FMA FINANCIAL MANAGEMENT ASSOCIATES, LLC.
P.O. BOX 957 ■ ANDOVER, MA 01810-0016 ■ 978-687-2867

FINANCIAL PERSPECTIVES

Inflation vs. Deflation: An Overview

By Troy Segal for Investopedia

Inflation occurs when the prices of goods and services rise, while deflation occurs when those prices decrease. The balance between these two economic conditions, opposite sides of the same coin, is delicate and an economy can quickly swing from one condition to the other. Central banks keep a keen eye on the levels of price changes and act to stem deflation or inflation by conducting monetary policy, such as setting interest rates.

What's The Difference Between Inflation And Deflation?

Key Takeaways

- Inflation is an increase in the general prices of goods and services in an economy.
- Deflation, conversely, is the general decline in prices for goods and services, indicated by an inflation rate that falls below zero percent.
- Both can be potentially bad for the economy, depending on the underlying reasons and the rate of price changes.

Inflation

Inflation is a quantitative measure of how quickly the price of goods in an economy is increasing. Inflation is caused when goods and services are in high demand, thus creating a drop-in availability. Supplies can decrease for many reasons; a natural disaster can wipe out a food crop, a housing boom can exhaust building supplies, etc. Whatever the reason, consumers are willing to pay more for the items they want, causing manufacturers and service providers to charge more.

So-called hyperfinflations occur when the increase in monthly prices exceeds 50% over some period of time. These periods of rapid price increases are often accompanied by a breakdown in the underlying real economy and may also see a sudden increase in the money supply. While hyperinflations can be scary, they are historically rare. The most famous example is the hyperinflation that struck the German Weimar Republic in the early 1920s. The nations that had been victorious in World War I demanded reparations from Germany, which could not be paid in German paper currency, as this was of suspect value due to government borrowing. Germany attempted to print paper notes, buy foreign currency with them, and use that to pay their debts. This policy led to the rapid devaluation of the German mark, and hyperinflation accompanied the development. German consumers exacerbated the cycle by trying to spend their money as fast as possible, expecting that it would be worthless and less the longer they waited. More and more money flooded the economy, and its value plummeted to the point where people would paper their walls with the practically worthless bills. Similar situations have occurred in Peru in 1990 and Zimbabwe in 2007–2008.

In reality, inflation can be either good or bad, depending on the reasons and level of inflation. In fact, a complete lack of inflation can be quite bad for the economy, as we will see below with deflation. A modest amount of inflation can actually encourage spending and investing, as inflation can slowly erode the buying power of cash—so it is relatively less expensive to buy that $1,000 appliance today than the same $1,000 in a year.

Hedging Against Inflation Stocks are considered to be the best hedge against inflation, as the rise in stock prices are inclusive of the effects of inflation. Since any increase in the cost of raw materials, labor, transport and other facets of operation leads to an increase in the price of the finished product a company produces, the inflationary effect gets reflected in stock prices.

Additionally, special financial instruments exist which one can use to safeguard investments against inflation. They include Treasury Inflation Protected Securities (TIPS), low-risk treasury security that is indexed to inflation where the principal amount invested is increased by the percentage of inflation. One can also opt for a TIPS mutual fund or TIPS-based exchange traded fund (ETFs). Gold is also considered to be a hedge against inflation, although this doesn't always appear to be the case looking backwards.

Deflation

Deflation occurs when too many goods are available or when there is not enough money circulating to purchase those goods. As a result, the price of goods and services drops. For instance, if a particular type of car becomes highly popular, other manufacturers start to make a similar vehicle to compete. Soon, car companies have more of that vehicle style than they can sell, so they must drop the price to sell the cars. Companies that find themselves stuck with too much inventory must cut costs, which often leads to layoffs. Unemployed individuals do not have enough money available to purchase items; to coax them into buying, prices get lowered, which continues the trend. (Note that deflation is not the same as disinflation, which is a decline in the positive rate of inflation from period to period).

Deflation can lead to an economic recession or depression, and the central banks usually work to stop deflation as soon as it starts. When credit providers detect a decrease in prices, they often reduce the amount of credit they offer. This creates a credit crunch where consumers cannot access loans to purchase big-ticket items, leaving companies with overstocked inventory and causing further deflation.

Prolonged periods of deflation can stunt economic growth and increase unemployment. Japan's "Lost Decade" is a recent example of the negative effects of deflation. Just as out of control hyperinflation is bad, uncontrolled price declines can lead to damaging a deflationary spiral. This situation typically occurs during periods of economic crisis, such as a recession or depression, as economic output slows and demand for investment and consumption dries up. This may lead to an overall decline in asset prices as producers are forced to liquidate inventories that people no longer want to buy.

Consumers and businesses alike begin holding on to liquid money reserves to cushion against further financial loss. As more money is saved, less money is spent, further decreasing aggregate demand. At this point, people's expectations regarding future inflation are also lowered and they begin to hoard money. Consumers have less incentive to spend money today when they can reasonably expect that their money will have more purchasing power tomorrow.

Deflation Changes Debt and Equity Financing

Deflation makes it less economical for governments, businesses, and consumers to use debt financing. However, deflation increases the economic power of savings-based equity financing.

From an investor's point of view, companies that accumulate large cash reserves or that have relatively little debt are more attractive under deflation. The opposite is true of highly indebted businesses with little cash holdings. Deflation also encourages rising yields and increases the necessary risk premium on securities.

The Bottom Line

Most of the world's central banks target modest levels of inflation, at around 2%–3% per year. Higher levels of inflation can be dangerous for an economy as it causes prices of goods to rise to quickly, sometime in excess of wage increases. By the same token, deflation can also be bad news for an economy, as people hoard cash instead of spending or investing with the expectation that prices will soon be even lower.

The FMA ADVISOR is published quarterly for the exclusive use by clients and associates of Financial Management Associates, LLC. The information herein was obtained from sources that we believe are reliable, but we do not guarantee its accuracy. Neither the information, nor any opinion expressed, constitutes a solicitation of the purchase or sale of any securities, commodities, or funds. Please note that past performance is no guarantee of future results.