Quant Perspectives

Monetary Policy Risk? Deflation!

Actions of central banks and governments could well lead to deflation (rather than inflation), and that's a possibility for which risk managers need to be prepared.

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Whenever one reads of global central bank activities beginning in 2008, one always finds the word "unprecedented." We continue to live through an "unprecedented experiment" in which central banks relentlessly print money to buy government and other debt securities to push the base money supply higher.

The Federal Reserve in the U.S. has more than quadrupled its balance sheet since 2007, and is fearful even of *reducing the rate of increase* of its asset growth. The reserve requirement for *Eurozone* banks is a minuscule 1% of liabilities and the European Central Bank must stillf impose a negative interest rate on bank reserves to encourage more lending. One could launch a National Security Agency (NSA) data-gathering drone that would hear G-20 central bankers targeting and wishing for positive inflation along the entire global circumnavigation route.

There's huge risk here! Stated less emotionally, there is great uncertainty of outcome - and that is precisely what "risk" is. Evidently, the central bankers hope that global economies will soon show strong growth to permit them to whittle down the balance sheets and restore interest rates to pre-Crisis levels over the next five years or so.

Inflation, however, could explode - or at least go trotting away from us faster than we can run to catch it. Of the several glaring weaknesses of fiat money, one is the illusion of control. The central bankers believe they have ultimate control over inflation, but such is not the case.

Individual investors have fretted for years over the ultra-low bond yields and prospects for runaway inflation. Arguably, the citizens at greatest risk are those nearing retirement who plan to live on the income of financial assets and pension annuities. High inflation would decimate such plans. Hence, these individual investors hedge with non-monetary assets (such as gold) that, of course, exacerbate the "low yield" problem.

Inflation ... or Deflation?

What, if anything, should financial risk managers of banks and other corporate entities be thinking and doing right now? Will such businesses suffer in a world of persistent, unbridled inflation?

As it happens, corporations are, relative to pensioners, fairly immune to inflation. The corporate structure itself is a natural hedge. Debt liabilities will lose value during inflationary years, and that's good for the debt *issuers.*

To the extent that a corporate's balance sheet holds a mix of financial and non-financial assets, the fall in asset value may match or be less than the drop in debt value. Further unlike the pensioners' fixed revenue, both the revenue and the expenses of businesses tend to "float" with inflation.

Professional risk managers, therefore, need not dread the onset of inflation. The corporate risk challenge is *deflation*! In deflation, the debt liabilities *gain* value. The assets of a non-financial corporate will likely "underperform the debt" in terms of the reaction to inflation.

While banks own predominantly financial assets that nominally appreciate during deflation, the corporate loans among such assets will fall in credit quality. In addition, the "floating" aspect of income statement expenses can be sticky on the deflationary side. For example, societies tend not to accept workers' wage reductions as a reasonable consequence of deflation.

One alternative wage reduction action is to slash headcount, with the obvious disadvantage of reducing capacity. Perhaps it's best for all employees (not just those in the financial sector) to have a variable "bonus" component to compensation that can move higher or lower with inflation and deflation, respectively.

The Asset-Liability Balancing Question

We began this article noting all the inflationary measures of central bankers since 2008. But the primary observations are "unprecedented" actions and a "highly uncertain" environment. It is entirely possible that the future will follow a deflationary, rather than inflationary, path. Continued bank losses and several bank reform proposals could curtail lending and the money supply, triggering prolonged deflation.

Should corporates, then, hedge or otherwise prepare for possible deflation? Our view is that executive management should make the deliberate choice. Just as a financial firm would match asset-liability interest rate risk, it is also feasible to match asset-liability *deflation* risk.

Consider a large homebuilder leveraged with financial debt while holding (non-financial) real estate assets. As it stands, this balance sheet is highly mis-matched in its deflation risk. To improve the match and reduce risk, this company could short a real estate or other non-financial asset in appropriate size.

The U.S. has not experienced a deflationary two-year period since the Great Depression of the 1930s. Likely for this reason, corporate risk managers may not often think in terms of asset-liability balancing for deflation. Let's not forget, though, that the absence of national *home price depreciation* since the Depression was a comforting thought in the years before 2008.

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