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Lowflation: Should We Fear Stable Prices?

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OVERVIEW

Bottom Line: Low inflation may be symptomatic of deeper problems, such as inadequate demand or central bank policy failures. The costs of low inflation could be high for European economies.

There is a new Washington consensus, and it consists of a simple message: low inflation threatens the global economy. A weak and disappointing economic recovery feeds the concern, especially at a time when inflation is below targets and near zero in many countries. When did price stability change from a goal to a problem? Is too little inflation a symptom or cause of what ails us?

Throughout the industrial world, debate rages over the causes and meaning of the chronically low inflation in the major industrial economies. Since the end of the Great Recession, central banks have seen inflation fall below their targets, despite unorthodox monetary policy aimed at jump-starting demand. Inflation is well below 2 percent in the Group of Three, or G3 (United States, Japan, and the eurozone), as well as in some Asian emerging markets. Though G3 inflation surveys show expectations anchored around 2 percent, bond yields have fallen this year as market participants bet on very low inflation going forward. These low market interest rates now seem at odds with the surveys.

Central banks have responded with rate cuts (European Central Bank), quantitative easing (Bank of Japan), and commitments to keep rates low and raise them only gradually over time (Federal Reserve, Bank of England). In the case of the European Central Bank (ECB), President Mario Draghi has cited the "pernicious negative cycle" of low inflation and tight credit conditions as the central reason for recent easing moves. Whether accurate or not, this line of argument has built a consensus for action on the ECB board. Meanwhile, Federal Reserve governors point to the lack of inflationary pressures as evidence that easy monetary policy contains little risk to price stability. So, while central bankers continue to predict their policies will return inflation to target, there is little doubt that the shortfalls are influencing the policy debate.

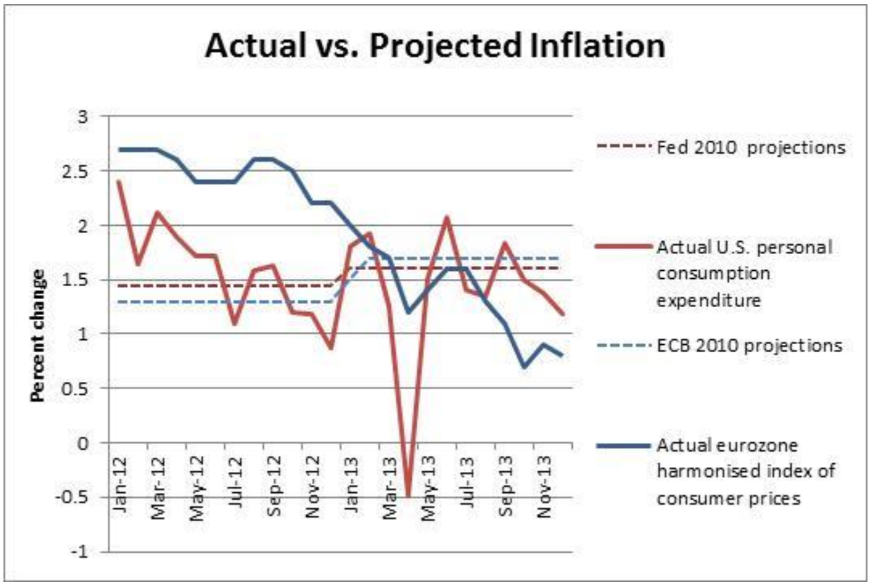
LOW INFLATION, NOT DEFLATION

There is a venerable body of economic analysis on the pernicious nature of deflation, which is usually defined as the broad-based, self-reinforcing decline in prices across an economy. When a country faces deflation, falling real wages and income weaken demand, dampen investment, and undermine confidence. The Great Depression in the United States and the Japanese experience with deflation after 1990 are often cited as evidence of the high cost of deflation and the challenge of ending it. Deflation was a significant risk coming out of the financial crisis of 2008/2009, and it took determined action by central banks to put those fears to rest. However, aside from a few countries on the periphery of Europe, there is little evidence of actual deflation in the industrial world today.

Since the end of the Great Recession, central banks have seen inflation fall below their targets.

At the same time, the stickiness of prices at near-zero levels is hard to explain. Most analysts expected that inflation would remain low for a while after the crisis, given the depth of the recession and the headwinds to recovery from damaged balance sheets and housing markets. Indeed, the sizeable economic slack that resulted was a central driver of the unconventional monetary policies adopted subsequently. But most public and private forecasters predicted prices would have begun to rise by now as recoveries reduced the amount of underutilized resources in the economy and put upward pressure on wages and goods prices (see Figure 1).

