The Fed and other central banks can now stop worrying about inflation. Price deflation is much more likely in the near term. However, deflation for a time need not be the terror central bankers’ fear, at least if the banking system is recapitalized and if industrial countries’ interest rates fall sharply.

RECENT INFLATION WORRIES

The Federal Reserve Bank minutes released on October 7, 2008, disclosed that as recently as September 16th, the Fed officials thought the risks to U.S. growth and inflation were roughly equally balanced. Moreover, the Federal Reserve Chairman, Ben Bernanke, acknowledged on the same day that, although the inflation outlook had improved somewhat, it remained uncertain. Central banks’ caution about inflation risks and reluctance to decrease interest rates is understandable given the experiences of 2008.

The financial markets may have taken the Fed’s view on U.S. inflation as representative of other central banks’ outlook on inflation, reinforced by the surprising ECB decision of October 2nd not to reduce interest rates. Following the Fed release, the Dow Jones index fell by 6.5 percent, as the markets discounted the internationally coordinated interest rate cut that they had expected. However, this sharp decline and the knock-on effects on world markets then helped precipitate the expected coordinated cut on October 8th.

We argue that the U.S. is now on the cusp of the most significant turning point for inflation in the last 20 years, so that many of the standard models are likely to go badly wrong. Forecasting inflation is notoriously difficult. There have been large structural shifts in the world economy (e.g. trade and financial globalisation) as well as in individual economies (such as the decline in trade union power). Monetary policy itself has shifted to a far greater focus on inflation. Energy and food price shocks can be large and very hard to predict, and indeed, the speed of price changes tends to increase with big shocks. Most forecasting models used by central banks therefore put a large weight on recent inflation. This approach tracks inflation quite well, except at turning points, because the models miss key underlying or long-term influences.
The economics of this turning point are straightforward. Global output is probably falling faster than at any rate since the war, except perhaps for 1974–5. Under these circumstances, large excess capacity develops and commodity prices fall. Many continue to believe that emerging markets will provide a stabilizing influence on the world economy: in fact the opposite is likely to be true. Countries such as China are highly geared to exports and above all to investment, which in China accounts for a larger fraction of GDP than does consumer spending. Apart from investment in infrastructure, health care and education, China’s investment is highly geared to growth. This makes the recent IMF forecast of 9.3 percent growth in China in 2009 unrealistic. If growth falls more sharply, as is plausible, the consequent reduction in investment will amplify the growth reduction in China, exceeding the percentage reduction in other drivers of global economic activity, such as U.S. consumer spending.

It seems unlikely that governments in China and similar emerging markets can compensate swiftly enough to boost domestic consumption. And with growing over-capacity, investment in goods production may fall even further, with serious implications for GDP. Hence the demand for commodities, which has been driven by emerging market growth, will fall sharply, and help decrease global inflation. Eventually through this channel, lower commodity prices and lower inflation will act like a huge tax cut for households, allowing interest rates to fall further and thus stabilise economic activity. Paradoxically, the faster oil prices now fall, the shorter will be the subsequent period of deflation, as further damage to the economies of industrial countries is avoided.

The more than 10% fall in oil prices on October 10 is very likely a signal that the OPEC cartel will not be able to cut output fast enough to maintain the price at anywhere near the $90 a barrel level. This is thought to be the target price favoured by the Saudis and indeed the price has hovered around this level for some weeks, despite all the bad economic news. History suggests that cartel discipline in conditions of collapsing demand is unlikely to be sustained. There are probably still hedge funds carrying the ‘long oil, short financials’ trade which has been so popular in the last year. As they unwind their positions, oil prices could fall below $50. (Note added in proof: by October 30, oil prices had fallen to close to $60.)

In a recent Oxford University discussion paper, we have designed new forecasting models for U.S. inflation, improving further on our earlier research which successfully forecast the 2001 U.S. recession (Financial Times, May 1 2001, p.19) and the subsequent recovery. Our inflation models for the U.S. consumer price index (as measured by the PCE deflator preferred by the Fed) build in a wide range of factors including oil and food prices, house prices, producer prices, unit labour costs, import prices, prices in other countries and the exchange rate, trade union density and the unemployment rate.

