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INFLATION AND DEFLATION



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What is the difference between debt deflation and deflation?

These are two different things, but they are related. Debt deflation is a theory developed by economist Irving Fisher during the Great Depression. It asserts that recessions and depressions are caused by the overall level of debt shrinking in an economy.

Debt deflation is the reduction in total debt in an economy. Today we have an unprecedented reduction in consumer credit and mortgage debt in the U.S. economy. People are either paying down debt using their savings or defaulting on the debt. And that is a problem. From an accounting balance sheet perspective, if the market value of debt (right side of the balance sheet) in an economy shrinks, then the market value of the assets (left side of the balance sheet) in the economy must shrink by the same amount if new equity (right side of the balance) is not added. Assets must be sold to reduce the debt. When many assets are sold all at once, values fall.

Deflation is a little different. Consumer price deflation is what the media most commonly means when it mentions deflation. The principle behind consumer price deflation is that consumer prices fall because people are consuming less, and businesses are forced to reduce prices to sell their products.

Anticipating lower prices in the future, people continue to consume less, and falling demand causes businesses to continue to cut prices. It becomes a self-reinforcing cycle of delayed consumption and price cutting. This is very damaging because businesses have to cut jobs and production to stay profitable, while people consume less because they lose their jobs. When business profits and employment income fall, it becomes difficult to repay loans.

So which is worse, inflation or deflation?

Deflation is much worse because it leads to falling profits and asset values. When profits and asset values fall, people go bankrupt. However, deflation is beneficial for those on fixed incomes with no debt, because their money buys more. Deflation results in lower interest rates.

With inflation, wages rise and debt becomes easier to pay off. If businesses can adjust to rising costs, their profits grow because they are getting higher prices for their products. But inflation is bad for those on fixed incomes because their money does not buy as much. Inflation results in higher interest rates.

Is real estate a good investment during deflation?

The answer depends on how much equity you have. During deflation, commercial rents will fall, and some tenants will go out of business because of falling profits. The most important thing when buying real estate during deflation is to avoid the need to go back to the bank to get relief on the mortgage payment.

If buyers pay all cash and have cash to make tenant improvements, foreclosure is not a threat if the property gets into trouble. There will be plenty of time in the years ahead when credit is expanding to leverage up the property, extract equity and increase returns. Deflation is a time for caution and reduced return requirements to protect investment principal.

What is the best investment strategy during deflation?

Investments with safe principal and steady cash flows are the best options during deflation. Even though the cash flow stream may be small, you can add the rate of deflation to the total return because the cash flows will be worth more in the future.

U.S. Treasuries are a good option for principal safety and steady cash flows. Longer-term bonds such as the ten-year and 30-year are preferred. However, investors should be poised to liquidate their investments in Treasuries when the economy begins to turn. It is likely that interest rates will rise at that point and cause a loss of market value in Treasury bonds.

Reducing debt is also a good investment strategy. The longer deflation persists, the more expensive it gets to service debt. Falling wages and prices make it harder to repay loans. Paying off the mortgage on your house becomes a good investment decision.

How does deflation affect mortgage rates?

Deflation causes mortgage rates to fall by impacting the yield on ten-year Treasuries. During deflation, investors shift their portfolios to Treasuries, which drives up the price and reduces the yield. The falling benchmark rate causes mortgage rates to fall.

During Japan's two decades of deflation, the yield on ten-year government bonds has remained below 2 percent even with the Bank of Japan (BOJ; Japan's central bank) buying huge amounts of government bonds, a practice known as quantitative easing.

According to Reuters, BOJ started their quantitative easing program by purchasing 400 billion yen (\$4.3 billion) per month and drove the yield on ten-year bonds down to 1.02 percent. In October 2002, they boosted purchases to 1.2 trillion yen per month, and by 2003 the yield had fallen to .43 percent. Currently, the ten-year bond in Japan yields just 1.04 percent.

Ben Bernanke has suggested he can stop deflation through quantitative easing (Fed purchases of U.S. Treasuries) to reduce interest rates. Will this work?

When the central bank of a country starts buying the country's national debt securities, it is typically interpreted as a purposeful weakening of the nation's currency. A weaker currency usually causes inflation. When a central bank aggressively buys Treasuries, it is seen as a precursor to hyperinflation.

Bernanke is not talking about aggressive purchases of Treasuries — yet. His goal would be to bring down all interest rates in an effort to spur consumption. When loans are cheaper, people typically consume more. Increased consumption could reverse deflation and lead to inflation.

The success of Bernanke's strategy depends on three things. First, would the drop in interest rates be enough to spur people to borrow? Second, do financial institutions have the capacity to lend? Third, do consumers have the desire to increase their debt burden?

Interest rates have been low for an extended period already. The Fed's actions to reduce interest rates further will have a smaller impact than they would have in 2007. Banks have eased lending standards from crisis levels, but credit is still hard to get for many borrowers in the United States. It is also possible that many American households do not want to go further into debt, even if low interest loans become readily available. So will Bernanke's strategy work? It's a risky bet that has never been tried in the United States before, so stay tuned. So far it has not worked for Japan. Rest assured that the Fed chairman will do everything possible to prevent prolonged deflation.

What is the best way for the United States to end deflation and get the economy going again?

First, the United States must reduce its trade deficit by selling more goods and services to other countries. Our trading partners need to purchase goods and services produced by American workers. As a nation, we must begin producing products that the rest of the world will buy. Trade agreements need to be strengthened to ensure equal trade of products between nations. This will create jobs and raise national income, thus easing the country's debt problem.

Second, the U.S. government must create an atmosphere of trust for American business owners. It must do everything possible to create an environment that increases the certainty of business profits. The final chapter of the Great Depression was written when the government quit demonizing business and awarded contracts that guaranteed profits for businesses to produce equipment for the war effort. Guaranteed profits gave businesses the certainty and incentive to hire more workers.

What could cause this strategy to fail?

The Japanese experience has shown us that massive increases in savings can severely retard economic growth. Japan is an export-led economy, yet it is still experiencing deflation. Consumption is restrained because of the propensity for aging seniors in that country to save. And the tight immigration policy is leading to a decline in population.

These two powerful factors have resulted in falling domestic consumption and, therefore, generated deflation. Low interest rates (easy monetary policy) and massive government borrowing and spending (stimulative fiscal policy) have not solved the problem.

Baby boomers in the United States have been largely overweight in stocks and real estate and underweight in safer, fixed-income securities for many years. Their consumption and investing patterns now appear to be changing in a way similar to the Japanese after their property bubble burst. After suffering huge losses to their wealth brought on by declining stock and housing prices, boomers are also expecting lower returns on their retirement assets. That means they will have to save more to achieve their desired lifestyle during retirement.

The end result is likely to be a higher savings rate and lower consumption in the future. Younger Americans may have to scale back on their spending as well because they can no longer borrow against the equity in their homes to finance purchases. America's reduced appetite for consumption could make it more difficult to avoid deflation.

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