The insidious impact of persistent high inflation

Following the success of the first article in our series on the topic of money, this time we look at the impact of inflation on our personal savings.

Over the last 18 months, the UK has faced significant inflationary pressures. Even after fourteen interest rate increases by the Bank of England, the real value of money in individuals' wallets and bank accounts is eroding fast.

As high inflation becomes a persistent rather than transitory feature of the economy, the impact on people's spending capacity is becoming more and more apparent. For those lower down the income scale, it is becoming harder and harder to pay for even the most basic goods and services, including food and energy. But another aspect of this new economic reality often gets overlooked: its insidious impact on savings.

There are essentially three things you can do with money: spend it, save it or invest it. The latter two often get confused with one another, but there are some key differences, the most important of which are the levels of risk taken and the potential returns on offer. Saving invariably involves earning a lower return but with virtually no risk. In contrast, investing offers the opportunity to earn higher returns but at a higher risk of incurring losses along the way.

In today's age of surging inflation, saving is rapidly becoming a loser's game. Even in times of moderate inflation of, say, 4-5% (half of the current rate) keeping cash in a current account or under the mattress for a decade or so would result in the loss of around half of your savings' purchasing power.

A savings account may offer some respite by offering interest of, say, 1-3%, but your money is still losing value. And savings accounts do carry a certain amount of risk. As the recent bank runs in the US served as a reminder, when you put your money in the bank it is no longer yours; you have, in effect, made a loan to the bank. Unbeknown to most depositors, that loan carries some counterparty risk. To mitigate that risk, the Prudential Regulation Authority's Financial Services Compensation Scheme protects up to £85,000 across all the personal and business accounts each depositor holds with the bank.

The upshot of all this is that even the most prudent of savers have seen their savings lose value in real terms in recent decades. Worse still, this trend is rapidly intensifying.

In fact, the only way to have any chance of preserving the purchasing power of the money you earn and accumulate over the course of your working life is to take ever larger risks with it. Which turns you into an investor, not a saver.

This situation is the result of several interlinking factors. The high inflation most economies are experiencing is primarily due to decades of ever-expanding money creation by the central banks and commercial lenders. Other factors such as the supply chain crises caused by the COVID-19 lockdowns and the energy crisis set in motion by the Russia-Ukraine conflict and the US-EU's largely backfiring sanctions on Russia have also played a part.

More than a decade of low, zero and in some cases even negative interest rates has further fueled inflation while depriving bank depositors of any meaningful return on their savings. The inevitable result has been to discourage saving while encouraging excessive borrowing, overinvestment and overspending. People overspend because they know that if they don't spend their money, it will rapidly lose value. This leads to rampant consumerism with all its associated problems. The rampant over investing leads to overvalued property, stocks and other financial assets, which in turn forces people to take yet more risks if they want to put money aside for the future.

Central banks' myriad experiments with quantitative easing have only compounded matters by encouraging even more speculation in financial assets. The resulting bubbles have disproportionately benefited the ultra-wealthy who are largely invested in those assets. They also benefit from the current system in another way: by being able to borrow huge sums of money at the lowest rates available, with which they buy up real assets such as property, companies and commodities.

Meanwhile, the personal savings rate – a measure of how much money people have left over after spending on bills, food, debt and everything else – has plunged across the West. In the US it reached 2.3% in October 2022, its lowest level since 2005. This was just two years after it rose to a record high of 33.8% during the COVID-19 lockdowns of 2020. It's a similar story across most Western economies, with Switzerland serving as a unique outlier, but even there the saving rate is falling.

The real tragedy is that all of this is entirely avoidable. If our economies were governed on the principles of sound money (i.e., money that is scarce and hard to reproduce, such as gold) as opposed to easy money (money that is abundant and easy to reproduce, such as today's fiat currencies), the value of money would be appreciating. In the meantime, technological advances and productivity gains would lead to falling, rather than soaring prices for many of the products we need and want. As a result, people would be able to save without taking any undue risk.

Such was the case during the belle epoque, when most official currencies were pegged to a gold standard. During that period the industrial revolution reached its apogee. Many of the infrastructural and architectural wonders of the world, from the electrical grid to huge steel bridges, to railroads and railway stations, to many of the beautiful buildings that still line our streets today, were built. During that time the money supply increased at a rate of around 1% per year (the rate at which new gold supplies were added to established gold stocks). This meant that over the long term the prices of many products actually fell as a result of productivity gains and technological advances, and people's savings were not eroded by inflation.

In recent decades, the productivity gains generated by globalisation have served as a countervailing force against inflation. But many of the basic products and services we depend upon, including food, education and healthcare, have not benefitted from this trend. Meanwhile, globalisation is now quickly shifting into reverse, meaning that the structural pressures driving inflation are, if anything, likely to continue growing. Central banks are even talking about adjusting their inflation targets upwards. The question is: what can savers do about it?

If you would like to discuss any of these matters further, please get in touch with your usual contact at Cartwright.

August 2023