Deflation

As Ireland officially moves into deflation, *Consumer Choice* discusses the consumer impact of falling prices - both good and bad.

AT A **GLANCE**

CPI data.

Impact of deflation.

For the first time in almost 50 years, the annual rate of inflation in Ireland is falling. The Consumer Price Index (CPI), which measures the average level of prices paid for good and services, showed that prices fell by 1.7% in January alone. Economists are predicting that for 2009 as a whole, the deflation rate will end up somewhere between 3% and 4%.

The news that prices are falling is probably sweet music to the ears of most consumers, who for years have had to endure a constant rise in the cost of living. However, deflation is not all good. Falling prices have implications for consumers who save, invest, live on a pension or draw a salary, and not all of these people will end up deflationary winners.

CPI data

The CPI, which measures inflation rates, is made up of figures compiled for twelve groups of goods and services ranging from clothing and footwear to housing costs. Pricing takes place in 86 locations throughout Ireland, with over 500,000 price quotations collected from a fixed representative panel. Most prices are collected monthly. Over the past ten years, the average annual inflation rate in Ireland has been 3.4%.

So what is causing Ireland to be in deflation now? Well, going by statistics for the month of January, the most significant price changes were decreases in Clothing & Footwear (-13.2%) and Housing, Water, Electricity, Gas & Other Fuels (-7.0%). Much of the decrease in housing costs can be explained by falling mortgage bills caused by cuts in European Central Bank interest rates.

Prices have not been falling across the board though. Some of the categories that showed an overall increase in prices in January are Miscellaneous Goods & Services (+4.6%), Health (+2.8%) and Alcoholic Beverages & Tobacco (0.9%). However, overall prices fell by 1.7% in January, so assuming the trend continues, as is widely expected, what will be the real deflationary impacts on consumers?

Impact on savers

The deflationary impacts on savers are two-fold. On the one hand, interest rates are usually lower in a deflationary environment, which means savers tend to get a bad deal on their bank deposits. At the same time, the real return on savings interest is higher because the cost of goods and services is falling. So, if annual deflation is 3%, a savings account that is earning an annual interest rate of 4% is actually benefiting from a real rate of return of 7%.

Irish savers are better placed than most to take advantage of higher real returns in a deflationary environment. Many banks are trying to solve their liquidity problems by attracting savers' money with competitive interest rates. Anglo Irish Bank currently offers a rate of 3.5% (AER) on their six month and two year fixed accounts. There are is also an attractive regular saver rate to be had, with Anglo's Regular Saver Account paying 5.5% on monthly contributions of up to €1,000. These rates are significantly higher than the European Central Bank's base rate which at the time of writing is at a record low of 1%.

Impact on borrowers

In the main, deflation is not good news for borrowers. While a deflationary environment usually implies a low rate of interest on debts, prolonged bouts of deflation increase the debt burden on borrowers. Whereas inflation erodes the value of unpaid debts over time, deflation makes them more expensive in real terms.

Mortgage holders are probably the group of consumers who are most likely to be impacted by the effects of deflation. Even if the ECB were to set interest rates at zero, with deflation of 3%, consumers with mortgages would effectively be repaying their debt at a cost of this rate in real terms. When set against a backdrop of rapidly falling house prices, the problem of an increased debt burden is compounded. According to figures published by the Central Bank of Ireland, outstanding residential mortgage lending in Ireland is over €1.1 billion as at December 2008.

Impact on pensions

The deflationary impact on pensions depends on the kind of pension that is being drawn and also on any budgetary changes, if the pension is related to government welfare spending. Private pension holders, whose income is fixed, benefit in times of deflation because their purchasing power goes up while their income remains the same. However, private pensions that are linked to the consumer price index could see their income reduced to reflect the fall in the cost of living.

It's a similar story with the State Pension. Provided the State Pension remains fixed at current levels, recipients of both the contributory and non-contributory pensions will gain during a period of deflation. The State Pension has been increased in recent years to keep pace with inflation and rising earnings. In fact a target of a weekly payment of €300 by 2012 was a commitment made in The Agreed Programme for Government. However it remains to be seen if the government will keep this promise or even reduce the amount of the State Pension if a deflationary cycle takes hold in Ireland.

Impact on investors

Investors with investments in fixed rate vehicles that pay a set rate of interest, such as government bonds, benefit in the same way as fixed rate savers during periods of deflation. The real rate of return earned is that of the bond, plus the annual rate of deflation. Investors in corporate bonds too are likely to benefit from a higher real rate of return. However, in a deflationary environment, corporate bonds holders must also assume more risk, as the company is more likely to default on its debt.

Gold is generally another investment winner in times of deflation, as it tends to be seen as safer than other assets. You can invest in gold by buying a Perth Mint Certificate which allows investors to buy gold bullion stored in warehouse in Perth, Australia. For stock market investors, periods of deflation usually indicate lower sales and profits in the wider economy so shareholders tend to suffer falls in the value of their assets.

Impact on workers

While deflation means that the cost of living falls, both public and private sector workers could see falling rates of pay at the same time. When the rate of inflation is positive, unions and private employees are in a much stronger position to negotiate increases in pay. Without this, wage cuts are easier to implement so in this respect, deflation tends to have a negative impact on workers' pay.

Aside from employee-employer tensions, deflationary wage cuts can also perpetuate deflation itself. By reducing workers pay, less money is available to consumers which can make goods and services harder to sell. This can create downward pressure on prices which in turn can lead to deflationary spiral.

Report by Mark Channing CC

GLOSSARY

- **Inflation** Inflation is the rate at which the general level for goods and services is rising. An inflation rate of 2-3% is thought to be the must sustainable level for most countries. The inflation rate in Ireland has averaged 3.4% over the past ten years.
- **Disinflation** Disinflation refers to a slowdown in the inflation rate i.e. when inflation decreases, but still remains positive
- **Deflation** Deflation is when prices in general are falling. It can be caused by a reduction in the money supply or by a decrease in government, personal or investment spending.
- **Hyperinflation** Hyperinflation is a situation where inflation that has gone out of control. One of the most recent cases of hyperinflation occurred in Zimbabwe where at one point, the highest denomination of note was $100 trillion Zimbabwean dollars. This wouldn't have even bought a loaf of bread.
- **Stagflation** Stagflation refers to the combination of a stagnant growth and rising inflation. The last time there was significant stagflation was during the 1970s.

Useful contact

Central Statistics Office
Skehard Road
Cork
tel (021) 453 500
email
webmaster@cso.ie

Useful website

www.cso.ie

choice comment

It is generally agreed that a short period of deflation does little real economic damage. In fact in Ireland, where prices have increased so much over the last number of years, a bout of deflation is a welcome relief to many consumers. However, long periods of general price falls are damaging. Japan experienced protracted deflation in the 1990s when consumers postponed purchases as prices continued to fall. After all, what is the point of buying something today, when it can be bought for less tomorrow? The result was that employment and investment also fell, and deflation meant that people with already huge mortgages saw their mountain of debt grow bigger in real terms. The 1990s are referred to as Japan's 'lost decade'. Let's hope in ten years time we don't look back and say the same about Ireland.