Deflation Bound

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It is often said that generals tend to fight the last war. Judging by their continued pronouncements about inflation risks, one has to wonder whether the same might not be said of central bankers.

Despite ever-increasing signs that the global economy is in the grips of a vicious process of financial market de-leveraging and asset price deflation, central bankers continue to fret about the threat of rising price inflation. They do so at the very time they should be worrying about the risk that a deep and prolonged recession could raise the specter of deflation of the sort that long plagued the Japanese economy after the bursting of its asset price bubbles in 1989.

Looking in the rearview mirror, there can be no doubt that over the last year inflation has risen to levels that must give rise to concern. Indeed, U.S. headline consumer price inflation has now risen to around 5 percent or to a level not experienced in the last 25 years. Similarly in Europe, headline inflation has ratcheted up to almost 4 percent or to a level that is approximately twice the European Central Bank's inflation target of "close to but under 2 percent."

However, in gauging the risk that too high an inflation rate might now be taking hold in the United States and Europe, it is important to recognize that the rise in inflation over the last year was primarily the result of an extraordinary spike in international commodity prices. This spike has had the effect of raising U.S. headline inflation by around 3 percentage points above what central bankers refer to as the core rate of inflation, which excludes food and energy prices. Meanwhile, core price inflation in both the United States and Europe has remained relatively well-behaved, having inched up only very modestly over the last year.

Most striking in the run-up in commodity prices was the more than doubling in international oil prices from $70 a barrel in early 2007 to more than $145 a barrel by July 2008. That doubling mainly reflected the world economy's rapid growth at a time that international oil supply was constrained by a prolonged period of underinvestment. The consequent spike in international oil prices had the effect of raising gasoline prices over the psychologically important $4 a gallon level. And to compound matters, the spike in oil prices coincided with a parallel spike in international food prices of a similar dimension.

Looking forward, as central bankers should do in setting interest rate policy, one has to be struck by the extraordinary bust in international commodity prices over the last four months. Since July 2008, international oil prices have about halved from $145 a barrel to around $70 a barrel, thereby totally reversing their earlier run-up. For their part, international food and metal prices have dropped by around 40 percent.

This extraordinarily rapid bust in international commodity prices has occurred as markets have rapidly internalized the ever-increasing signs that the global economy is more than likely headed for its worst economic recession in the postwar period.

Among the reasons for pessimism about the U.S. economic outlook over the next few quarters has been the spectacular equity market crash in early October. That crash, together with the ongoing U.S. housing market bust and falling corporate bond prices, has had the effect of reducing U.S. household wealth by around 80 percentage points of gross domestic product (GDP) over the last year. Worse still, that crash has coincided with the virtual freezing up of credit markets that has both increased borrowing costs and substantially reduced credit availability to both households and corporations.

Sadly, a deep economic recession will hardly be confined to the United States. For a similar equity market bust and a similar vicious credit crunch has also occurred across the globe. In those circumstances, one must expect that the international commodity price bust of last four months will prove to be anything but ephemeral. Rather, one should not be surprised to see international prices drift even lower in coming months as commodity demand wanes as the global recession takes hold.

In the same way that the earlier spike in international commodity prices caused headline price inflation to rise substantially above core inflation up until July 2008, one must now expect that the recent dramatic bust in international commodity prices will cause headline inflation to decline substantially below the core inflation rate.

At the same time, one must expect that, over the next year, core inflation will gradually decline in both Europe and the United States as a deep recession opens up large gaps in labor and output markets. As a result, there is every prospect that headline inflation over the next year could very well be negative in the United States and Europe.

The prospect of falling headline inflation should make both the Federal Reserve and the European Central Bank more mindful of Japan's painful experience with price deflation in the 1990s after the bursting of its asset price bubbles. More to the point, it should alert them to the folly of insisting on fighting past inflation battles when the real risk to the global economy is that of a deep and prolonged deflationary recession.

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