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Understanding Deflation August 2010

A current source of concern for economists (who are often fortune tellers in business suits) is the threat of deflationary spiral, and for good reason. Like most economic principals, deflation spiral is a concept that is difficult for the average person to understand.

According to Wikipedia (yes I know that academics cringe when people source Wikipedia), a deflationary spiral is a situation where decreases in price lead to lower production, which in turn leads to lower wages, which leads to further decreases in prices. Let me try to give you an example. Macy's sales are down due to the recession. In an effort to increase sales, Macy's reduces prices. In order to still be profitable at reduced prices, Macy's is forced to reduce its workforce. These workers now have less money to spend, forcing Macy's to cut prices even further to generate sales. Multiply this example across the entire economy and you start having real problems. While the idea of falling prices may sound good, it is critical to remember that when a business cuts prices, they must cut expenses somewhere else (i.e. labor).

Due to many factors (primarily too much government involvement in business) Japan has been suffering from a deflationary spiral for more than 20 years. The last incident of deflation in the United States was in 1930 and it lasted for three years.

Is deflation a threat to the United States right now? While I don't have a crystal ball (there is no shame in this as neither does anyone else), there are many current indicators of inflation. Here are just a few examples over the last 12 months:

The Consumer Price Index (CPI) is up 1.1%

The Producers Price Index (the inflation number used by pros) is up 2.8%

Crude Material prices are up 30.4%

Real weekly earnings for all private-sector workers are up 1.5%

Will there be inflation or deflation in the near future? I don't know, but neither does anybody else. Are we currently experiencing inflation? Yes. Is this entire discussion outside the realm of things we can predict or control and as such has no place in one's financial plan? Yes. Let us continue to focus on only those things that matter, like how you will maintain dignity and independence in the 30th year of your retirement.

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