Breaking the money illusion

The cost of inflation is often misunderstood or ignored, with significant implications for consumer spending and economic behaviour on a wider scale

In the three months to February, the average weekly earnings of UK employees (including bonuses) increased by 3.5%, according to the latest report from the Office for National Statistics. This may sound good, but when the figures are adjusted for inflation, the percentage drops to just 1.6%, giving consumers considerably less purchasing power than the headline figure might suggest.

Changes in 'real' terms, which account for the impact of inflation, are key to understanding the true value of money. Yet research has shown that many people think only in 'nominal' terms, with little consideration for what the face value of money is really worth and can actually buy. Indeed, experiments have demonstrated that people often choose a higher nominal pay hike over a lower real hike, even though the real increase would make them better off.

This so-called 'money illusion' - a term popularised by the economist John Maynard Keynes - can have significant implications for consumer spending and economic behaviour on a wider scale. It can also affect the way we think about the value of money in the future, including our pension plans and returns on investments.

Looking at real returns

Since the global financial crisis, inflation fell sharply as the economic slump and rising unemployment meant shops and business could not raise prices. At the same time, central banks cut interest rates close to zero to stimulate the economy.

As banks follow the central bank when setting their own interest rates, savers received virtually no interest on their accounts. UK inflation has since risen- at 1.9% in March- while rates have remained below 1% for a decade, meaning that anyone relying on their savings for income has become worse off.

This analysis applies to investments such as bonds, shares, property and gold, all of which will have a return measured in nominal terms and one measured in real terms.

Fixed income assets such as government bonds (gilts) pay the same level of interest whether inflation is rising or falling. If inflation rises, the value of both the interest payments and of the money invested in the bond will fall in real terms.

The impact of inflation on stock prices is a little more complicated. Inflation reduces the net present value of a company's expected cash flows, suggesting that stock prices should fall as a result. At the same time, however, rising prices suggest that those future cash flows will be higher because companies are able to make bigger profits. In theory, these two forces should cancel each other out. In practice, markets often recoil at signs of inflation for fear the economy is overheating and interest rates will go up.

Economic reality

Accounting for inflation is also important when analysing economic growth. Statisticians calculate the total value of the output of an economy every year. In 2018, the nominal size of the UK economy was £2.12 trillion, up by 3.4% on the $2.05 trillion for 2017. However, growth in real terms was just 1.4% in 2018 (£2.01 trillion to £2.03 trillion).

The concept isn't just important economically. It can also be a political issue, with governments choosing to focus on the measure that best suits them. When a country is in the grip of inflation, its growth rate can look huge in nominal terms though this figure is largely meaningless to consumers who may be struggling to buy basic goods.

Another danger comes from underreporting inflation, which makes the headline figure of growth in real terms look higher than it actually is. For example, Argentina was forced to revise the way it produced inflation figures after it was exposed for underreporting soaring inflation over the previous decade to make growth figures look better.

In the run-up to the 2015 presidential election, the government's statistics office reported inflation at 15% compared to estimates from private economists at 27.9%, one of the highest rates in the world. Critics said the government was trying to mask Argentina's major economic problem for political reasons. Consumers at the time said the official inflation figures did not jibe with the price rises they were experiencing personally. There was also evidence that investors were moving money abroad to stop their money from being eaten up by inflation.

The bottom line is that being able to look through the nominal figures and focus on what is left after inflation will leave investors, employees and shoppers better able to understand what is happening to the value of their money.

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