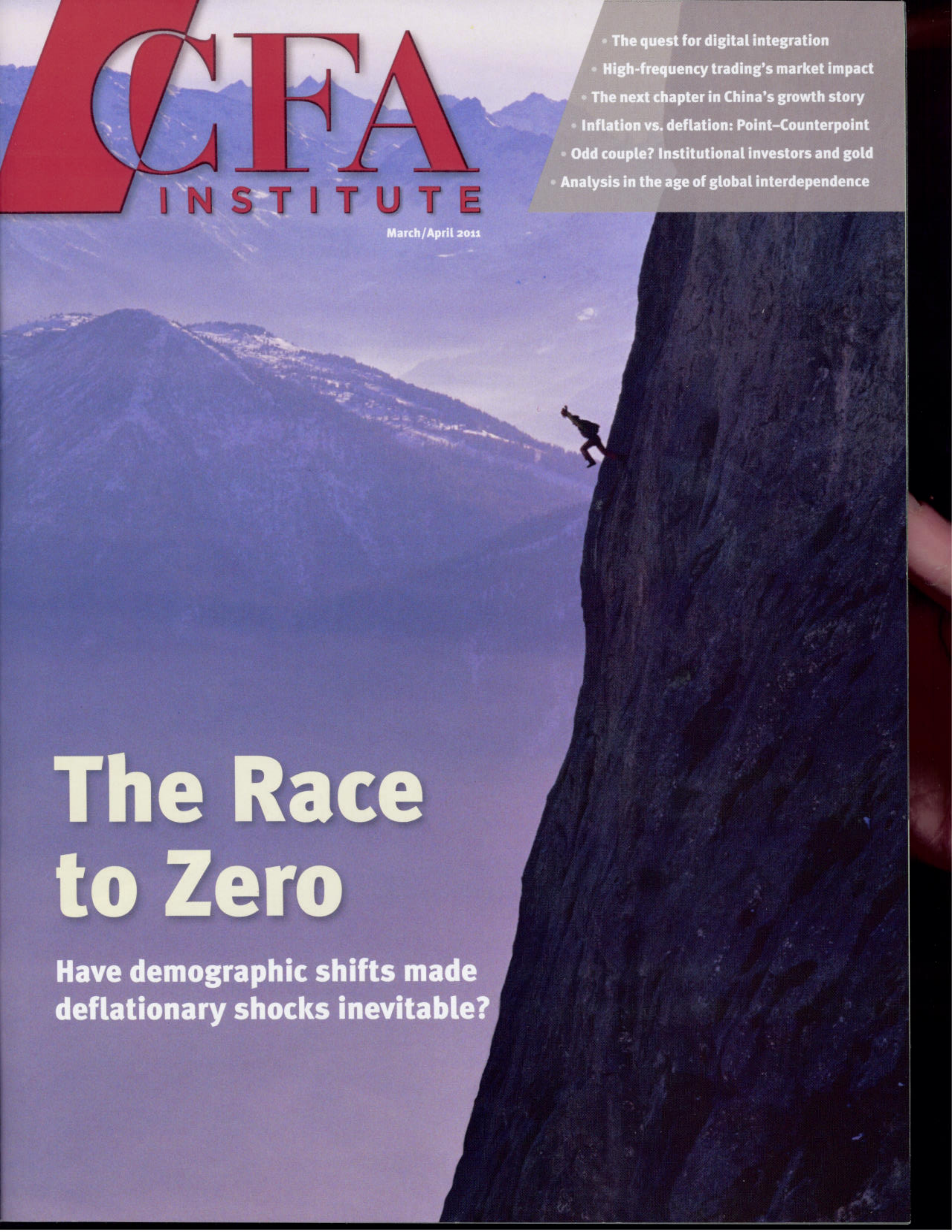
CFA INSTITUTE
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Have demographic shifts made deflationary shocks inevitable?

The greatest macroeconomic risk for investors today is not inflation but deflation.

