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Inflation: Good, bad or ugly for real estate? Part 2

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In the last issue, I made a case for why inflation is good for real estate owners.

On the flip side, high inflation can be detrimental to people wanting to get into the real estate market. The cost of debt could be very high. For example, some will remember that, during the Carter administration, inflation was running at about 18%, and bank loans were often as high as 15%. It was almost impossible to pay that level of debt service, and potential buyers stayed out of the market. This was also a point where owners who wanted to sell provided their own financing to buyers, at lower rates that were more affordable.

In general, people dislike inflation for all the right reasons, as well as certain less rational emotional reasons. The Yale University economist Robert Shiller found that, in a study titled "Why Do People Dislike Inflation?", in countries all over the world, the majorities said they would prefer low inflation and the potential high unemployment that comes with it, over high inflation and low unemployment. Shiller determined that the biggest reason was that people simply believed that higher prices reduced the standard of living and make them poorer.

It was also determined that inflation increases uncertainty, which makes people nervous. Shiller found that since inflation "weakened" a country's currency, it affected overall moral in a country or economy. People rightly or wrongly tied inflation to an overall lack of monetary discipline and failure to live within one's means. No one in the Shiller studies mentioned any possible benefits of inflation, showing an intrinsic emotional prejudice to this potential.

In contrast to all that is said above about inflation, both good and bad, there is recently some concern of deflation, or even stagflation, where prices of goods decrease, but so do wages and overall employment. When deflation occurs, real estate prices drop. People stop buying, because they believe they can buy it cheaper, later. It appears nobody is in favor of deflation, and most point to a stagnated economy in Japan for the last 10 years as the poster child of that phenomenon.

As a result, economists are beginning to agree more that a modest amount of inflation, say 2% to 3%, would be good for our current economy. If people believe that prices are going to rise in the future, they may be more willing to spend in the present, since they can put money to work now that would otherwise lose value in the future. With that investment comes more employment, more growth, and potentially higher wages. Putting more money in the pockets of employed people will increase consumer spending, adding more to that great dominant factor of gross domestic product.

I tend to agree. Even thought the cost of borrowing will be higher, modest inflation would benefit real estate. With companies growing, needing space, and prospects able to pay higher rent, it is the kind of modest growth scenario most of us would like to see.

From the modest research I did to write this article, it also is clear that we don't know whether or when inflation will happen. Many people have different theories. However, most worry that keeping the lid on inflation now can only lead to greater likelihood that the lid will be blown sky high, when it all reaches the boiling point. Let's hope otherwise.

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