



THE FINANCIAL PLANNING ASSOCIATION

of San Diego

HOME

PLANNER RESOURCES

SHOULD YOU WORRY ABOUT DEFLATION?

It's back!!! Well, at least talk about it is back.

The talk is about deflation, a general falling of prices instead of the far more common inflation, which has seen prices rise an average of three percent a year for the last 70 years.

Deflation is a word that only people over age 70 are intimately familiar with, having lived through the last time this country experienced real deflation, the Great Depression, when prices fell 25 percent in three years. But fears of deflation have surfaced periodically in recent years as the annual inflation rate fell below three and even two percent at times, and the specter of deflation is being raised again by such economic experts as Federal Reserve chairman Alan Greenspan. Should you worry about deflation? Is there something you should be doing with your personal finances to offset the potential impact of deflation?

First, it's difficult for most people to imagine that deflation is lurking around the corner. Aren't prices going up—especially big-ticket items like insurance, college and health care? Yes, but other prices are declining. In April, the producer price index, which measures prices at the wholesale level, including cars, energy and tobacco, fell a record 1.9 percent. The broad measure of retail prices for consumers, the Consumer Price Index, also fell 0.3 percent for the same month.

So what? Aren't falling prices a good deal? Like an economy-wide sale? Price cuts due to increased output per worker are good, but it's not so good when prices are falling because of companies cutting prices to combat decreased consumer demand. In a deflationary cycle, consumers are more apt to delay discretionary purchases in anticipation that prices will further decline. That, in turn, leads to a sluggish economy and layoffs and further reduced demand and more layoffs and—you get the picture. Japan over the past decade has been the poster child of the devastating effect of deflationary times.

While some experts worry about the U.S. economy sinking into a Japan-style malaise, most economists forecast, at worst, mild deflation—if it occurs at all. Still, predictions are always suspect, so what might you do at your personal financial level to brace yourself if deflation strikes?

One of the first steps is to reduce debt—something that's usually a good idea during any type of economic times, but is especially beneficial during deflation. That's because in deflationary times you're repaying debt with more valuable dollars—if you've got a job to repay debts with. And Americans currently have piled up a lot of debt.

Preparing for a possible job loss is another defensive step. The job market is tough enough right now, but it could look really bad in a deflationary period. The traditional advice would apply here: build an emergency account so you have cash reserves to pay the basic bills should you lose your job. Keep your job skills sharp and diversified. Establish a line of credit if you don't already have one, because you won't get one if you're unemployed. Establish a tight budget and look for ways to cut expenses without slashing critical items such as health insurance.

On the investing side, high-quality bonds and cash are considered good investments in deflationary times because they generally hold or increase in value. Stocks have done well during mild deflation, but generally not well during serious deflation. Real estate also suffers hard during deflationary times.

On the other hand, you should be investing for long-term goals—at least five to ten years away or more—so most financial planners don't recommend making major investment changes based on short-term trends. One thing to pay special attention to, however, is whether your 401(k) or similar retirement account is overloaded in company stock. Even in good times, many advisors recommend limiting company stock to a maximum of 10 to 20 percent of your total portfolio. But it's especially risky if the health of your company is in jeopardy should the economy sink into deflationary times. Then you risk suffering the double whammy of losing your job and significant value in your investment portfolio.

June 2003—This column is produced by the Chapter of the Financial Planning Association. We can be a continued resource for your personal finance coverage. If you use all or part of this column, please credit FPA or one of its Financial Planner Members.

CFP®, CERTIFIED FINANCIAL PLANNER and the federally registered CFP (with flame logo) are certification marks owned by Certified Financial Planner Board of Standards, Inc. These marks are awarded to individuals who successfully complete CFP Board's initial and ongoing certification requirements.