Databases selected: ProQuest Newspapers, ProQuest Central

Money: Inflation or deflation? If you think the direction's down ...

Anonymous. **The Guardian**. London (UK): Mar 28, 2009. pg. 6

Abstract (Summary)
If you believe the UK economy is set for Japanese-style long-term deflation, locking away savings in fixed-rate bonds is the way to go. Nationwide offers a fixed 4.15% return on its five-year bonds, a good rate in the current climate but which might prove a fabulous one. If inflation falls to -3% and stays there for several years, the decision to save at such a rate would fall into a "greatest financial decisions" category. However, if you believe we are due a shorter period of deflation, and a big jump in interest rates when inflation returns, a different strategy is required.

First Direct has one of the best tracker mortgages on the market at 2.39% above Bank of England base rate for life, giving a current pay rate of 2.89%. But, as London & Country's David Hollingworth points out, while that might look like a brilliant rate right now it's not going to look so good if the base rate is 5%. That deal's pay rate would be 7.39%.

"The world has changed. Yet most economic advice, and financial and investment advice, assumes inflation is here for ever. Everyone needs to accept that deflation matters more than inflation. If you plan for deflation, you won't be caught out. Deflation makes fixed-income more valuable. If you plan, instead, for inflation, you will be disappointed. Only gilts do well in a deflationary environment," he adds.

Full Text (869 words)

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Savings

Buy Nationwide five-year bonds, 4.15%

If you believe the UK economy is set for Japanese-style long-term deflation, locking away savings in fixed-rate bonds is the way to go. Nationwide offers a fixed 4.15% return on its five-year bonds, a good rate in the current climate but which might prove a fabulous one. If inflation falls to -3% and stays there for several years, the decision to save at such a rate would fall into a "greatest financial decisions" category. However, if you believe we are due a shorter period of deflation, and a big jump in interest rates when inflation returns, a different strategy is required.

ICICI Bank will let you lock away your money for one year at 3.9% or two years at 4.1%. The India-owned bank is 100% protected by the UK's financial compensation scheme up to pounds 50,000. If you have a minimum pounds 10,000 cash, Close Brothers this week launched a two-year, fixed-rate bond paying 4.3%.

Anyone riding out two years of falling prices, and the zero interest rates that would surely follow, would be very happy as their savings earned more than 4% - particularly if rates start rising quickly from 2011, allowing them to then jump ship and redeploy their significantly enhanced reserves.

Mortgages

Buy First Direct tracker, at 2.39% above Bank of England base rate

If deflation takes hold, interest rates will probably remain ultra low, so you don't want to fix at a high rate. Instead, those looking for a new home loan might want a deal that tracks the Bank of England base rate.

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Investments

Buy M&G Gilt and Fixed Interest, Allianz Pimco Gilt Yield

The winners from deflation will be government bonds, assuming the government does not default on payments, or the bonds of top-quality, recession-proof companies. These pay a set interest, which will be worth more at a time when prices are falling. You can buy gilts direct or through a fund, such as Allianz Pimco Gilt Yield (up 14.5% over the past year) or M&G Gilt and Fixed Interest (up 11%). Find details of these funds on trustnet.co.uk.

Investment adviser David Kauders of Kauders Portfolio Management (gilt.co.uk) has for years warned about an impending bear market, and believes it has far to go. Capital destruction in stock markets, falling house prices and job losses will knock inflation on the head, and the only place to preserve your capital is in gilts, he says.

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Property won't bail you out. Huge mortgages will remain a growing burden on those who took them out, paticularly as companies impose pay freezes. Meanwhile, prospective buyers will defer purchases in anticipation of lower prices, which will in itself hasten the deflationary spiral.

Pensions

Buy State pension, AVCs

Pensioners dependent on state handouts could be the unlikely winners from deflation. State pensions change at the start of each tax year on 6 April, and the increase is based on the RPI the previous September. Last year, that was at a relatively high 5% rather than this week's zero rate. So the basic state pension will rise from pounds 90.70 to pounds 95.25 for a single person.

Even if deflation continues, and prices start falling year in, year out, pensioners are protected. The government is committed to increasing the state pension by RPI or 2.5% a year, whichever is higher. So if prices remain static over the coming year, and most workers suffer pay freezes or pay cuts, pensioners will enjoy an increase in the basic state pension from pounds 95.25 to around pounds 97.65 in 2010.

But those who took inflation-linked annuities could find their income falling if inflation turns negative. Annuities from Prudential and Standard Life could fall, while those from Norwich Union and L&G will not decrease, but then will not rise until RPI has reached its previous level. AXA policies are under review.

Many people with final-salary pensions are protected from deflation. Most schemes were set up in the days when inflation was common and offer annual minimum increases in benefits, often 3%, regardless of RPI.

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But for younger workers saving into a pension, deflation is likely to be bad news. It tends to hurt equities, in which pensions are invested. Not only might workers suffer pay cuts, they may also be asked to pay more into their pension via additional voluntary contributions (AVCs) - with no guarantees as to how much they will pay out.

[Illustration]
Caption: article-28MonDeflation.1