What you should know about inflation before you speak to the public

ICHD Policy brief

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"Inflation [...] is the world's greatest robber. A covert thief, it steals from widows, orphans, bondholders, retirees, annuitants, beneficiaries of life insurance, and those on fixed salaries, decreasing the value of their incomes. Inflation extorts more wealth from the public than do all the other thieves, embezzlers, and plunderers combined".

Don Paarlberg "An Analysis and History of Inflation"

Inflation is an enemy

Understanding of inflation changes over time. Years ago, economists claimed that except the negative social implications of inflation, it has also some positive implications for production and economic growth, and therefore, sometimes a higher level of inflation should be allowed to address some problems of economic development. Time, however, puts things right, and the recurring financial-economic crises, social-economic disasters, and the progressing economic thought resulted in a universally accepted position: inflation is an enemy.

Many have already agreed that purposefully allowing for high inflation is nugatory, risky and won't lead to anywhere nice. Today it is already obvious that in order to increase the potential of economic development it is necessary to implement structural reforms in education, healthcare, governance, technological progress, technical innovation and other spheres, rather than ensure fake inflation triggers. Only such reforms will help increase the level of productivity in the country and thus result in expanded potential.

What should the inflation rate be?

Thus, one has to ask: what should be the annual inflation rate? The expert answer would be: zero. Best professionals in the field would support this answer. They will present a concise and clear argument: inflation is an enemy. The next question then would be: why don't the central banks around the world target zero inflation as an objective? The answer again requires some expertise, and depends on the intricacies of calculating inflation. No matter how various countries in the world calculate inflation, there will always be an objective statistical error: the calculation will always show at least a little bit more, than the reality is. For this and other reasons, it is accepted that deviation in more developed countries is around 1-2%, and in developing economies 3-4%. Thus, to ensure de facto stable prices, the first group of countries aim for 1-2% annual inflation rate, and the second for 3-4%.

In Armenia the aim is 4%, and the Central Bank uses all its inventory to ensure the inflation rate stays within the mentioned range.

And what is inflation? A user-friendly definition

Inflation is the increase in the general prices. We often use the term 'inflation', but it is not very smart to speak of 'inflation' every time we see a price of a goods rise in a shop. It is very difficult to calculate inflation, and amateur efforts should be discouraged: it is always a better idea to refer to the inflation rate calculated by specialists.

Devaluation or valuation of national currency versus the currency of another nation or economic zone is the change in the exchange rate, known as 'kurs' in layman's terms; the exchange rate that we can see on the boards of money changers. It is much easier to speak of exchange rates, because one

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can see how much a dollar was and what it has become. It is much more difficult to engage in a conversation about inflation.

As a micro-economic indicator, inflation is regulated by the Central Bank (CB). It is rather challenging to explain in a user-friendly manner how CB does it, but the simple description would be the following: by making the money in the country more or less in a way that the prices do not go up above the intended level. For many years the Central Bank has succeeded in doing this.

There are several visible patterns. Around the New Year holidays, the prices go up. It has been so for quite a while. Starting from February of the next year, the opposite tendency is observed, and in summer especially, prices go down. The question 'why' requires a very long explanation, but it is a fact that it has always been so, and it will require significant changes in the structure of our economy for this pattern to change, and to ensure a more 'level' pricing throughout the year. This is exactly why one should not be surprised to hear a seemingly controversial statement like "the level of the prices for food and non-alcoholic beverages increased by 10% by the last quarter of the year, but throughout the year the increase of the prices of these goods has been only 3.6%". At the beginning of the new year prices will drop down again, and the cycle will be repeated.

To assess the social impact of inflation, it is always a good idea to look at the increase of income, in order to understand whether it is the income that has increase more rapidly, or the prices. Usually, when people complain of inflation, especially when it is seasonal, implicitly they are complaining of low income. One of the helpful indicators in this regard is average salary, which should be monitored. What increases more rapidly: the average salary of the inflation rate? This is easier to compare, and this comparison is an indicator of the social impact of inflation.

The policy brief has been elaborated based on the opinions exchanged by the participants of the discussion "Post-crisis role of the Central Bank and fiscal policy", organized on 9 February, 2019 within the project "Improving communication strategy for the fiscal and financial sector".