

Price

pendulum swinging

towards deflation

An interest rate cut and lower prices for petrol and consumer goods are a welcome sign that inflation is well and truly under control. Yet this run of good news for Australian consumers is part of a global trend that is raising concerns that the price pendulum has swung too far.

Respected global economist Nouriel Roubini is one of many discussing the potential for deflation: "Simply put, we live in a world in which there is too much supply and too little demand. The result is persistent disinflationary, if not deflationary, pressure, despite aggressive monetary easing."

Falling inflation

Australian inflation fell to 1.7 per cent in 2014, or 2.2 per cent if you take the Reserve Bank's preferred measure of underlying inflation.

Prices were lower for petrol, clothing, computers, household appliances and furniture. This was surprising given that the Australian dollar fell sharply in the December quarter and many of these goods are imported.

There were also moves in the other direction, with price rises for childcare, education, insurance and

financial services. But the price falls for imported goods indicate that Australia is importing lower prices from overseas where inflation is very low and even negative in some countries.

So accustomed have we all become to complaints about the rising cost of living, it beggars belief that anyone could be concerned about cheaper goods. Yet persistent price falls can be bad news if shoppers and businesses stop spending in anticipation of lower prices ahead, creating the potential for deflation and recession.

What is deflation?

Deflation occurs when falling prices for goods and services drag the inflation rate below zero. As the table below shows, Europe and Ireland are already in this position despite the best efforts of central bankers to stimulate spending and inflation by cutting interest rates to close to zero.

Deflation increases the real value of money because you can buy more goods with the same amount of money. By the same token, it also increases the real value of debt.

Inflation	As at Dec 2014 (%)
Australia	1.70
Eurozone	-0.17
China	1.60
United States	0.76
Great Britain	0.55
Canada	1.47
Germany	0.19
Ireland	-0.30
Japan	2.38*

*November 2014
Source: global-rates.com



What causes it?

Deflation is relatively rare but when it does happen it is often at a time of technological change. For decades now rising speeds and falling costs of computing and the internet have been transforming the global economy and the pricing of goods.

Since the 1960s the price of one unit of computing power, measured by floating point operations per second, or FLOPS, has fallen from US\$8.3 trillion in today's money to US8c. This fuels productivity and cuts the cost of doing business.

Deflation can also be caused by a drop in demand for goods and services. This can be a symptom of high unemployment and falling wages which are exacerbated by technological disruption, forcing businesses to lower prices to entice people to buy their products.

Fighting deflation

Central banks generally cut interest rates as their first line of defence against deflation to stimulate growth and encourage people to spend now rather than waiting for prices to fall further.

But deflation is more difficult to fight than inflation because interest rates can only be cut to zero. That's why central banks in the US, Japan and now Europe have moved to the second line of defence by increasing money supply. Or in modern economic speak, quantitative easing.

While the US announced an end to easing last year, in January 2015 the European Central Bank launched a \$1.4 trillion bond-buying program.

Since the global financial crisis trillions of dollars have been injected into the global economy. But despite this and record low interest rates many developed economies are struggling to get inflation off the floor.

The hunt for yield

The recent move by the European Central Bank will make Australian shares and bonds more attractive to overseas investors, thanks to our falling dollar and relatively high interest rates.

While our cash rate is the lowest since 1958 and bond rates have also slipped, they are still significantly higher than the zero rates on offer in Europe and the US.

The hunt for yield is also likely to intensify for Australian investors in 2015. After the Reserve Bank's February cut in the cash rate to 2.25 per cent term deposits with maturity dates of under a year are paying less than three per cent.

As a result, investors who depend on income from their savings may decide to include more shares in their portfolios. Shares in the big four banks and blue chip stocks such as Telstra and Wesfarmers offer dividend yields, including franking credits, of between six and eight per cent.

While deflation is not a pressing issue for Australia, it is occurring in parts of Europe and this will have flow-on effects for global markets.

If you would like to discuss your investment strategy in the light of issues raised in this article please give us a call.

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