Inflation: Good, bad or ugly for real estate? Part 1

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Much has been said about impending inflation recently, by politicians, banks, economists, and the Federal Reserve. Generally speaking, many feel that it is coming, well, because, people just think that it has been due for a long time. But the Fed has waged a successful war against it to date. Specifically, as we know, the Federal Reserve has stated that it will keep interest rates low through 2013 by whatever means it has at hand. When the lid comes off, and interest rates are allowed to rise, inflation will theoretically accelerate.

There are good reasons to think this way, other than "it's overdue." Government has been stimulating the economy with real money being given, or loaned, at low interest rates, effectively by borrowing money from China (a classic example) other countries, or even ourselves (we own 40% or $1.665 trillion of our own debt) through the sale of government backed bonds. Essentially, but not actually, we have been printing money to flood the market with stimulus. At some point, the flood of dollars has to have a devaluatative effect, thereby inflating the price of goods. Thus our actions become an erosion of purchasing power.

But how bad is inflation? And how bad or good is it for real estate? The answer is, it depends. It depends upon which position you play in the real estate game. Essentially, inflation can be positive or negative to various players, all at the same time. It depends on whether:

* You are a debtor or a creditor. If you owe money at a fixed rate, you can pay it back in the future with cheap dollars. In other words, the same payment you make now will be the same a few years from now, but the payment is worth less. (think present value calculation) Thus, inflation is bad for creditors, and it is often said that the Fed's job is to protect creditors, i.e. banks which have loaned money.

* Thus, it is bad for banks that have lent on a fixed rate basis, but bad for borrowers who have borrowed on a floating rate basis. If, for example, the loan rate is 6%, and inflation is 3%, the real rate of return to the lender is 3%.

* It is bad if an individual is on fixed income, since rising prices make things unaffordable. However, where there is wage inflation as well, the price inflation can be a wash.

* It is bad for the economy typically, because in anticipation of inflation, investors might buy gold, or some similar commodity, a typical hedge against inflation. In buying gold, they have put their dollars into non-productive resources, at opposed to businesses which could grow the economy, thus further destroying growth.

* Finally, inflation at a few percent, can potentially lead to hyper inflation, loosely defined as inflation out of control. This has occurred occasionally in history, such as post World War II Europe, where certain European currencies became virtually worthless.

From our real estate perspective, building owners can do very well in an inflationary environment. They own hard assets which typically hedge against inflation, in other words rise in price with inflation. Owners can increase rent to "keep up with inflation" assuming there is demand. It is true that variable costs such as heating and air conditioning, maintenance, and general labor will go up with inflation as well, but owners can pass these costs along to tenants, effectively getting more rent. Finally, owners might have fixed debt, which as previously noted, can be paid back in future devalued dollars.

Thus, inflation is typically beneficial to real estate owners, up to a point. In the next New England Real Estate issue, I explore where inflation can hurt real estate, and why people generally fear it, in any case.

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