[youtube:http://www.youtube.com/watch?v=9VbUjytvXrU auto]Video recorded June 2008 - but article below written March 2009 - highly relevant 14 years later as one of the factors which led to inflationary spike - because banks had such a fear of inflation during COVID pandemic, that they erred on the side of over-stimulation.

I **have in my pocket a $10 trillion dollar bill** – printed in Zimbabwe just a few weeks ago, but when I was there it was not enough to buy even half a loaf of bread. The country has been hit by inflation running at around 1 billion % a year. In January 2009, the people decided enough was enough. Teachers, doctors and nurses went on strike, shops stopped accepting the currency, and the government started to allow people to trade in US dollars and South African Rand. By March the situation was already stabilising. The Zimbabwe experience puts the global economic crisis into context.

I'm a Futurist, an advisor to many of the world's largest banks on global trends, and a keynote speaker at many of their most important events.

**At a time of global fears about inflation (last year) and deflation (this year) it is good to take a big step back and look at the wider picture, why life will continue relatively unchanged for most people, why we are likely to see inflation become a major problem again, and why we are likely to see political instability in some nations, and even fall of governments.**

Governments in countries like the UK have been chasing an inflation rate of just 2% - which I have argued for some time in my book Futurewise has been too low. Why? Because history shows us that things happen which shock the system, causing a rise or fall of inflation by more than 2%: those shocks can be inflationary (eg war and interruption of oil supply) or deflationary (eg credit crisis).

It is hard to manage inflation rates in a narrow range over a long period, because actions taken can take a year or more to work, and their impact is always uncertain. So chasing a 2% rate will always carry a risk that from time to time a country may head into negative inflation – or deflation. And of course that is precisely what is happening now.

## Why Deflation Matters

Deflation matters because most people don't understand it, and that is because all the normal rules of finance go into reverse. People start taking actions which are the wrong ones, and the economy can easily grind to a halt.

Take for example, who pays what on a loan.

Most people understand that if you borrow money, you need to pay interest every month for that service – and that is true in “normal” times when there is inflation. But in serious DEFLATION, borrowers need to RECEIVE interest. In serious DEFLATION, savers need to PAY interest. The interest rate is formed of three elements:

**1) SERVICE:** The bank needs to pay the people that arranged the loan, advertised it, collect interest, pay the office rent, make a profit and so on.

**2) RISK:** Some loans never get repaid, and those losses have to be met from extra payments loaded onto all the other loans that do get repaid. So an extra amount of interest is added to every loan to cover risk. The higher the risks of non-payment, the higher the interest rate needs to be – to make things as fair as possible to other borrowers. One element of the sub-prime crisis was failure to price risks accurately of lending to people on low incomes, with very amounts of their own money in the property.

**3) CHANGES IN MONEY VALUE:** If I borrow $100 from you this year and give it back to you in 12 months, there may be a problem. If prices are rising by 10% a year, by the time you get your money back, the $100 will only buy 90% of what you would have been able to buy before. So why would you lend me the money? At the very least you are going to want me to pay you 10% interest so that when you count what you have a year later ($110) it is still able to buy what the original $100 did before. So in order to get people to lend money, you usually have to offer a rate of interest on their savings that is close to (preferably above) the rate of inflation.

So we add together: the SERVICE costs of the mortgage service itself, the cost of the RISK, and the CHANGES IN MONEY VALUE.

If the inflation rate is – say – 2%, then the SERVICE COST might be 1%, RISK cost 0.5% and CHANGES IN MONEY VALUE 2%. If you are lucky and considered “low risk” you might therefore be able in theory to get a home loan for around 3.5%. Or if market conditions are tough, it might be as high as 6 or 7%. It all depends where the money is being borrowed from, and what interest rate the bank has to offer to tempt those people or organisations to lend to the bank (make deposits).

