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Inflation Scare: Crazy but Real

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The recent steps by the Federal Reserve to preempt deflation have—ironically and unexpectedly—prompted a surge in inflation fears both inside the United States and abroad, especially in China. Specifically, the Fed's measures to go beyond the stimulus inherent in a zero percent federal funds rate by purchasing Treasury and mortgage securities has conjured visions—especially in the eyes of major buyers of Treasury securities, China foremost—of massive money printing to underwrite trillions of dollars of additional government borrowing at low interest rates. As markets have shown, if that were the Fed's intention—which it decidedly is not—the effort would fail because excessive money printing—creating a money supply larger than the quantity of money demanded—would push up interest rates as inflation expectations rose.

Pressure on the Fed

The Fed's commitment to price stability remains firm, although markets have their doubts given the rise, since March, of more than 100 basis points in inflation expectations that drove yields on ten-year notes as high as 4 percent early in June. While that interest-rate level is not extraordinary by historical standards, the pace of the rise and its association with higher expected inflation are striking—especially given a fifty-nine-year low of –1.3 percent in the year-over-year Consumer Price Index (CPI) inflation rate. As recently as mid-March, when the Fed committed itself to purchase $300 billion of Treasury securities, yields on ten-year notes dropped sharply from 3 percent to 2.5 percent. A rise of 150 basis points to nearly 4 percent, with 100 basis points of that move attributable to higher inflation expectations, certainly sounds an alarm bell that any central bank would take seriously, especially given the extremely negative consequences for the struggling housing sector as mortgage rates rise. Even more significant is the implied loss of confidence in the Fed's commitment to price stability.

Fortunately for the Federal Reserve, not to mention the rest of us, the rise in inflationary expectations is unlikely to persist given the increasingly benign path of actual inflation over the past year, not to mention continued risks of deflation. As noted above—it bears repeating—the latest U.S. inflation statistics through May show that year-over-year CPI inflation was –1.3 percent, a fifty-nine-year low. Core inflation, which has been running at a 1.8 percent year-over-year rate, has been driven entirely by goods prices. Year-over-year core services inflation is virtually zero, while year-over-year core goods inflation is 2.2 percent, partly because of supposedly higher prices for motor vehicles and sharply higher tobacco prices, up at a 114 percent annual rate over the last three months due to sharp tax increases. According to the Bureau of Labor Statistics (BLS), the prices of new vehicles rose at a 6.4 percent annual rate over the past three months—an extraordinary statistic that is inconsistent with collapsing auto sales. The purported strength in vehicle prices is apparently tied to the late introduction of 2009 models whose sticker prices are higher than those of 2008 models. Anyone who has shopped for a new car surely knows

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that motor vehicle prices are falling rapidly. Once the BLS catches up with this phenomenon, we will see a sharp drop in motor vehicle prices, which, along with lower tobacco prices, will contribute to a move in the year-over-year core inflation rate to 1 percent or lower over the next several months.

Oscillations between fears of inflation and deflation in postbubble periods are not unusual.

While actual inflation statistics in the United States, Europe, and Japan (not to mention China) show prices heading lower, the fact remains that widespread discussion of "hyperinflation" in the press, along with elevated fears of the potential inflationary impact of Fed purchases of government bonds, has pushed up inflation expectations. Those factors have also caused interest rates to rise by an amount that, along with higher gasoline prices, will actually slow the economy.

China's Special Fears

Foreign buyers of Treasuries, such as the Chinese, have openly expressed their fears that the Fed's plans to underwrite Treasury purchases, coupled with rising U.S. budget deficits, will create inflationary money growth. A look at China's experience with the U.S. efforts to contain the Great Depression of the 1930s using expansionary measures to push up prices makes it easier to understand their fears about possible higher U.S. inflation and problems for China that would be inherent in an aggressive reflationary American policy. Early in the 1930s, China was on a silver standard that permitted the Chinese currency to depreciate and help cushion China from the global depression. Yet, as aggressive deflation-fighting emerged in industrial countries, China's situation turned rapidly worse. The British devaluation of sterling in 1931, followed by the U.S. dollar devaluation in 1933 and 1934 as the United States boosted the dollar price of gold, amounted to an export of U.S. deflationary pressures to China. The rise in the dollar price of gold and the attendant drop in the silver price of gold created a revaluation for China. That revaluation imposed severe deflationary pressure in the midst of China's political chaos tied to the struggle between the Kuomintang and the Communists for control of the country.

