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[Inflation, deflation, stagflation.](#)

Food prices are rising, property prices are falling and economic growth is stalling. The ultimate balance of these factors will determine whether the global economy will be ravaged by surging prices or whether the economy will slow sufficiently to depress asset prices for years to come. Currently we appear to be in that state of limbo known as 'stagflation', an extremely devastating condition that is bad for everything and everyone.

Prices are rising for many agricultural products as demand increases from the rapidly growing economies of India, China and other developing countries such as Brazil and those in Eastern Europe. As people in these countries become wealthier they tend to progress from a subsistence diet (rice, potatoes etc) to a more protein based diet (meat, fish etc) and that requires more food for animal feed. The overall demand for agricultural products increases and that pushes up prices. Whereas this is inconvenient for us in the West it is positively disastrous for those living in poverty who can't afford the higher prices. Some countries have seen food riots and have started hoarding their own agricultural stocks rather than trading it. India has banned futures trading in several food commodities to reduce speculation.

The oil price has hit a new high and has risen over 900% in the last 10 years (from \$12 in 1998 to \$125 today), again partly driven by demand from developing countries but also helped along the way by speculators around the world who can now easily buy derivatives based on the oil price. Gas and electricity prices have also increased, uranium for nuclear power has shot up, even the price of coal has made a comeback. Prices of metals have been rising sharply for several years now because the supply/demand balance has remained tight, pushing up the price of everything they feed into.

In spite of rising prices in these raw materials, inflation for many people in the West has been low for years, often around 2-3% according to official government figures. However, most economists take those figures with a pinch of salt because they tend to exclude certain volatile items, depending on which country's figures you are looking at, such as food, oil and even ignoring mortgage payments. The official (core) figures have tended to give prominence to goods that have seen falling prices such as clothing, electronics and airfares. The difference between these goods and those that are seeing rising prices is that they are usually non-essentials and they have been one of the main beneficiaries of the extra money that the financial system has created in recent years. As people have gone out to 'shop til they drop' they have been buying these goods and haven't had to worry very much about the rising prices of essentials such as food and warmth. It is families and pensioners, the people who spend a greater proportion of their income on these essentials, that have experienced much higher rates of rising prices than someone who shops regularly for leisure items.

Inflation takes time to feed through and now it is starting to register for a greater number of people in the West. This pushes up demands for higher wages which in turn fuels higher inflation expectations. Rising credit costs, coming after a decade of splurging on debt, is

starting to get worrying and people are feeling their finances being pinched. They can cut back on shopping for non-essentials but they struggle to cut down on electricity, petrol and food. If prices of basic goods and services keep rising then they find that their ability to control their spending is diminished, it is taken out of their hands.

Rapidly rising inflation is a tangible and noticeable problem and as people cut back on their spending of non-essential or luxury goods this tends to have a negative effect on the wider economy. Economic growth is slowing or becoming negative whilst prices of many things are still rising. This is stagflation and is difficult for central banks to deal with effectively. They can't easily cut rates to stimulate growth because this then exacerbates inflation. If they raise rates to cool inflation then they risk choking off any remaining consumer confidence. In reality most governments will make a decision to prioritise the fight against inflation or stopping economic decline and they will either lower interest rates (as in the US) or raise rates (as in Australia) accordingly.

Having experienced inflation and stagflation, the next big worry is deflation. There are some who believe that lowering interest rates to stimulate economic growth could be ineffective at this stage in the economic cycle. Most people would agree that it was low interest rates that created a credit bubble in the first place, making credit cheap and easy to obtain, leading to an unsustainable situation and too much leverage in the financial system. Whilst it could be regarded as reckless to lower rates again, it is quite likely that lower rates will no longer provide the incentive to borrow and invest once more as many people and countries are still heavily indebted, and there has also been a huge shift in emphasis on credit quality by lenders regardless of the cost of money (as illustrated by the credit crunch).

On the way up through the cycle extra financing provided greater purchasing power which in turn pushed up prices, as witnessed in the markets for commodities, property, art and luxury goods. An attempt to sell a diamond-encrusted skull for \$50m could only happen at the top of an economic boom. Conversely, a retraction of spending power (due to less credit) coupled with a greater focus by lenders on securing their borrowing is likely to see prices pushed lower. We are already seeing this most prominently in the property markets of Spain, Ireland, the UK and the US where prices are coming down. In simple terms, prices are falling and people expect them to be lower in the foreseeable future, a view that is likely to be applied to a growing number of sectors such as consumer electronics, cars and furniture. Anything that is related to real estate or anything that is considered discretionary is going to come under severe price pressure as more people find they have less disposable income. And as consumers find themselves under more financial pressure they are going to start saving money again and paying down debt, not spending it.

This is where Japanese history becomes interesting and it won't just be Ben Bernanke who will be looking closely at the Japanese experience of the 1990s. This is often known as the Lost Decade because Japan experienced damaging deflation from the beginning of the 90s after the twin bubbles in the stock market and real estate market burst, causing a downward spiral in asset prices. Japanese people stopped spending money, afraid of the consequences of doing so and conscious that if they postponed their spending decisions they would probably find prices lower in the future anyway. This attitude is very bad for the domestic economy and Japan proved that interest rates as low as zero are not necessarily

going to encourage people to borrow and spend again, not once they have already had their fingers burnt. Economists usually say that the problems in Japan were different from today's problems but years of working in the financial industry teaches you that the financial whiz kids can always come up with new ways to lose money and no two financial disasters are exactly the same.

The world has just been through a massive expansionary phase in money creation within the financial system and this has fed through into the prices of stocks, commodities and real estate. The long-term global bull market in equities probably ended in 2000, the bull market in real estate probably ended in 2007 and we have yet to see what happens to the bull market in commodities. Whilst these market peaks have not occurred simultaneously they can't be dismissed and the similarities with the Japanese problem certainly deserve some respect from investors and central bank governors. We might be experiencing inflation, we might be facing the prospect of deflation but what we know for sure is that we are currently in the grip of stagflation and it is this which is possibly the scariest because it takes control away from the policymakers and reduces their ability to act. If we are on the brink of a major step change in the pace of the global economy then it is likely that one of these forces will assert itself and if it is deflation then we should be worried, we have already seen what that did to Japan.