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Business Solutions

## Stash your cash?

**Inflation - the guaranteed way to erode your wealth**

Imagine if the prices of bread, bananas, eggs and petrol increased more than 1,000 times a year?

You'd be paying \$4,000 for a loaf of bread, \$5,000 for a dozen eggs, \$2,000 for a kilo of bananas, not to mention almost \$2,500 for a litre for petrol!

You would have to take a supermarket trolley to the shops just to carry your cash! Now, imagine how you would cope if you were a school teacher or a sales executive and your salary had not increased in line with increasing prices.

This may sound far fetched, but it's exactly what has been happening to the people of Robert Mugabe's Zimbabwe where inflation runs at over 1 million per cent a year. It also happened in Germany in the early 1920s, when prices famously increased by more than thirty thousand percent in one month! <sup>1</sup>

Inflation on this scale, called hyperinflation, usually has a very simple cause – faced with an economy in ruins, the government simply prints more money. This currency pays the army and the public service bills, but with no real assets to back the money, it loses all value and becomes worthless paper. A dollar is suddenly and literally not worth a cent and prices rise accordingly.

However, it would be a mistake to think inflation is only a problem for third world countries with bankrupt economies. Inflation, best described as a decline in the real value of money or a loss of purchasing power, is present in every free market economy, even in relatively good times. Think about it - prices tend to go up, not down and when they go up, the purchasing power of the money in your pocket decreases. Only a totalitarian government that freezes prices artificially can keep inflation close to zero.

In Australia, our Reserve Bank (RBA) has a stated policy of adjusting interest rates in order to restrict inflation to between 2% – 3% a year. That's as low as it is likely to get in a free market economy, unless of course a severe recession hits the economy causing deflation (the opposite of inflation). We'll discuss the deflationary forces buffeting the world economy in a moment, but today Australia's inflation rate looks pretty good. In June last year, the official inflation rate in Australia crept up to a not so good 4.5% boosted by huge increases in the price of petrol.<sup>2</sup> You may remember Wayne Swan talking about the 'inflation genie' escaping from the bottle, and the RBA increasing interest rates until August last year to curb inflation and force it back towards the target band. Since then, the price of crude oil has dropped, the global financial crisis has sapped consumer spending and economists once again expect inflation to sit between 2% - 3%. Other countries are not so lucky.

Snapshot

# Snapshot



They have been more seriously affected by the financial crisis and fear a more severe economic slow down causing deflation.

But what about deflation? On the surface it seems like a good concept. After all, who wouldn't want 'lower prices' everyday? Unfortunately, deflation has a nasty side-effect on consumer debt (household mortgages, personal loans and credit cards) as well as government and company debt – it increases it in real terms! So while inflation slowly erodes wealth by diminishing its purchasing power, deflation erodes wealth by effectively increasing the value of existing debts! In the United States and the United Kingdom, house prices have fallen by 10% -26%, unemployment is rising and demand for goods and services has dropped sharply in the face of the biggest downturn since the 1930's.<sup>3</sup> This has led to the prospect of deflation. In response, both countries are increasing the supply of money through greatly reduced interest rates and government handouts. While this is similar to what Mugabe did in Zimbabwe, there is one important difference - the USA and UK have real economies and real assets backing the money, and are capable of being 'inflated' out of their troubles. Of course, this strategy may result in inflation becoming a future problem. How big a problem will depend upon how well central banks and governments navigate the crisis.

Let's be clear, inflation will still be an issue for Australians over the next 20 years. Inflation is the main reason why fixed interest investments have traditionally never been too popular with sophisticated investors who understand its effect.

If you invest \$100 for 12 months in a fixed deposit account at 10% per annum, you are guaranteed to receive \$110 back at the end of that year, right? Well no, not quite. If the inflation rate is 5% per annum, the buying power of your hundred dollars worth of capital would be worth \$95 in a year's time and your \$10 interest would be worth around \$9.50. In other words, inflation has stolen around \$5.50 from you.

In reality, assuming an interest rate of around 7% per annum and inflation of 4.5% per annum the value of your money is actually only increasing by around 2.5% per annum after inflation has taken its toll. On top of that, these earnings are likely to be taxed!

This is precisely why long-term investors generally prefer the share market. Despite the volatility of share investments, they have the potential to increase in value over time, as well as the benefit of earning tax-free or tax advantaged franked dividends. We cannot forecast the future, but historically, the long term average return of Australian share investments has exceeded the rate of inflation by about 8% p.a.<sup>4</sup>

This may be cold comfort at the current time, but it is nevertheless one of the truths of investing. Bank fixed deposits may be a more secure place to stash cash, but they can be a poor way to protect your capital against the eroding effects of inflation.

1. Globe Asia August 2008

2. rba.gov.au

3. [http://www.straitstimes.com/Breaking%2BNews/Money/Story/STIStory\\_356334.html](http://www.straitstimes.com/Breaking%2BNews/Money/Story/STIStory_356334.html)house

<http://www.reuters.com/article/domesticNews/idUSTRE52J3GA20090320> Datastream 2008

4. <http://www.australianunity.com.au/au/finplanning/pdfs/Fact%20Sheet%20What%20is%20Investment%20Risk.pdf>

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