AGREE

Relatively speaking, deflation poses a greater threat than inflation to investors and the economy as a whole. Deflation has devastating psychological and tangible impacts and tends to result in a self-perpetuating downward spiral from which it is difficult to recover.

Declining prices lead to lower profits, which eventually lead to greater unemployment because firms cannot afford to maintain staffing levels. What makes deflation particularly challenging for firms is they are unable to "pass along" a decline in the price level of goods to workers. If the average price of goods has decreased by 2 percent, workers arguably should be willing to accept a 2 percent decrease in wages, but this is rarely the case. People tend to think in nominal terms and would be unwilling to accept a decline in pay. In contrast, with inflation, workers readily accept a pay increase, often thinking they are "better off" when in fact their position has not changed because the pay increase was offset by inflation.

Deflationary periods not only shrink profit margins but often lead to a general decrease in demand. Consumers will frequently postpone or forgo purchasing big-ticket items because they expect prices will fall further and are reluctant to buy. With consumer confidence in the doldrums, the negative impact of deflation on the economy is exacerbated.

Another critical factor to consider is what deflation can do to the value of what is for most of us our largest asset: our homes. The recent housing crisis illustrated how declining housing prices—even if the decline was warranted—quickly eroded the equity millions of families held in their homes.

The negative impact of deflation on profits, employment, and overall confidence has a crushing effect on investment returns. Firms that are not earning healthy profits cannot reward equity investors and often cannot afford to repay debts, leaving bondholders in an equally precarious situation.

Current conditions in the United States and other developed economies would seem ripe for a period of deflation. Despite the aggressive attempts of central banks to fuel economic growth, inflation remains surprisingly benign. (The year-over-year change in the consumer price index was 1.5 percent in December 2010.) Consumer confidence levels also remain well below what is typically witnessed within a healthy economy.

It has been suggested that changing demographics, specifically an aging population, will lead to an era of deflation. Older individuals tend to borrow less and save more, which is not conducive to economic growth. Just ask Japan. Furthermore, many of the elderly live on a fixed income, so deflation would seem favorable to these individuals because their fixed income would buy a greater amount of goods.

The U.S. population is getting older, and this trend is expected to continue. According to the U.S. Census Bureau, roughly 8.1 percent of the population was 65 and older in 1950. By 2050, the Bureau projects that this age group will make up more than 20 percent of the U.S. population.

Although an aging population is not the primary driver of deflation, this condition (combined with other factors) produces an environment that, unfortunately, is a breeding ground for deflation.

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A significant contributor to the extended Japanese deflation has been the rapid aging of the country's population. The U.S. is aging more slowly, but the majority of the baby boom generation has passed through its peak spending years and is now more focused on saving and reducing debt. This change will weigh on consumer spending, magnifying the deleveraging brought on by the housing bubble collapse and recession. Demographic changes are by nature very powerful but also very slow-acting forces; therefore, their impacts will be felt over the long term. In the short term, however, a weaker dollar may produce some commodity inflation manifested in higher prices for food, energy, and raw materials.

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DISAGREE

There are two reasons why inflation will be a more prominent threat than deflation over the coming decade. First, one cannot escape the quantitative theory of money, which states that $MV = PQ$ or that the monetary base (M) multiplied by the velocity of money (V) must equal the total amount of goods in the economy (Q) times their price (P). Because the quantity of goods grows at real GDP (about 2.5 percent a year on average over the past 20 years), any growth in the money supply (MV) in excess of this amount will create inflation, as the price level must adjust to bring the equation into balance. The only two things that can offset rises in the monetary base so as not to create inflation are (1) a rise in the quantity of goods and/or (2) a decline in the velocity of money. Since the start of the great recession, the velocity of money has indeed fallen about 11 percent. However, the velocity now sits »