Our models have been tested out of sample on monthly data from 2000 to the present, and surpass standard models by wide margins. A key element of these models is the long-run adjustment in consumer prices to costs and other prices. The model suggests a long-run solution for U.S. consumer prices as a function of unit labor costs (with a weight of over 50%), U.S. house prices and foreign consumer prices converted into Dollars. Unit labor costs in the U.S. are central to the model and have remained low despite higher goods price inflation. House prices have a powerful effect in the model.
entering with a long lag. Their importance lies in the role of rents in the consumer price index, but probably also reflect other macroeconomic influences. House price falls have offset some of the recent inflation from higher oil and food prices, and we expect lower and still falling house prices now to be a major deflationary force. Declining foreign inflation and recent Dollar appreciation suggest little prospect of imported inflation. Since oil and food prices are falling sharply, and have further to fall, while unemployment is shooting up, our models suggest that U.S. consumer price inflation must fall at record rates over the next 6–12 months. Our models of the underlying components, durable and non-durable goods and services inflation, further reinforce this view. It is entirely credible that the U.S. inflation rate, measured over 12 months, will become negative within the next 18 months.

THE POLICY DEBATE

While some observers are still worried about inflation risk, others are concerned that the usual monetary transmission mechanism is not working and that a Japanese-style ‘lost decade’ for the U.S. is in prospect, while others worry about a 1930s style slump in the industrial countries.

With sharply falling U.S. inflation, the debate about whether monetary policy can stem deflation and whether the ‘zero lower bound’ on interest rates is a constraint, will really begin. The zero lower bound arises because nominal interest rates cannot fall below zero unless Aaron Edlin’s Dr. Strangeloan effects become profound. But if nominal interest rates stay positive, while inflation is negative, then real interest rates may become too high for an economy in recession, causing recession to become more severe and prolonged.

These deflation fears were mistakenly raised in 2001–3, when the strong U.S. response of credit, the housing market and consumer spending to lower interest rates should have made the debate redundant. Influenced by a misreading of the Japanese experience (see Muellbauer, 2007 and Muellbauer and Murata, 2008) this led to excessive protection against the ‘tail risk’ of deflation. Ironically, that policy response helped to fuel the credit and housing bubble, whose collapse has triggered the current recession, which may actually bring about deflation.

There are important differences between the structure of the Japanese and the U.S. economies. Among these is the enormously high level of liquid assets held by Japanese households, which tends to lead to lower consumption when interest rates fall. These differences, and the fact that lessons have been learnt from Japan’s ‘lost decade’ on the need to refinance the banking system, suggest that a ‘lost decade’ for the U.S. is most unlikely.

The policy implications outside the U.S. and Japan are that central banks can safely cut policy rates and continue aggressive liquidity support operations with little inflation risk. With the Fed funds rate at 1%, there is only a small scope in the U.S. for doing more with this instrument. In any case, with so little confidence in the financial system, and credit constrained by concerns about falling housing prices, the usual transmission channels from the policy rate have been blocked. Hence the emerging emphasis on recapitalizing the banking system seen in European and U.S. policy announcements on October 13th and 14th is properly placed.

We predict that as some confidence returns in an eventually recapitalized banking system, and long bond yields decline with the fall in inflation,
mortgage and other borrowing rates will fall and monetary transmission will come back to life, supporting economic activity and stabilizing real house prices, albeit at a substantially lower level.

Finally, on the question of a 1930s style slump in the industrial countries, there are two major differences between now and then. The industrial world is now far more dependent on (mostly foreign) oil than it was then. The extreme rise in real oil prices was a major cause of the current recession, and its reversal will be a major factor in the recovery. The other crucial difference is that we know enough about what is at stake not to repeat the errors of the 1930s.

Letters commenting on this piece or others may be submitted at http://www.bepress.com/cgi/submit.cgi?context=ev.

REFERENCES AND FURTHER READING


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