Then U.S. policy created a further shock. On December 31, 1937, the U.S. silver purchase program sharply boosted the global price of silver, which resulted in a rapid flow of silver out of China, further intensifying the deflationary pressure. China's silver standard collapsed in 1938, forcing China onto a fiat currency standard. The political instability and turmoil in China and the loss of the silver currency anchor allowed the government to print money to pay its bills, resulting in a disastrous transition from deflation to hyperinflation in China that compounded the political and military chaos in that country.

The important point—although the contemporary situation in China is far more orderly than that of the 1930s—is that China's fear of foreign-generated monetary disorder persists, especially when the United States is undertaking unusual monetary measures to combat a severe economic contraction. China's publicly stated fears about aggressive reflationary efforts in the United States are understandable based on the history of the Great Depression, but a strong case can be made that they will not be realized in the current Fed battle to combat a severe recession.

Deflation Risks Persist

The actual risks in the United States and globally, based both on inflation data and underlying causes of inflation pressures, still tilt more toward deflation than inflation. Oscillations between fears of inflation and deflation in postbubble periods are not unusual. A reading of the history of the Great Depression and of Japan's experience in the 1990s makes clear that postbubble periods witness volatile movements in inflation expectations that, in turn, greatly complicate the task of managing monetary policy.

For now, there are three main bulwarks against a rise in U.S. inflation and an actual threat of deflation: depressed demand growth worldwide, especially in the United States, tied to persistent deleveraging by American consumers and banks; large and rising excess capacity tied to that sharply lower demand (especially in the traded-goods sector); and finally, and most important, the Federal Reserve's unshaken and unconditional commitment to price stability. That commitment has been clearly articulated by Fed chairman Ben Bernanke and all members of the Federal Open Market Committee (FOMC), which decides on the path of monetary policy. As inflation fears have emerged over the past month, all members of the FOMC have made clear their readiness to withdraw monetary stimulus quickly—should the need arise—despite the awkward fact that the need to do so is far more remote than those in markets dreaming of "green shoots" believe to be the case. The Federal Reserve can withdraw accommodation far more quickly than the U.S. and global economies, burdened with substantial excess capacity, need them to do so should any hint of inflation arise. History abounds—in the Great Depression and in Japan in the 1990s—with examples of central banks withdrawing stimulus too soon rather than too late.

Signs of global excess capacity are present everywhere. The most obvious clue lies with the virtual collapse of industrial production concentrated in the tradable-goods sector in export countries including Germany, Japan, and China. The breakdown has been so rapid that overall growth in Germany and Japan collapsed at an extraordinary and unprecedented 14 percent annual rate during the first quarter, while U.S. growth fell by "only" a 5.7 percent annual rate.

A relapse to negative consumption growth during the middle quarters of this year will sharply challenge any plans to increase production both in the United States and globally.

Although it is true that the collapse in industrial production and exports followed a collapse in demand tied to the financial crisis after Lehman Brothers failed last fall, and although there will be some recovery of production, support for ongoing production growth is highly uncertain. Broadly, far too much production capacity is available in many industries, and the major engine of global demand growth—the U.S. consumer—is sharply retrenching. Reduced inventories will eventually increase the need for production only if the demand for output rises. While China is sharply increasing demand—especially for domestic infrastructure and other capital spending—with its aggressive stimulus program, global support for goods and services in an environment of excess capacity remains very weak.

