

Inflation looms over deflation risk

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Economists of monetarist and Keynesian persuasions disagree about many things. However, they are currently united in their views on inflation. They see the risk of deflation as being far greater. This conventional wisdom is reflected in extremely low yields for government bonds in Europe and the US. Yet a resurgence of inflation may be closer than many believe.

Monetarists concede that central banks are printing money in vast amounts to stimulate their economies. This will not lead to inflation, they say. The newly minted cash is not being lent out but stored in bank vaults. The "money multiplier", to use the technical term, has collapsed. It is no secret why this is happening. Households and businesses are overstretched and fearful about the future. As a result, they are borrowing less and saving more. As long as such fears persist, according to monetarist logic, the Federal Reserve can carry on printing money with impunity.

The aim of the central bank's policy of quantitative easing is to dispel the threat of deflation and get people to borrow and spend more. The "unconventional measures" being undertaken by central banks around the world are novel and unproven. If the authorities overreact to the spectre of deflation and print more money than is necessary, inflation expectations might suddenly pick up. The continued hoarding of money depends on people believing that a fiat currency, such as the US dollar, will remain a store of value in future. If this confidence dissipates due to excessive measures by the Fed, then cash would be considered a hot potato. The velocity of circulation would rise and inflation surge.

Inflation expectations might also shift if the markets lose confidence in the state of the public finances. Washington is set to produce a deficit this year of \$1,800bn (£1,237bn, €1,325bn). The cost of bailing out Wall Street runs to several thousand billion dollars more. Meanwhile, the Fed has promised to expand its balance sheet by more than \$2,000bn. Governments that issue debt in their own currencies and control their monetary printing presses do not tend to go bust. Rather, the sovereign default takes place covertly through a depreciation of the currency.

If market participants come to suspect the US government faces insuperable financial burdens and that the Fed is losing its political independence, inflation expectations are liable to change rapidly. Clearly, this issue is a concern to China's leaders who, having acquired an enormous mountain of Treasury bonds in their foreign exchange reserves, are aware that Americans might seek at some stage to inflate away their foreign obligations.

Keynesian economists do not focus on inflationary expectations or on the money supply. Instead, they point to the dramatic collapse of demand in the global economy as a sign that deflationary forces will be around for a long while. Goldman Sachs estimates the current "output gap" to be about 8 per cent of global GDP. Inflation will not pick up until this spare capacity has shrunk, according to Goldman.

This argument should be viewed sceptically. There are times when inflation and economic activity move in the opposite direction. For instance, periods of rising inflation and unemployment are relatively common during emerging market crises. The US witnessed something similar during the stagflation of the 1970s. Leading indicators suggest the US economy is set to decline sharply in the first quarter. The last time these indicators were so dire occurred in 1974. Yet there was no deflation in that year. Rather the inflation rate climbed to 12 per cent.

The British economist Peter Warburton of Economic Perspectives raises fresh doubts about the output gap in an intriguing new paper ("Making the Case for an Early Return of Inflation"). Mr Warburton argues the expansion of global trade over the past couple of decades exerted downward pressure on inflation. During the boom years, the global supply chain was tuned to perfection, he says. The credit crisis, however, has fractured this supply chain; companies have gone bust, working capital has been hard to come by, and inventories have been run down. As a result, the productive capacity of the global economy has shrunk and the world has become more inflation prone. "An aggressive stimulus package to aggregate demand," writes Mr Warburton, "which seeks to restore the status quo ante will encounter inflationary tendencies at lower levels of activity than before".

The deflationary consequences of the credit crisis may persist for some time. However, an early revival of inflation is not off the cards. Prudent investors should start implementing measures to protect their portfolios against such an outcome.

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