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## INFLATION, DEFLATION OR BOTH?

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Last year I visited Tokyo, during my academic sabbatical from teaching at York University. I was looking forward to technical discussions with research colleagues of mine, but I especially relished the chance to chat with ordinary Japanese about their personal finances. Japan is quite different from Canada on a number of levels and common folks face a number of unique challenges in managing their financial affairs. The Japanese live almost 5 years longer than retirees in the rest of the world, their stock market has been in a slump for over 20 years and they have been suffering from official **deflation** – as measured by the central Bank of Japan -- for the last decade. In contrast, here in Canada the Consumer Price Index (CPI) has actually increased by 17% in the last eight years alone. Hey, can you imagine declining prices for goods and services every single year for the last decade? You probably don't need to save as much for retirement, no?

But as I quickly learned, listening to these long-lived seniors, deflation isn't quite what it seems at first. While the Japanese economy has officially been experiencing deflation – a fall in the consumer price index (CPI) – there is a large segment of the population, and especially retirees whose **cost of living** continues to increase every single year. They complain bitterly that most things they need – like medical care, groceries and other living basics – increase every year.

Here is the problem in a nutshell. Inflation is measured by averaging thousands and thousands of individual numbers representing changes in prices from month to month. The methodology behind the construction of these indices could fill volumes of academic journals (actually, they do) but the bottom line is that they are averages. Averages, quite simply, imply that some items go up more than average and some go up less than average.

I had a great statistics professor at York University who used to joke that if you place one hand in scalding hot water and the other in freezing cold water, the average temperature of your hands would be just right. You are also in excruciating pain.

Now let's get back to inflation measurement. Some things are hot (got up by more than average) and some are cold (go up by less than inflation). But, what if the things you like to buy – or have to buy – are more likely to be the hot ones as opposed to the cold ones?

Technically speaking the falling prices of plasma screen TVs, laptops and cell phones are offsetting their groceries, nursing homes, medications, the costs of long-term care facilities.

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Here is a question for you: Does 95 year-old Mrs. Watanabe consume more of the former or the latter? You get the point.

One of the many byproducts of this fallacy of the averages phenomena is what has happened over the last two years with our American cousins. U.S. Social Security payments – which are equivalent to the Canadian Pension Plan (CPP) – are adjusted for inflation annually based on the change in the consumer price index. (The CPI-W, technically.) But, for the relevant period in 2009 and 2010 this index (average) did not increase, so retirees didn't get a raise. The caused no small riots in the nursing homes from Florida to Arizona and beyond. In fact, president Barak Obama proposed that every retiree get a \$250 check to make-up for the lack of inflation adjustment.

Here is another example closer to home. In Canada, while the inflation rate was 1.9% during the 12 months ending in September 2010, the inflation rate in Ontario was closer to 3% while the number in Manitoba was closer to 1%. In fact, I suspect that Toronto's inflation rate is higher than 3%

*Bottom line: beware of averages.*

Some of you might be dismissive of 1% to 2% differences, but even a very small inflation rate can have a disproportionate impact on the purchasing power of money over long periods of retirement. The enclosed table should give you a sense of what a 2% or 3% inflation rate can do to your purchasing power over the 20 to 25 years of an average retirement and beyond.

<b>Question: What Will \$1,000 Really Buy You....</b>					
<b>Assuming an Annual Inflation Rate of ...</b>					
<b>In Year #</b>	<b>0%</b>	<b>1%</b>	<b>2%</b>	<b>4%</b>	
10	\$ 1,000	\$ 905	\$ 820	\$ 676	
15	\$ 1,000	\$ 861	\$ 743	\$ 555	
20	\$ 1,000	\$ 820	\$ 673	\$ 456	
25	\$ 1,000	\$ 780	\$ 610	\$ 375	
30	\$ 1,000	\$ 742	\$ 552	\$ 308	
35	\$ 1,000	\$ 706	\$ 500	\$ 253	

If you are receiving \$1,000 per month in coupons on a bond, or in pension income that is not adjusted each year for inflation, then it will buy you \$1000 worth of goods and services 10 years, 20 years and 35 years into retirement – assuming no inflation.

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But, if we experience a 2% inflation rate for a 25 year period, which is pretty much what we are getting now, the purchasing power of your \$1,000 decays to a mere \$610. You go to a store with a cheque that says \$1,000 and you can only purchase \$610 worth of groceries. Where did the other \$390 go? That's inflation. And, if inflation averages 4% per year, your purchasing power is reduced to almost \$375.

Considering the fact that the average length of retirement is 20 years, and a substantial fraction might spend 25 or 30 years in retirement you simply can't afford to ignore inflation and its quirky calculations.

*Ok. So, what should you do about it?*

First of all, and this might be obvious, make sure you understand the difference between nominal and real income. If you are being a promised or guaranteed \$1,000 of income per week, or month or year, the purchasing power will most certainly erode.

On a more general level, Canadians approaching retirement should budget for an increasing personal inflation rate, even if the population-average inflation rate is flat or negative. Note that I am not necessarily saying that you will be spending more each year of retirement. That's another debate. What I am saying is that the things you will be spending on will likely go-up by more than inflation. Remember that even if the gap is 1% -- between your inflation rate and the population inflation rate -- it can make a big difference over time.

Finally, be proactive. The investments you hold should produce real, tangible income returns. This would include commercial and residential property, corporate equities, common stocks, and anything else that is a part of the real economy. These assets do not promise a smooth and bumpy-free ride, but at least you're headed in the right direction.

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