5 percent below its 50-year average and only 6 percent above its 50-year low, making it unlikely to continue falling. More importantly, velocity has been increasing since bottoming out in the second quarter of 2009. It is impossible for inflation (an increase in the price level) not to take hold with a steady-to-growing velocity and a rapidly expanding monetary base. As a result of the Federal Reserve's unprecedented actions aimed at combating the threat of deflation and stimulating the economy, the monetary base as measured by M2 has been increasing at a rate of 5.7 percent a year since the start of the recession. With near-zero short-term rates and the continuation of quantitative easing, it is unlikely this rate will slow meaningfully. The end result cannot be anything other than inflation. In fact, if we assume that (1) M2 continues growing at 5.7 percent, (2) velocity returns to its 50-year average over the next 10 years, and (3) the real economy grows at its 20-year average of 2.5 percent a year, inflation will average 4 percent a year. This may not sound like a lot, but it would reduce the value of US$1 today by nearly one-third in 10 years.

Second, inflation is the most politically palatable solution to the current fiscal dilemma facing the United States. When a nation becomes structurally insolvent because it is running persistent deficits with no ability to pay down its national debt, it has two choices: either enact severe austerity measures that increase taxes and cut spending (including social programs) or default on its debt—through outright default, inflation, or currency debasement. When more than half of the debt owned by the public is owned by foreigners, the temptation to default overwhelms the desire to enact austerity measures. Further, the top 20 percent of U.S. citizens own 93 percent of the financial assets. Thus, a default (while catastrophic in its secondary effects) impacts only a little more than 20 percent of the voters and is only half as painful as austerity (because foreign investors own 50 percent of the debt but would not be directly affected by austerity). Politicians tend to strongly prefer "solutions" that affect only 10–20 percent of the voting populace over those that affect all of it. However, most politicians understand that an outright default would have disastrous consequences (think Lehman Brothers times about 100). Hence, the only way to quietly default is via inflation. By printing money to debase the currency, the United States can repay its debtors with dollars that are worth much less (in terms of purchasing power) than those originally borrowed. Unfortunately, this default via inflation bears extremely high costs in terms of reducing the wealth of the population and creating severe economic disruptions, but the effects tend to operate with a lag, whereas the effects of an outright default or austerity program are obvious and immediate. Thus, one strains to see where the political will to stop rampant growth in the money supply will come from. To the contrary, most elected officials will face strong incentives to adopt policies and appoint individuals to the Federal Reserve who will deliberately grow the money supply to reduce the fiscal burdens facing the United States.

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Deflation in its simplest terms is an indication of oversupply and economic prosperity. Take the case of Japan, the first of the deflationary economies. There is sufficient infrastructure in terms of roads and train lines, as well as sufficient housing and production capacity. Hence, the nation is prosperous. The smooth handover of this prosperity to the younger generation is key. This would include not only a handover of wealth but also of knowledge and businesses. Investment is needed in the following areas: (1) developing businesses that help the transfer of wealth, knowledge, and business to the younger generation, (2) finding new markets for goods and services, (3) migrating young workers to aging societies to provide services to the aging population and absorb oversupply and provide tax revenues to the government. So, yes, there is risk. But that's the good news, as it gives active investers a chance for returns.

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There is ample evidence supporting deflationary trends. There is ample historical evidence supporting inflationary trends. Demographics provide lessons that are very difficult to overcome as long as each population segment continues to act in accordance with historical tendencies. If the tendencies of a particular demographic or those of a population as a whole change, demographics will apply less. It is just as likely as not that we have entered a period in which the global balance of demand and supply has changed. For example, if China and other emerging nations continue to industrialize, demographics are likely to be less dominant, ceding dominance to government policy and money flow. My point is that we may certainly be destined for both inflation and deflation in the United States and other developed nations. "Stagflation" is as likely a possibility as either inflation or deflation. It is possible, even likely, that overcapacity and changing demands of an aging population will create deflation in many asset classes while other asset classes in demand in other parts of the world will continue to rise in price. This is made even more probable because many of the world's commodities are "dollar denominated." As the U.S. Federal Reserve's goal of weakening the dollar unfolds, commodities priced in dollars will rise (at least for the citizenry of the United States). In short, it is easy to make a case for both inflation and deflation. Unfortunately for U.S. citizens, the answer to the question "which is the greatest risk for investors—inflation of deflation?" may be both.

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