inflation and financial instability leads to more entrepreneurship and other resources being devoted to speculation in existing assets such as real estate, and less to the expansion of production and employment.

Reduced attention to productivity: Higher productivity is an important sustainable way of improving the overall standard of living in a country. In the absence of inflation, wage negotiations are focused on proper compensation to employees in accordance with improvements in their productivity. With high inflation, salary or wage increases consist overwhelmingly of compensation for inflation, and productivity issues become less important and may be neglected.

Wastage of resources: During very high inflation episodes (fortunately this has not happened in South Africa) prices have to be increased daily. A shop assistant, for example, may have the full-time job of writing a new price on each item every day or updating a list of the prices of the various articles. The assistant would, without inflation, have been able to do more productive work, such as selling items to clients. The lower the inflation, the less time is spent on the repricing of items.

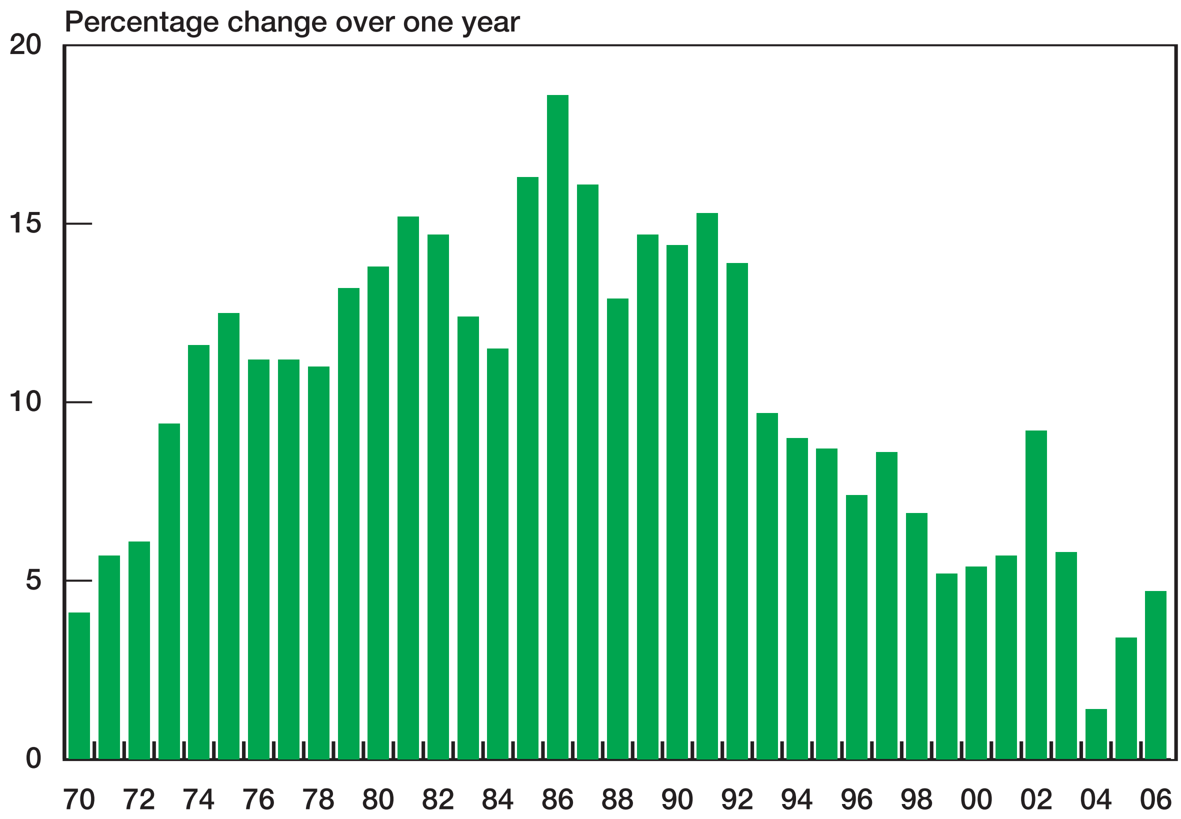
Heightened tension and social disruption: A society plagued by high inflation devotes more energy to redistributive issues, in which case each person or group perpetually tries to gain or regain a better price, wage or position. This destroys the fabric of society in a wider sense than simply through its impact on the production of goods and services.

Claims are often made by ill-informed people that inflation is not bad. They argue that higher inflation will stimulate economic growth.

These claims are false. It is quite easy and inexpensive to print more money, thereby boosting inflation; even the poorest countries could do that. If this were the way to achieve economic prosperity, no poor countries would remain on earth. If money is printed to stimulate the economy it may work for a short period of time, but people will soon realise what is going on and instead of producing more they would simply start to increase prices and wages much more rapidly. In the end, the country would face high inflation with all the destructive and distortive effects outlined above, and would be certainly left with a weaker economy.

The South African Reserve Bank, like central banks in most countries, is therefore strongly opposed to inflation, and uses its monetary policy to combat it. Such policy action is conducive for continued economic growth, prosperity and a fair distribution of income and wealth. Low inflation and a stable financial environment are indeed prerequisites for the achievement of these objectives on a sustainable basis.

Graph 1: Consumer prices



This is the second in a series of fact sheets on the South African Reserve Bank, compiled by the Research Department: Information Division and distributed by the Executive Management Department: Communications Unit.

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Last updated: July 2007