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The specter of inflation: Good or bad for real estate?

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The other day, a friend asked whether I was looking forward to inflation, as it would certainly improve real estate values for owners. An odd question, I thought, but I agreed inflation is coming; it's just a matter of when. I thought about whether a real estate person would be happy with inflation. I knew the issue was complicated, and there were various points of views, so I decided it needed a little research.

First, a few general concepts and definitions: "Inflation" is defined as a rise in general level of prices of goods and services. When general price rises, money obviously buys fewer goods and services. Consequently, inflation also is an erosion in purchasing power of money. Economists also agree that high rates of inflation, and hyper-inflation which is inflation in the extreme, are often accompanied by growth of the money supply. Typically, when there is inflation, there is growth in the economy.

"Stagflation," on the other hand, is not so good. It is the situation when both the inflation rates and the unemployment rates are persistently high, a decoupling of the traditional inflation process. In other words, under stagflation, prices are rising, but people do not have the income to pay for it, because the economy is flat. So, while some inflation may be good for real estate, stagflation is clearly not.

This differentiation between inflation and stagflation highlights the first question about whether inflation is good for real estate. Inflation can be workable, and sometimes very beneficial to real estate. This is when prices are increasing (good for sellers), and there are buyers with money to pay increased prices. It's when all factors of inflation are rising in sync. However, if decoupled, i.e. no wage increases or growth in employment, we have rising prices with nobody to pay. This is clearly not good for real estate, because the cost of building ownership and operation is increasing, while rent (demand) is flat.

The next part of the "is inflation good" question is the issue of costs of money. Clearly inflation is good for borrowers, if there are locked in a low rate of financing. As interest rates go up, they make lower payments than the overall market, improving their cash flow, and are ultimately paying with inflated or dollars, worth less than when they borrowed them. If, on the other hand, their borrowing rates were floating, the rates would typically keep pace with inflation, creating a neutral situation. It is no better or worse than before.

Where rates have been relatively fixed or low, and pre-financing is required, it is difficult to refinance into a higher interest rate market. The original pro forma on which the building was purchased is no longer relevant. We have all read that this is the current situation, where many properties bought four or five years ago, near the peak of the market, have low fixed interest rates. Now, the properties are worth less, the loans are due, and the rates are higher. This will indeed be difficult for real estate owners.

My final variable on the inflation question is supply of real estate. If there is excess supply, inflation of building costs and values will typically not help real estate owners. With excess supply, buyers and renters have options. In residential real estate, for example, inflation in the New York City area, or Boston, or San Francisco may have beneficial impact on real estate owners. However, in areas in the southeast and southwest, where clearly there is excess supply, overall inflation in the economy will not help owners or sellers. There must be constrained supply in order for inflation to be beneficial to real estate.

I'm now ready to answer my friend's question. I'm going to say that modest inflation is good for real estate. People should buy it as hedge, as hard assets in times of uncertainty. But it doesn't work everywhere, for everyone. There has to be a strong economy, and people working and improving their wages, to keep up with inflation. Otherwise, no one will be there to pay the inflated prices.

So, bring it on, but bring on the jobs to go with it.

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