The great inflation debate

Inflation pessimists expect a major acceleration of inflation in the coming years. But **Richard B. Hoey** maintains that core inflation is likely to remain low over the next two years, with occasional volatility.

Views about future inflation in response to recent monetary policy and expected future monetary policy are at the core of many current debates about the economic and market outlook. Four key aspects of the inflation outlook are the money growth perspective, the output gap perspective, the inflation expectations perspective and the public opinion/political perspective.

The inflation pessimists expect a major acceleration of inflation in future years in response to the rapid acceleration of money supply growth that has occurred over the last year. But we believe that the story is more complex than that. A downward trend in velocity has emerged in response to the broad financial crisis. Velocity tends to accelerate when there is expansionary financial innovation. However, this process has gone into reverse over the last year.

We believe that the financial crisis was so severe that it is very hard to tell yet whether the rapid money supply growth will prove to have been appropriate or excessive. We believe that the ultimate inflationary implications of recent strong money growth are much more uncertain and ambiguous than many inflation pessimists argue. The combination of a procyclical tightening of financial regulation and orderly deleveraging should contribute to a relatively sluggish recovery in private credit growth and a subpar pace of economic recovery. In this context, our most likely case is that core inflation should remain low, with occasional volatility due to volatile energy prices.

Another perspective on inflation is linked to the output gap, an economic measure of the degree to which actual output falls short of the potential capacity to produce goods and services. The severity of the recent recession is such that it is clear that the world faces a substantial output gap with an excess supply of both productive capacity and labour. This is intensified by the continued government support in emerging markets for further increases in productive capacity and the continuing shift of low-skilled labour into the modern labour force in those countries. The result is likely to be downward pressure on core consumer prices in the near term, only partially offset by a higher level of energy prices. On any reasonable forecast of global economic growth, the output gap will remain quite high for at least another several years. The result is likely to be a persistence of a trend of relatively low inflation.

The third perspective on inflation is that of inflation expectations. There are occasions when self-feeding expectations of inflation and deflation can contribute to a vicious cycle of worsening inflation or deflation, sometimes reinforced by major currency swings. At other times, long-term inflation expectations are anchored near a certain rate, dampening the tendency for actual inflation to deviate for long from that norm.

Reliable central bank behavior can create expectations that their policies will eventually force actual inflation rate to revert back towards a stable mean. Central banks have explicit or implicit inflation targets or anchor (often about two per cent) and attempt to create anchored inflation expectations. To the extent these policies are credible, anchored inflation expectations among consumers, businesses and investors contribute to behavior patterns that raise the odds that inflation deviations prove temporary.

Fed chairman Ben Bernanke wished to drive inflation expectations back up into the normal zone. In response to this aggressive monetary policy ease, inflation expectations rose as intended. So far, however, long-term inflation expectations have only risen back to normal – to about two per cent from near zero as measured by the 10-year TIPS spread. Inflation pessimists point to the upward trend of inflation expectations and expect that it will persist. However, Fed supporters argue that inflation expectations have merely returned to normal. It is too early to be sure which interpretation is correct. We agree with the optimists – this policy should support normalisation of the inflation rate rather than a deflationary or inflationary spiral.

We believe the Fed's goal is to stabilise inflation expectations near two per cent. What is uncertain is whether the Fed will have the independence to actually achieve this. The Fed knows there will come a time to tighten the provision of liquidity and raise rates to avoid excessive future inflation. This is subject to "independence risk" – the Fed can decide that it is time to begin to tighten monetary policy but get political pushback preventing it from acting. Concerns about independence risk have risen as the long-term budget outlook has deteriorated.

Many inflation pessimists argue that the Fed will be pressured to hold down interest rates to help finance the massive continuing deficits. This is a plausible fear. However, we believe a more likely result may be a "crowding out" of some private sector activity if real yields (yields minus inflation) remain relatively high even in a low inflation context due to high deficit financing as consumer deleveraging continues.

It has been 30 years since Americans have felt the full pain of excessive inflation. They are currently experiencing the pain of excessive deflation, especially in real estate. In this context, many people do not see fighting inflation as a major priority. If the structural budget deficits are not addressed and the markets perceive that the Fed will lose its flexibility to pursue anti-inflationary policy when it is finally needed, inflation expectations could become destabilised. We are hopeful that this can be avoided. For now, we believe that monetary policy credibility remains high, even if fiscal policy credibility remains low. Investors are likely to await policy actions to reduce the structural deficit before developing any conviction that it will be successfully addressed. In the meantime, the large global output gap implies that actual inflation is likely to remain low over the next two years, with occasional volatility due to energy prices. MW

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