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888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

Inflation or Deflation?

The great mystery of our macroeconomic future.

BY MARTIN FELDSTEIN

The investors that I talk to these days are not sure whether to worry more about future inflation in the United States or about future deflation. The good news is that the answer—for at least the next few years—is that investors should worry about "neither."

America's high rate of unemployment and the low rates of capacity utilization imply that there is little upward pressure on wages and prices in the United States. And the recent rise in the value of the dollar relative to the euro and the British pound helps by reducing import costs.

Those who emphasize the risk of inflation often point to America's enormous budget deficit. The Congressional Budget Office projects that the country's fiscal deficit will average 5 percent of GDP for the rest of the decade, driving government debt to 90 percent of GDP, from less than 60 percent of GDP in 2009. While those large fiscal deficits will be a major problem for the U.S. economy if nothing is done to bring them down, they need not be inflationary.

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Sustained budget deficits crowd out private investment, push up long-term real interest rates, and increase the burden on future taxpayers. But they do not cause inflation unless they lead to excess demand for goods and labor. The last time the United States faced large budget deficits, in the early 1980s, inflation declined sharply because of a tight monetary policy. Europe and Japan now have both large fiscal deficits and low inflation.

The inflation pessimists worry that the government will actually choose a policy of faster price growth to reduce the real value of the government debt. But such a strategy can work only in countries where the duration of the government's debt is long and the interest rate on that debt is fixed. That is because an increase in the inflation rate causes interest rates on new debt to rise by an equal amount. The resulting higher interest payments add to the national debt, offsetting the erosion of the real value of the existing debt caused by the higher inflation.

In the current situation, the United States cannot reduce the real value of its government debt significantly by indulging in a bout of inflation, because the average maturity on existing debt is very short—only about four years. And the projected fiscal deficits imply that the additional debt that will be issued during the next decade will be as large as the total stock of debt today. So raising inflation is no cure for the government's current debt or future deficits.

Those who worry about deflation note that the U.S. consumer price index has not increased at all in the past three months. Why won't that continue and feed on itself—as it has in Japan—as consumers delay spending in anticipation of even lower prices in the future? And doesn't Japan's persistent deflation since the early 1990s also show that, once it begins, deflation cannot be reversed by a policy of easy money or fiscal deficits?

But the recent weakness in U.S. prices is very different from the situation that prevails in Japan. Zero inflation for the past three months has been a one-time event driven by the fall in energy prices. The other broad components of the consumer price index have increased in recent months, and the consumer price index is up about two percentage points over the past twelve months.

Moreover, surveys of consumer expectations show that U.S. households expect prices to rise at more than 2 percent in both the coming year and the more distant future. That expected inflation rate is consistent with the difference in interest rates between ordinary U.S. government bonds and Treasury Inflation Protected Securities. With such expectations, consumers have no reason to put off purchases.

A second reason for relatively low inflation in recent years has been a temporary fall in the cost of production. As firms shed workers during the economic downturn, output fell more slowly. The resulting rise in output per worker, together with slow wage growth, reduced unit labor costs. That process is now coming to an end as employment rises.

So the good news is that the possibility of significant inflation or deflation during the next few years is low on the list of economic risks faced by the U.S. economy and by financial investors.

But, while inflation is very likely to remain low for the next few years, I am puzzled that bond prices show that investors apparently expect inflation to remain low for ten years and beyond, and that they also do not require higher interest rates as compensation for the risk that the fiscal deficit will cause real interest rates to rise in the future. ◆

Martin Feldstein, a professor of economics at Harvard, was Chairman of President Ronald Reagan's Council of Economic Advisors and President of the National Bureau for Economic Research.