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Inflation? Deflation Is New Risk

By FLOYD NORRIS OCT. 30, 2014

"Be very, very careful what you put into that head, because you will never, ever get it out."

— Cardinal Thomas Wolsey

on King Henry VIII

So it is with inflation. A generation of economists and central bankers who lived through the 1970s learned that there is a large risk from runaway inflation and that steps must be taken to stop it before it gets out of control.

In reality, the threat these days comes from inflation that is too low, or even from deflation. Many of the world's economic problems would be reduced if we could get more inflation than we have now.

Unfortunately, some central banks concluded after the first bit of revival from the Great Recession that it was time to tighten credit, lest superlow interest rates bring a burst of inflation pressure. They saw a need to confront the possibility of soaring prices before it was too late.

The Swedish central bank, which began to raise interest rates in 2010, in part because of worries about a housing price bubble, completed its reversal of policy on Tuesday, cutting its target interest rate to zero after raising it as high as 2 percent in 2011. But Lars E. O. Svensson, a noted economist who resigned from the Swedish central bank board last year, warned that more steps might be needed, including negative interest rates.

The Swedish blunder was not as great as the one committed by the European Central Bank when it raised rates in 2008 — a worse time to do that is hard to imagine — and then again in 2011. Mario Draghi, who became E.C.B. president in late 2011, has done yeoman work to offset the damage of that policy, but consumer price indexes in several eurozone countries are indicating deflation has arrived.

On Wednesday, the Federal Reserve's Federal Open Market Committee sort of ended its program of buying long-term Treasury bonds and mortgage-backed

securities, known as Q.E. for quantitative easing. But it will not unwind those purchases, at least for the time being. As the securities it owns mature, the Fed will roll over the proceeds into new securities.

Now, with quantitative easing ending, what has the Fed accomplished?

It has helped the economy, although not nearly to the extent that might have been hoped. Inflation, far from accelerating as some conservative economists forecast, has been running consistently below the Fed's 2 percent target. The Fed's preferred measure, the index of personal consumption expenditures, is up 1.5 percent over the last 12 months, both overall and excluding volatile food and energy prices. It has been more than two years since either measure was up as much as 2 percent. Imagine the criticism hurled at the Fed if inflation had been running above its target for that long.

What we have not heard from the Fed is any clarification of what it will do if inflation does not pick up, let alone if it falls close to or below zero.

"The real question," said Jon Faust, an economist at Johns Hopkins University, "is how the F.O.M.C. will express its commitment to getting inflation back to 2 percent." Until he left the Fed this summer, he was a special adviser to the last two Fed leaders, Ben Bernanke and Janet Yellen.

Mr. Faust was speaking before the Fed's statement on Wednesday. The answer was that the Fed did not have many words about the question, let alone the "words with teeth" that Mr. Faust believes are likely to become appropriate.

The only dissent at Wednesday's meeting came from Narayana Kocherlakota, the president of the Federal Reserve Bank of Minneapolis, who in a speech this month said, "In my view, inflation below 2 percent is just as much of a problem as inflation above 2 percent." He wanted a commitment to push inflation up to 2 percent.

"The likelihood of inflation running persistently below 2 percent has diminished somewhat since early this year" was all the Fed statement had to say about the issue.

There is nothing magic about 2 percent, and some economists think that a 3 or 4 percent target might make more sense. But you don't have to favor a higher target to realize the current inflation rate is not helping the economy.

At the moment, the threat of deflation is clearly greater in Europe than it is in the United States, and presumably some of the factors forcing prices down, including falling agricultural commodity and energy prices and a strengthening dollar, will diminish as time goes on. But if those weakening commodity prices

signal a coming decline in economic activity around the world, the picture could worsen.

What is needed is for Fed officials, and other economists, to make clear some of the damage that low inflation can inflict on an economy. They make adjustments harder for countries that need to become more competitive. Cutting nominal wages is difficult and can be devastating for workers facing fixed costs, like mortgage expenses. But if there is inflation, real wages can decline as nominal wages remain level.

It has become common for some economists to denounce the effect of low interest rates on fixed-income investors, but that is not the complete story. Certainly those with money to invest now face an unappealing set of choices. But those who bought long-term securities years ago — when inflation was expected to be considerably higher than it now is — are receiving more value than they expected.

The much discussed ratio of national debt to gross domestic product also suffers. Consider the 18 nations in the eurozone. Collectively, their national debts rose by 7.8 percent in 2012 and 2013, forcing up the debt-to-G.D.P. ratio by 5.2 percentage points. From 2004 to 2006, their debts rose nearly as rapidly, by 7.4 percent. But the debt-to-G.D.P. ratio actually fell by a percentage point. At the time, European economies were growing and inflation was also pushing up the nominal gross domestic product figures. Now there is little if any growth or inflation, and the result is to worsen the debt picture.

The markets inferred from the Fed's statement that credit tightening through higher interest rates would more likely arrive sooner than expected, and the dollar rose. If the economic growth and job figures continue to look good, and if inflation manages to rise at least a little, that forecast could be a good one.

But what will happen if inflation — and inflation expectations — do decline? So far, as can be seen in the Survey of Professional Forecasters conducted quarterly by the Federal Reserve Bank of Philadelphia, the 10-year inflation forecast has remained stable at 2 percent. If it began to fall, that would catch the attention of Fed officials.

But the bond market is not so confident. The market inflation forecast can be estimated by calculating the inflation rate at which a purchase of a normal Treasury security would be no better or worse than the purchase of an inflation-protected Treasury security of the same maturity. At the end of last year, the 10-year inflation forecast was 2.2 percent; now it is 1.9 percent. The one-year

forecast then was 1.5 percent; now it is a forecast of deflation, negative 0.75 percent.

What could the Fed do if it turns out deflation is a real threat? In theory, it could resume quantitative easing. It could also jawbone Congress to provide more fiscal stimulus. If the Republicans win control of the Senate in next week's elections, the first alternative might bring angry denunciations from both sides of Capitol Hill. The second might simply be ignored.

As long as deflation is a possibility, the Fed would be well advised to explain, again and again, why inflation that is too low is also bad for the economy. The lesson that high inflation is a threat is well known to politicians and voters. There is a need, as Cardinal Wolsey might have said, to get something else into their heads.

Correction: November 1, 2014

The High & Low Finance column on Friday, about the risks of deflation, misstated the market forecast for the 10-year inflation rate. It is 1.9 percent, not 1.7 percent.

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