Never mind inflation, what's your deflation hedge?

FIELD NOTES

BY MICHAEL KEENAN

North America, led by the United States, is experiencing its first "low inflation" recession in decades, and a casual glance at the headlines might lead to the conclusion that inflation is not only low, it is in outright retreat. Any number of price indices fell through much of 2001 and the near-term inflation outlook in Canada and the United States has been downgraded to the very low single digits. An interesting issue for investors is whether low inflation can become too much of a good thing and risk becoming deflation. If so, what will it mean for investment policy?

First, what is deflation and why should we worry about it? The pernicious deflation that is most worrisome occurs when prices for a broad basket of goods and services are declining and when there are widespread expectations of further price declines. So it is important to distinguish between general price declines and relative price declines. Relative price declines occur when some goods or services get cheaper in comparison to others. These happen all the time. In fact, declining prices are a more or less permanent feature of doing business in some industries. High rates of innovation in certain technology industries, for example, can lead to steady declines in costs, which are passed on to customers in the form of lower prices. This "local" deflation is productivity-driven and, from a macroeconomic perspective, is benign because it needn't affect overall economic activity. So you might not buy a digital camera this year because you are waiting for the prices to come down, but, in the meantime, there is no reason not to spend the money on something else.

However, broad-based price declines, or general deflation, is potentially dangerous. This occurs when the prices of most goods and services are falling and when people expect that prices will continue to fall. The expectation of falling prices, for example, may cause people to postpone discretionary spending across the board, thereby reducing aggregate demand. Also, many businesses may see their revenues fall in line with prices, which would force them to reduce wages and costs and make it more difficult to service fixed-cost nominal debt. And if borrowers are having difficulties servicing debt, chances are that financial intermediaries will have difficulties. This could reduce the availability of credit and depress business investment. Note as well that interest rates can only fall so far – i.e. to zero. This means that if prices are falling and interest rates are at or near zero, real interest rates will tend to be positive and increasing. This would give people another reason not to spend money and serve to further reduce business investment. Since deflation has a lot of potential for self-perpetuating misery, policymakers should wish to avoid it.

MUCH ADO ABOUT NOTHING?

It may be a bit early to sound the alarms about deflationary spirals. For one thing, the current inflation outlook may not be as weak as the headline numbers suggest, particularly if the recession is short and shallow as many analysts are forecasting. Inflation does after all have a large cyclical component. The more conceptual argument against deflation-mongering, however, is that the economy has a line of defence in the form of the central bank. Just as inflationary periods are ultimately caused by too much money chasing an economy's stock of goods, deflationary periods should only develop if there isn't enough money to go around. So the monetary stimulus that central banks provide through interest rate reductions in response to deflationary shocks exerts upward pressure on prices going forward, countering the deflationary momentum. If interest rate reductions alone are not sufficient to turn things around, central

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banks have other options like buying government or private sector bonds, or depreciating the currency by buying foreign exchange – anything to get the money flowing. Therefore, while we might not be able to avoid deflation altogether, it can, in theory, be reversed expeditiously by appropriate central bank action.

An era of low inflation need not imply a high risk of deflationary spirals. But if you accept that we are in an era of low inflation, the risk of deflationary surprises seems to be at least as interesting a question for investors as the risk of inflationary surprises. As high-productivity technology industries account for a larger share of national output, their deflationary influence on the price aggregates will grow. Globalization, trade and deregulation are also keeping the pressure on a number of more traditional industries to increase productivity and reduce prices. And the closer an economy runs to zero inflation during normal times, the more exposed it is to negative shocks or central banking errors that could serve to impart deflationary momentum. We do, after all, have the situation in Japan to remind us of the potential costs of policy errors in a low inflation environment, not to mention the fact that extricating an economy from deflation may be more difficult in practice than it is in theory.

SO WHAT ABOUT ASSET MIX?

What would deflation mean for pension fund management? In terms of the balance sheet, deflation hurts fixed liability borrowers by increasing the real value or their debts. And while pension funds are not borrowers in a traditional sense, they have a lot of liabilities, so pension balance sheets would certainly be at risk. Assuming that long-term interest rates would fall with deflation surprises, pension funds would experience an increase in the present value of their liabilities, to the detriment of solvency levels. Notably, since real long-term interest rates are higher than nominal interest rates when prices are falling, pension funds with inflation-linked liabilities suffer proportionately less damage if the sponsor is prepared to cut nominal pension benefits in line with the general decline in the price level.

In terms of assets, bonds are the natural deflation hedge. More specifically, long-term, high-quality, nominal, domestic bonds would seem most appropriate. Long-term of course to match the tenor of typical pension liabilities, and high-quality because it takes a strong business model to service debt in a deflationary environment. Nominal bonds are preferred to inflation-linked bonds because the real value of nominal coupons and principal will increase as prices fall, while domestic bonds are probably preferred to international bonds because one can have no certainty that the interest rate performance of foreign bonds will match that of domestic liabilities. As earnings fell and risk premiums rose, equities would presumably suffer from a deflationary economic backdrop while real assets would also presumably do poorly since the very nature of deflation is a flight from goods to money. So, to the extent that plain, old nominal bonds are the best hedge, the textbook 60/40 pension fund has a good bit of deflation protection on the balance sheet. Whether this is too much protection, or not enough, depends of course on your assessment of deflation risks.

WHAT DO YOU EXPECT?

As a final point, we have made a couple of references to expectations without much elaboration. Expectations play an important role in price formation and you would imagine that a severe deflationary cycle would not likely take hold until people started expecting deflation. To the extent that central banks have credible commitments to maintain price stability or a positive rate of inflation (as in Canada), general prices can presumably fall modestly for a while without accelerating downward, provided people expect the monetary authorities to take all actions necessary to right the ship. So if your reaction to commentary regarding impending deflationary spirals is to roll your eyes and turn the page, that may be a good thing as it suggests that you don't have much in the way of deflationary expectations. It's when you start reading right to the end that you should begin to worry! ■