Deflation: How it might impact you

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Real Money

While global stock markets have rebounded sharply since the conclusion of the large scale military conflict in the Middle East, fundamental economic problems still plague the world.

In the United States, Europe and especially Japan, many long-term structural problems have yet to be addressed. As a result, there are increasing concerns regarding deflation, widespread economic contraction, rising unemployment and a host of other issues, which have not manifested themselves in similar form since the great Depression of the 1930s.

The geo-economic question paramount for businesses today is "does deflation — meaning falling prices for some types of goods and services — represent a greater threat than inflation?"

The Federal Reserve Bank in the United States clearly thinks so. The central banks in Europe and Japan are not concerned yet with these issues because of the kinds of social problems that are prevalent in those countries. Their social contracts favor retirees and a high level of social services over business activity.

Currently, U.S. industry has several advantages over its overseas counterparts. The U.S. economy is based on consumerism, and this has helped fight deflation. In contrast, China's culture is based on production. Japan is a nation of savers and has had deflation for several years, as people there will not invest in an uncertain future. Americans and American companies excel at manipulation of symbols. American businesses are controllers of public opinion, and the government tries to manage our population's consumptive patterns. We are pre-eminent in marketing. Our cultural dominance makes us money in the form of exporting entertainment worldwide and U.S. entrepreneurs lead the world in innovation, particularly in the fields of medicine, technology, and the creation of new types of financial instruments.

Unfortunately, none of these traditional U.S. business strengths can continue to work well against the power of deflation. Deflation, or declining prices, reflects a lack of confidence in the future.

Recent reports show that the U.S. economy has lost over 2 million jobs since 2001, the year of President George W. Bush's first tax reform. The 2003 tax act is supposed to create jobs, but it is hard for me to see this happening. Since we import so many of our goods from overseas and we depend so much on foreign capital to support our budget deficits, the money being given to wealthy investors is unlikely to be funneled back into new business investments. There are 10 million people looking for work today in this country, in all regions and in all professions.

Deflation, if it were merely a reduction in prices, would not be of great concern except that it also means that it is harder for everyone to earn money. It is particularly hard for people who have debt because each dollar of earnings, be they from profits or wages, becomes harder to obtain. In inflationary times, it makes sense to borrow money because, as prices for everything go up, there is more money around to pay off one's old debt with successively "cheaper" dollars.

In the midst of a deflationary contraction, wages go down for all workers, jobs become scarcer, and it becomes harder to service one's debt. This is true for individuals with credit-card debt, for families with mortgage debt, for businesses with commercial loans, and for countries who run a deficit. Debt and deflation are an unwelcome mix.

Our nation is mired in debt, and this is one reason the Federal Reserve and Bush administration officials are doing everything they can to prevent deflation. Some of the tactics being used are: lowering interest rates, increasing government spending, cutting taxes, printing money, and government purchases of bonds in the open market in order to put more liquidity into our economy.

The economic doldrums that our nation has found itself in for the last several years has many causes. Terrorist attacks, corporate scandals, SARS-related anxiety and political instability have all contributed to individual and business reluctance to commit to spending for the future. The economy wants to move forward because there is pent-up demand for new technology. But, on the other hand, American consumers have had a 15-year spending spree with little respite. The debt levels of our citizens and government are astounding.

What kind of investment strategy does well in deflationary times? The first step would be to pay off outstanding debts. The sooner one's interest-rate burden decreases, the more quickly one's cash flow becomes positive. Real dollars coming in is the key to thriving in deflationary times. Real dollars go further in purchasing real goods. When economic conditions improve, those assets purchased at bargain prices will start to appreciate in value. Bonds do well if interest rates fall, though Japan's experience has shown this does not hold true at very low interest-rate levels.

Preservation of capital is the other most important goal in a deflationary or stagnant economic environment. Prices on manufactured goods can fall at the same time as those that can be mass-produced in wage-paying countries, prices for high value-added services rise. Quality medical services, education, and professional services are not subject to the same deflationary pressures as are the price of clothing, and consumer electronic devices. The net result is that unless one has cash, material standards of living will decline.

How does the stock market perform during deflationary times? The price of financial assets and real-estate assets both tend to fall during long periods of deflation. Assets that throw off a steady source of income are the most valuable. Dividend-paying stocks, income-producing real estate or real-estate contracts backed up with ample collateral are the most efficient investments during long economic contractions. Many companies lose their ability to raise prices, which negatively affects their profits.

Expense control becomes key, both on a personal and organizational level, as reducing one's cash flow going out contributes more to success during deflation than during inflation. Unfortunately, our government is considering how to stimulate economic activity. This portends larger national debt levels.

During inflationary periods, corporations tend to buy back their own stock and this has helped some stocks from melting down over the past three years. This tactic becomes extremely difficult to execute during deflationary times. You can tell which companies are really making money by seeing who can afford to pay dividends. When deciding what investments to buy during deflationary times, look at the "dividend payout ratio." If a company has a dividend payout ratio of 100 percent, it is paying out all of its earnings or profits in dividends. It is not uncommon to see some firms and some mutual funds paying out more than 100percent of what they are earning. This is akin to eating one's own flesh in order to stay alive. It just doesn't work for very long.

Deflation means that interest rates continue to stay low or go lower. Regardless of the size of the government deficits, and the printing of money to try to stimulate business activity, people need to feel confident in order to invest in new equipment, people and technology. This kind of confidence has not yet returned to the markets. Sometimes government spending can also crowd out private investment and not just by soaking up the excess money that's available for loans.

Deflation creates a very real opportunity for economic power to migrate from one nation to another. Generally, it takes a war or several generations of squandering wealth for empires to dissipate. The Asian Rim countries stand the best chance of benefiting from the current worldwide economic slowdown, but in the short-term, everyone is adversely affected.

China, along with other Pacific Rim producers such as Singapore, Korea, Hong Kong and Malaysia, all have large numbers of highly motivated, technically oriented, hard working, savings-oriented people. Deflation hurts their ability to export to the United States so their profits go down as well.

International stock markets might not be a place for U.S. investors to make money because foreign management has motivations that favor employees over stockholders. China has amassed huge reserves of foreign capital due to their excessive productive capacity and low consumptive patterns; however; its ability to wield this power on a global scale has not yet been exercised.

In a worst-case scenario, traditional approaches to accumulating and managing wealth such as retirement plans, Social Security and guaranteed health benefits are all threatened by rampant deflation. The belief that long-term investing in stocks and bonds and the long-held confidence that residential real estate acts as a rock solid reservoir value, comes into question in a period of prolonged, severe price declines.

Investor reliance on public markets to take care of individual needs becomes severely challenged in periods of deflation. Companies that rely on consumer debt could experience difficulty, and the traditional jump start of the economy, "spending today and paying tomorrow," simply does not happen in such times.

The medicine for deflation is economic activity. Government officials are aware that they need to stimulate business, and they are attempting, through trade agreements and tax cuts, to get things going. There are, thankfully, some traditional American values — frugality, self-reliance and trading with one's neighbors — that would help us deal with deflation. People who lived through the 1930s remember them as hard, but they also say the bonds of friendship and the sense of community created by pulling together to deal with deflation was an uplifting experience. It all comes down to attitude!

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