## Big Deflation - banks pay interest on loans, customers on deposits

But now think about what happens in DEFLATION. Imagine prices are falling at 20%, year on year for several years (very unlikely, but it is easier to see the principle of what happens, using larger numbers). You lend me $100. After a year, when I give it back to you, everything you want to buy is a lot heaper than it was. The $100 I hand back is worth a lot more than when you lent it to me. So I have lost out. If I had kept the $100 in cash hidden away, it would have grown in what it can buy by $20, just sitting there, not even in a bank.
So if I borrow money from the bank, I should expect that bank to pay ME. Not the other way round.

That means if you have a home loan of $100,000, the bank should be putting money into your account every month as a thank you for being so kind as to borrow money off them.

**1) SERVICE:** In deflationary times the bank still needs to pay the people that arranged it, advertised it, collect interest and so on.

**2) RISK:** When prices fall across the whole economy by 20% a year, then at first there are huge risks to the bank that people may not pay their monthly interest, and walk away, leaving them with a low value asset to sell to try to pay off the loan. But there is a complication....

**3) CHANGES IN MONEY VALUE:** If I borrow $100 from you when there is 20% deflation, then by the time you get your money back, the $100 will buy 20% more than what you would have been able to buy before. It is going to cost me 20% more to give you your money back. Plus any interest or charges on the loan to cover SERVICE and RISK. It could be that the interest on the loan is “only” 2-3%, but that actual cost to me is that amount plus the 20% to cover 20% deflation.

So if deflation is running at 20%, I would expect the cost of the loan to be around 16% PAID TO ME FROM THE BANK, not the other way round. The bank is compensating me for the cost of holding an asset, which is falling in value. At this point there is a new risk: to me as the borrower, that the bank stops paying out each month. I am then as a borrower left with an amount owing to the bank which is growing in value every year by 20%, and an asset (home) whose value is falling rapidly towards zero. A scary situation. If the borrower walks away, the bank ends up with no capital back, and a worthless asset.

Most people find these things hard to understand.

## Impact on pensions of inflation and deflation

Another example is pensions. People often say that inflation is bad for pensioners because their capital is wiped out. And then when deflation comes they say it is bad for pensioners because their income falls to zero. But you cannot have it both ways. What then is the optimum inflation rate for pensioners?

**Answer:** inflation or deflation rates can be irrelevant SO LONG AS the return they get on their investments reflects the situation.

Any pensioner that has an index-linked pension is unaffected by inflation as the rate of price increases is matched by increases in what they receive. Pensioners that rely on interest from savings are in a different situation. They need to receive a rate of interest that is higher than inflation, and spend only the extra if possible.

So if inflation is at 5%, and they receive 7% after tax, they need to reinvest 5% of the value of their capital to keep their savings the same in real value year by year, and only spend 2%. In practice they are unlikely to get 2% more than inflation, after paying tax, either from cash in the bank, or from government bonds. They may do better in the longer term in the stock market (albeit with major risks).

In deflationary times, interest on their money may be zero but all is not lost. Their capital is growing in value as prices fall, so they should be able to spend a little capital each year while still keeping the actual buying power the same of what they have left. They just need to hope the bank does not start charging them high rates of reverse interest for the privilege of looking after their money.  An alternative is to invest the cash in an asset which the pensioner hopes will gain in value, even if only by 1 or 2% compared to cash.

## How deflation kills consumer spending

There is another problem: when prices are rising every week, people think that it is a good idea to buy quickly before things get more expensive. But if prices are falling, people start to think it is a good idea to put of buying things for a while. And if a whole nation does that, the economy stops dead. People lose jobs, business closes, there is less money in the economy generally, demand falls, prices fall some more, and round we go again.

Japan had a prolonged period of deflation in the 1990s and then a very slow recovery which took more than a decade, only to be hit again recently, and many governments are scared that the same may now happen to many other nations, all at the same time.