FIGURE 1. PROJECTIONS PREDICTED RISING INFLATION RATES



Sources: Federal Reserve, Eurostat

How much should we be concerned about prices rising at around 1 percent annually? After all, while price stability is generally accepted as a good thing, and high inflation clearly destructive, there is little actual evidence that small differences in inflation make a big difference for economic growth. If 2 percent inflation is seen as price stability, is 1 percent inflation less efficient? The answer would appear to depend on the reasons for the shortfall.

LOW INFLATION: WHY WORRY?

One of the concerns regarding low inflation is that the economy is just one shock away from deflation. From this perspective, and given that monetary policy operates with "long and variable lags," some buffer against that risk makes sense. Beyond that, low inflation is perhaps symptomatic of a more fundamental problem of inadequate demand, and reflects the failure of the United States, Europe, and Japan to have a more significant liftoff in growth.

Inability to control the inflation rate could indicate that central banks have the wrong economic model.

A second set of concerns relate to worrisome signals to markets when central banks cannot hit targets. An inability to control the inflation rate could indicate that central banks have the wrong economic model, or that they are underestimating the damage caused by the Great

Recession. Over time, missing targets can undermine the credibility of the central bank and the effectiveness of its policies. On the other hand, it is worth remembering that, before the euro, the Bundesbank missed its monetary targets about half the time, yet still was seen as highly credible.

One reason why central banks might get the outlook wrong is by misestimating the downward structural pressures that result from globalization and demographic changes. The increasing effect of emerging markets on competition and deflation is widely appreciated, and may continue to exert downward pressure on prices even as growth in these countries' trade shares slows. But there is also a cyclical element to the story. In the case of Europe, I would argue that low inflation reflects a too-tight policy from the ECB and an incomplete monetary union, even after last week's rate cuts. But it is much harder to make the case that the policies of the Bank of Japan (following the introduction of Abenomics in early 2013) and the Fed have been too tight. Indeed, in recent months a number of market analysts have highlighted early indications that U.S. prices are moving up.

Outside Europe, low inflation is more symptom than cause of low growth.

The International Monetary Fund (IMF) has been in the vanguard, arguing that the costs of low inflation could be high globally, particularly for Europe. The arguments against too-low inflation in Europe are threefold: low inflation raises the real burden of the debt and increases real interest rates (interest rates net of inflation) to levels too high for full employment; it prevents the adjustment of relative prices across the eurozone, delaying the needed improvement in competitiveness and rebalancing of demand toward the periphery; and it can destabilize market expectations for future inflation. Without an ability to adjust their exchange rates against other countries in the currency union, and against the backdrop of extremely high government debt levels coming out of the recession, Europeans face a protracted period of low growth that can justify aggressive action from the ECB.

Beyond Europe, prominent economists such as Paul Krugman and Larry Summers argue that there may be a long-term problem of inadequate demand. Citing the "secular stagnation" theory of Alvin Hansen, they argue that as a result of weak long-term growth and demand (in part a result of demographic trends that are shifting down the growth in the labor force), interest rates cannot go low enough in real terms to achieve full employment. Their policy prescription involves easier fiscal policy to boost demand and, perhaps, a Federal Reserve that keeps rates low for longer.

It is hard to distinguish structural stagnation, which could be long-lasting, from "headwinds" from the financial crisis, including damaged consumer and bank balance sheets, and weak housing and labor markets. These headwinds will continue to recede as markets heal and balance sheets are repaired. In this regard, the U.S. economy is much further along than Europe, where deleveraging and bank cleanups are far less advanced, notwithstanding the progress made this year with the stress test and asset quality review.

Globally, there is some evidence for the headwinds thesis in the stabilization (and in some cases increases) in commodity prices and trade. Both had been weak following the recession, contributing to deflationary pressures. Inflation now looks more likely to be driven by traditional cyclical factors in the future, including slack in labor and product markets. In the United States, we see this shift in a renewed debate over how close we are to full employment, following a series of strong employment reports. Economists are divided over whether continuing high rates of long-term unemployment will continue to exert downward pressure on wages, or whether the figure that matters most is the short-term unemployment rate, which is closing in on levels usually associated with an uptick in inflation.

WHAT SHOULD BE DONE?

Overall, I am drawn to the conclusion that, outside Europe, low inflation is more symptom than cause of low growth. I am sympathetic to the notion that low inflation in normal circumstances makes the policy response to a recessionary shock more challenging, because it is difficult to lower real rates sufficiently. From this perspective, a higher inflation target (Olivier Blanchard and others have called for a 4 percent target) has merit, though it is hard to see how central banks can credibly explain that shift to their publics. Whether there is any hard evidence that a 2 percent inflation target is best, it appears likely that policymakers will have to continue aiming for that level. Fortunately, central bank reflationary policies do appear to be working. With inflationary prospects beginning to diverge across the major regions, this suggests that monetary policies will also diverge—with further easing required in Europe and Japan, and normalization in the United States. Over the longer term, we once again may discover value in low inflation and price stability.

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