The most recent data on U.S. industrial production and capacity utilization are both timely and indicative of the global picture of excess capacity. From March through May, U.S. industrial production contracted at a 13.7 percent annual rate—about equal to the 13.5 percent rate of contraction over the past year. In other words, the decline has been persistent even during the most recent period when some have spoken of a recovery. As a result of this unprecedented swoon in output growth, capacity utilization has fallen to 68.3 percent and 65 percent in the manufacturing sector. These levels are dramatically below the average utilization rates over the past ten years of about 78 percent and 76 percent respectively. Capacity utilization at these levels is the lowest on record in the postwar period and reflective both of the persistent drop in aggregate demand and the existence of substantial excess capacity.

Analyses of inflation pressure, including those from the Federal Reserve, all include measures of excess capacity. As capacity utilization drops, understandably, deflationary pressures intensify. The incentive to use pricing discounts for firms with excess capacity to attempt to gain market share is intense. Beyond that, industrial production is one of the coincident indicators followed by the Business Cycle Dating Committee at the National Bureau of Economic Research (NBER). Some "green shooters" suggest that the NBER may be thinking about declaring an imminent end to the U.S. recession. That is not going to happen with capacity utilization falling and year-over-year inflation accelerating to the downside while the unemployment rate is rising—probably to exceed 10 percent by fall.

The key to a return to output growth—both in the United States and globally—is the recovery of demand growth. The most important component of global demand growth is U.S. demand growth. Despite substantial policy support from tax rebates and special government payments contained in the fiscal stimulus package enacted in February, U.S. consumption growth has failed to recover while American households have used the extra funds provided by the government stimulus measures either to increase savings or equivalently to pay down debt and, more recently, to pay higher fuel bills, which, so far, have amounted to the equivalent of about a $50 billion tax on U.S. consumers.

The most recent U.S. retail sales report showed that core retail sales, excluding motor vehicles, building materials, and gasoline, were flat in May. On a year-over-year basis, nominal core retail sales actually fell at a 2.1 percent rate and were slightly weaker in real terms. The implication of the May retail sales report is that consumption growth will probably drop by between 1 percent and 1.5 percent at an annual rate during the second quarter, down sharply from the 1.6 percent annualized consumption growth rate in the first quarter. Bearing in mind that consumption fell at more than a 4 percent annual rate during the second half of last year, a relapse to negative consumption growth during the middle quarters of this year will sharply challenge any plans to increase production both in the United States and globally. Beyond that, such a persistent fall in consumption growth is unprecedented in postwar history.

Households still have too much debt in an environment of falling home prices, rising unemployment, and deleveraging banks. That is why tax rebates are being saved or used to pay down debt.

Assembling all the components of U.S. GDP growth, it appears likely that the U.S. growth rate during the second quarter will be about –2.5 percent annualized. Given the substantial excess capacity, persistent drop in home prices, and weakness in the traded-goods sector, it seems unlikely that U.S. third-quarter growth will be above –3 percent. While there may be hope for a moderation in the downward pressure on U.S. and global growth by the fourth quarter, that outcome depends critically on a rebound in U.S. consumer spending. If U.S. consumers continue to repay debt and deleverage and find it difficult or impossible to obtain credit as U.S. banks deleverage, it is difficult to envision a robust recovery in demand growth within the next six months.

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Inflation Threat?

Some analysts have tied the rise in inflation expectations and the threat of future inflation to statistics in the monetary sector, recalling Milton Friedman's dictum that "inflation is always and everywhere a monetary phenomenon." By that, Friedman means that if the money supply grows faster than the demand for money, prices will rise. But there is no evidence that money supply growth is excessive, especially in view of the rising demand for money in the form of deposits at federally insured banks.

Recently, some analysts have noted that a sharp increase in the monetary base portends a risk of sharply higher inflation. But the monetary base is not the money supply; it is the raw material out of which the financial system creates money. The rapid increase in the monetary base has been undertaken by the Federal Reserve to offset a collapse in the money multiplier, which in turn reflects sharp deleveraging by the banks. The sum of the growth of the money multiplier and the monetary base equals the rate of growth of the money supply, which needs to be held about equal to the growth of the demand for money if prices are to remain stable. Over the past year, the monetary base has grown at a rate of 112 percent—far above normal. However, the rate of growth of the M2 money supply has been a far more modest 9 percent, with the large difference being accounted for by a collapse in the money multiplier. That collapse reflects the sharp contraction of intermediation by the banking system. Much of the growth in M2 is due to a rapid increase in small-denomination time-and-savings deposits at the banks, as households have dropped the safety of insured deposits in an environment of sharply elevated financial uncertainty.