## How deflation kills banks

Deflation is a real risk for people who lend money secured against the value of assets. In deflation, the assets are worth less, and the risk grows to the lender in a way which is hard to forecast. Every time prices fall, the bank has to look again at whether it is safe to go on lending or whether they need to stop for a while to build up some more assets. We have seen that banks can take many months to recalculate these liabilities, especially if they have bought or sold packages of mortgages from other banks.

But if they stop lending, prices fall some more, and around we go again. We see this in lending for people to buy homes, or to run their business.

## Winners in the current crisis

1) Those with cash in the bank will find huge opportunities in the current crisis – as assets come up for sale at a real bargain price (business, land, property and other things).

2) Those with large loans on rates which are fixed to government rates will enjoy huge cost reductions.

3) Those who work for government, who are locked into regular salary increases for the next year or two will do well – secure jobs, more income, falling costs.

## Losers in the current crisis

1) Those who run out of cash and borrowing power, with hardly any value left in their assets, who could lose everything they have worked for over the years

2) Those with large loans, locked into high fixed rates for several years

3) Those who work in the private sector, who may be faced with falling income or loss of job

## And the future? High inflation again

One thing is certain. Never before in the history of the earth has so much money been poured by governments into stimulating their own economies. Their aim is to get the economy going again, stabilise prices, prevent uncontrolled deflation, and restore job growth. But in our globalised world it is even harder than before to predict what the impact will be. How can you keep the stimulus within your own nation? How can you prevent funds wandering into other

economies? The answer is that you cannot do so. Our world is locked into a single complex economic structure of structures.

Most economic actions take at least a year before you see full impact, yet governments are announcing new steps almost every day.

When your house is on fire, you don't stop hosing water, the moment you hope the flames are dying down. When you are scared of deflation, you are likely to overdo things to be on the safe side.

It is hard to imagine that our world will gently recover to a point of perfect economic balance, which in US and EU would be around the arbitrary figure of 2% inflation.

Far more likely is that a rebound will come with a vengeance, as in almost every other recovery, with overshooting, overexcitement in the markets, high inflation, high share prices, high house prices – and then high interest rates, governments grabbing money back out of the economy with high taxation, and reversing previous stimulation in other ways. Leading to...... another crash of course.

The only real question is by when.

So we should be ready for more unstable times, which could last at least another decade.

## And the lesson from Zimbabwe?

And the lesson from the $10 trillion note in Zimbabwe? Life does (eventually) go on. Despite huge hardships and pain. Most people do survive against all odds, even if they have less materially than they might have hoped. Zimbabwe also had to cope with a terrible drought and political instability. But as I have seen with my own eyes just last week, even in the poorest and remote rural areas, for most people, most days, life carries on. I say that to give us hope in the current global downturn.

The world has not come to an end. If an economy shrinks by 3% or 5% in a year, it just resets to what life was like in that nation, on balance, maybe just 3 years ago or less. Most people will still be in work. Most jobs still need to be done. People in developed nations will have less to spend on things like cars, washing machines and sofas – things which probably don't really need replacing for another year or two, if mended. They may eat more simply, do more jobs themselves, and actually have more spare time. They may even be happier. There is a very poor correlation between household income and happiness, as many studies show – see Happynomics
.

Just think back to what life was like when you were a child. And compare to the life that children live today. A step back by a few years may hardly be a disaster. Of course, this is an average picture, and the axe falls very unfairly and unevenly. For a family to lose one or both incomes is a real crisis with huge impact on everyone. Losing a home through repossession is very traumatic. For someone about to retire to find they have lost almost all their life savings is a disaster that will affect them until the day they die.

Yes we live in a time of great (unequal) suffering. But the greatest inequalities are not usually between those in places like London or New York in work or out of work, but between all those in places like Europe and the great majority of the rest of the world who live on less than $5 a day, of which hundreds of millions live in simple mud and thatch huts in Africa, or in urban slums in Asia. As I say, we need to see the big picture.

Expect tensions to grow in many nations, and between nations, between those who are wealthy and those who are not, with political crises, demonstrations and in some cases fall of governments.