Ifo Viewpoint

Ifo Viewpoint No. 103: Forget Inflation

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To paraphrase Winston Churchill, never have so many billions of dollars been pumped out by so many governments and central banks. The United States government is pumping $789 billion into its economy, Europe $255 billion, and China $587 billion. The US Federal Reserve increased its stock of base money in 2008 by 97%, the European Central Bank by 37%. The Federal funds rate in the US is practically zero, and the European Central Bank's main refinancing rate, already at an all-time low of 2%, will likely fall further in the coming months.

The Fed has given ordinary banks direct access to its credit facilities, and the ECB no longer rations the supply of base money, instead providing as much liquidity as banks demand. Since last October, Western countries' rescue packages for banks have reached about $4.3 trillion.

Many now fear that these huge infusions of cash will make inflation inevitable. In Germany, which suffered from hyper-inflation in 1923, there is widespread fear that people will again lose their savings and need to start from scratch. Other countries share this concern, if to a lesser extent.

But these fears are not well founded. True, the stock of liquidity is rising rapidly. But it is rising because the private sector is hoarding money rather than spending it. By providing extra liquidity, central banks merely reduce the amount of money withdrawn from expenditure on goods and services, which mitigates, but does not reverse, the negative demand shock that hit the world economy.

This is a trivial but important point that follows from the theory of supply and demand. Think of the oil market, for example. It is impossible to infer solely from an increase in the volume of transactions how the price of oil will change. The price will fall if the increase resulted from growth in supply, and it will rise if the increase resulted from growth in demand.

With the increase in the aggregate stock of money balances, things are basically the same. If this increase resulted from an increase in supply, the value of money will go down, which means inflation. But if it resulted from an increase in demand, the value of money will increase, which means deflation. Obviously, the latter risk is more relevant in today's conditions.

If the underlying price trend is added to this, it is easily understandable why inflation rates are currently coming down everywhere. In the US, the annual inflation rate fell from 5.6% in July 2008 to 0.1% in December 2008, and in Europe from 4.4% in July 2008 to 2.2% in January 2009.

At the moment, no country is truly suffering deflation, but that may change as the crisis deepens. Germany, with its notoriously low inflation rate, may be among the first countries to experience declining prices. The most recent data show that the price index in January was up by only 0.9% year on year.

This deflationary tendency will create serious economic problems, which do not necessarily result from deflation as such, but may stem from a natural resistance to deflation. In each country, a number of prices are rigid, because sellers resist selling cheaper, as low productivity gains and wage defense by unions leave no margin for lower prices. Thus, deflationary pressure will to some extent result in downward quantity adjustments, which will deepen the real crisis.

Moreover, even if prices on average exhibit some downward flexibility, deflation necessarily increases the real rate of interest, given that nominal interest rates cannot fall below zero. The result is an increase in the cost of capital to firms, which lowers investment and exacerbates the crisis. This would be a particular problem for the US, where the Fed allowed the Federal funds rate to approach zero in January 2009.

The only plausible inflationary scenario presupposes that when economies recover, central banks do not raise interest rates sufficiently in the coming boom, keeping too much of the current liquidity in the market. Such a scenario is not impossible. This is the policy Italians pursued for decades in the pre-euro days, and the Fed might one day feel that it should adopt such a stance.

But the ECB, whose only mandate is to maintain price stability, cannot pursue this policy without fundamental changes in legislation. Moreover, this scenario cannot take place before the slump has turned into a boom. So, for the time being, the risk of inflation simply does not exist.

Japan provides good lessons about where the true risks are, as it has been suffering from deflation or near-deflation for 14 years. Since 1991, Japan has been mired in what Harvard economist Alvin Hansen, a contemporary of Keynes, once described as "secular stagnation."

Ever since Japan's banking crisis began in 1990, the country has been in a liquidity trap, with central bank rates close to zero, and from 1998 to 2005 the price level declined by more than 4%. Japanese governments have tried to overcome the slump with Hansen's in 2008.

But all of that helped only a little. Japan is still stagnating. Not inflation, but a Japanese-type period of deflationary pressure with ever increasing public debt is the real risk that the world will be facing for years to come.

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