A comparison of the growth rate of the M2 money supply at about 9 percent with year-over-year nominal GDP growth headed for a rate of –1 percent or lower during the second quarter defines a sharp drop in velocity—at about a 10 percent rate over the past year. Velocity has fallen because the desire to hold money, particularly insured bank deposits, has risen during a period of rising deflationary pressure and increasing financial uncertainty.

The inflation threat cited by many stems from the fact that, if banks suddenly began to lend rapidly, the monetary base could convert into far more rapid money growth. That danger, however, is remote, because the Federal Reserve could either drain reserves from the banking system to lower the monetary base or raise reserve requirements, thereby lowering the money multiplier in order to constrain the inflationary impact of more aggressive intermediation by the banking system. Simultaneously, given that the stock of money held relative to nominal GDP has risen (a definition of the drop in velocity), should the desire to spend that money return rapidly, inflationary pressure would rise. Here again, however, the Federal Reserve could control the process by rapidly contracting the monetary base and slowing the growth of the money supply before inflation pressures had a chance to develop. The likelihood of this benign outcome would be increased by the fact that, right now, inflation pressures are actually on the deflationary side and, absent a sharp increase in the growth of demand, likely to remain so. Furthermore, if deflation emerges, the demand for money, which appreciates in terms of purchasing power, will rise and deflationary pressure will further intensify. The Fed must remain on guard against such a possible self-reinforcing deflation.

Fed Credibility Is the Key

When all is said and done, the events of the last several months have sharply underscored the importance of the credibility of the central bank. Because the Federal Reserve has been forced to take unconventional measures to preempt deflation fears, it has, somewhat ironically, prompted fears of inflation because of the scope of the measures it has undertaken and their unfamiliarity to the general public and to the large foreign purchasers of Treasury securities, especially the Chinese. China's historical experience with the United States during the Great Depression helps to explain its leaders' concerns regarding the safety of their massive Treasury holdings—over $1 trillion.

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Given these underlying circumstances and the intensity of the pressures on the global economy and financial system, the challenge facing the Fed and other central banks in conducting monetary policy is formidable. As is quite typical during extraordinary postbubble periods, the Fed will be forced to acknowledge the worries of markets about incipient inflation and probably will not move to increase its prospective purchases of Treasury securities and mortgage securities and, indeed, may slow the pace at which it indicates those purchases will occur. Meanwhile, the Fed will probably indicate that its concerns over the economy, along with the benign actual picture of inflation, suggests that any actual tightening or withdrawal of existing accommodation is still over a year away. Were the Fed to suggest that it might actually raise interest rates by the fourth quarter, as markets began to believe during the most intense phase of the inflation scare early in June, the resulting drop in global equity markets and an accelerating drop in house prices as mortgage interest rates rise further, would quickly remind the doubters that the most frightening thing in this postbubble period is not the threat of inflation, but rather the threat that the Fed is forced to withdraw monetary accommodation too soon.

One final note, the Fed's problems and the concerns of holders of Treasury securities would be substantially reduced if the Obama administration showed some signs of concern about the rapid increase in U.S. budget deficits that, in turn, fuels concerns about the Fed's need to accelerate money printing. While the Fed will not accommodate a sharp rise in federal borrowing that is underway should that accommodation boost inflation, it would be far better not to force the Fed into a position in which it would have to demonstrate its commitment to price stability by engineering a sharp increase in real interest rates to contain rising inflationary expectations from the federal government's extravagant debt issuance. We experienced that extraordinarily uncomfortable situation between 1980 and 1982. Repeating it now in the midst of a sharp global recession with massive extant excess capacity would not be pleasant.