Investment Fundamentals

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Deflation

- Inflation measures the overall change in prices of goods and services over a set period—and deflation is the term used when these prices fall over time.
- Falling prices can have unfavorable effects on the economy, including rising unemployment and reduced demand.
- Central banks try to manage inflation, steering their economies away from deflation, through interest-rate policies.

Why are economists so concerned about deflation—the general fall in prices of goods and services? To understand why deflation can be considered an economic menace, one must first understand inflation.

Deflation is Nothing Without Inflation[1]

When inflation occurs, it means the average cost of goods and services is increasing. In the U.S., this is often measured by the Consumer Price Index and the Personal Consumption Expenditures Index. Both indexes take a representative pricing sample, or basket, of major categories such as food and beverages, housing, apparel, transportation, medical care, recreation, education, communication and energy. If, for example, the reference basket of items cost $100 last year, and inflation was measured at 2% over the past year, then that basket of items can be reasonably expected to cost $102 today. This does not mean the prices of *all* items in the basket will increase by 2%—some will rise by more, others will rise by less, and some may even fall.

While no one likes to spend more money than they have to, many economists believe a little inflation is a good thing for the economy. In fact, the Federal Reserve prefers to see inflation at roughly 2% per year. Most central banks similarly make low inflation a key policy objective. The thinking is that maintaining low inflation helps the market system avoid higher, unpredictable inflation—which is not conducive to investment or well-behaved currency exchange rates, and can cause turmoil in a country's foreign trade.

The Price of Reduced Prices

While a central bank's low-inflation objective can help protect an economy from unpredictable, sharply rising prices, it also helps protect against inflation rates falling below zero—or deflation. This is important for several reasons. One is that a falling cost of goods and services is often accompanied by a falling cost of labor (and thus lower incomes). In other words, while people may be spending less at the gas pump and the grocery store, their wages might drop as well. And as consumers are paid less, they become even less willing to spend as they wait for prices to fall even further. This results in further economic weakness and a deflationary downward spiral that can be difficult to reverse.

Perhaps the biggest concern about deflation among economists, however, is the effect it can have on debtors (borrowers) and the financial system. While creditors are hurt by unanticipated inflation, debtors are burned by deflation. If you borrow $100 and have to pay it back after a period of deflation, the $100—as well as the intervening interest payments—would have increased in value, thus making it more difficult for you to repay the loan. When this occurs across a market, and more and more loans start to go unpaid, the financial system itself experiences duress.

So deflation can cause a domino effect: stress on borrowers who have to pay back more in real terms than the nominal value they borrowed; which leads to stress in the financial system, as loans are not being repaid on time; which leads to tighter lending standards and bank failures; which leads to declines in asset values, a decline in overall demand (or collapse, if deflation is especially severe, as it was in Great Depression, along with widespread bank failures), rising unemployment, and underinvestment that imposes costs on future economic activity and output.

Managing Prices and Investor Anxiety

Investors concerned about inflation can include inflation-sensitive assets (such as commodities, commodity-related equities, credit, Treasury inflation-protected securities) in their portfolios that are designed to respond positively to inflation, as well as assets that are likely to hold up in the less-common case of deflation (cash, high-quality government and corporate bonds, and certain defensive equity sectors).

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[1] *For more on inflation, please see SEI's Investment Fundamentals: Inflation, June 2014.*

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