

## Is inflation a global threat?

By Przemysław Woźniak

### Introduction

Positive signs emerging from the global economy prompt many economists to voice their concerns about the threat of imminent inflation. However, a careful investigation of the current economic environment suggests that while some risks exist and need to be monitored - inflation is very unlikely to get out of control in the short-to-medium term.

The biggest concerns surround the effects of fiscal measures introduced by governments worldwide to counter the impact of the financial crisis. These measures included an unprecedented array of actions, including bank bail-outs, nationalizations, liquidity injections, fiscal stimuli, credit incentives and various decisions resulting in a sharp loosening of both monetary and fiscal policy. Some of them have been devised and implemented for the first time, sparking considerable uncertainty about their long-term consequences. Notwithstanding these risks, inflation fears seem to be unsubstantiated for at least two reasons. First, the actual incurred costs related to anti-crisis measures are much smaller than the declared commitments widely circulated in the media. Second, the crisis-triggered wealth loss is paramount compared to any estimate of fiscal support programs.

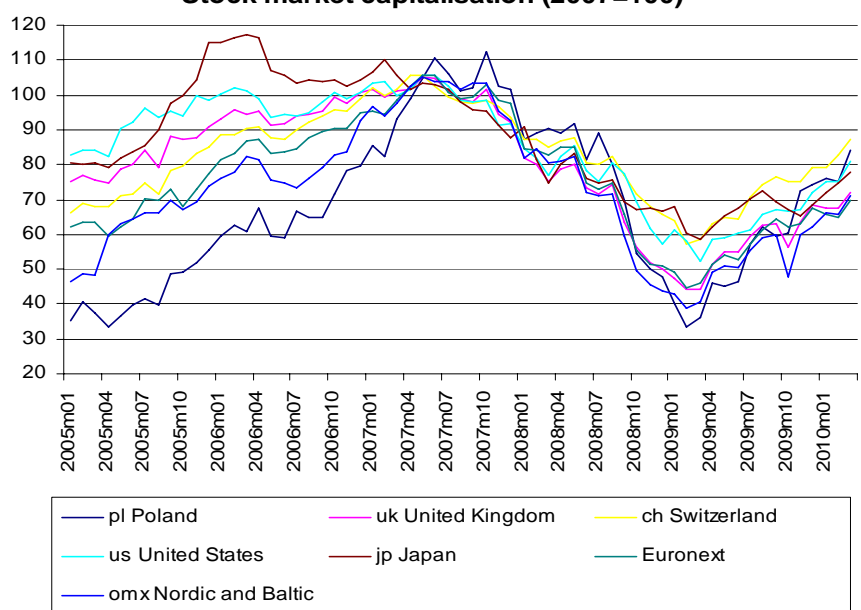
### Unsubstantiated Risks?

By mid 2009, the International Monetary Fund (IMF) estimated the cost of all fiscal measures at \$20-25 trillion, half of which was spent in the U.S. alone and an additional 45% by other advanced economies. This left roughly 5% for emerging economies. While this amount looks gigantic at face-value, in a recent Chatham House report Vanessa Rossi and R.D. Aguilera<sup>1</sup> indicate that only about \$5 trillion represents actual fiscal spending. Bank bailouts accounted for the lion's share of government support, mostly in the form of guarantees rather than upfront costs. Rossi and Aguilera estimate that guarantees on loans and deposits added up to as much as 80% of the \$23.8 trillion in total government support. The vast majority of this amount represents *potential*

*spending* rather than *actual costs*. The authors assess the actual spending – due to upfront bailout costs and fiscal stimulus plans – at less than \$5 trillion. Furthermore, the Fed's intervention in the U.S. commercial paper market, a significant component of the U.S. support program, cannot be counted at face value since the papers are constantly being rolled over and repaid. Likewise, other forms of support, such as bank shares and other toxic asset take-overs through the Troubled Assets Relief Fund (TARP) are likely to be recovered once markets rebound.

On the other hand, the crisis generated paramount losses of financial and housing wealth, which exceeded the scale of government support. Rossi and Aguilera estimate that private financial wealth contracted by a massive \$40-50 trillion from the beginning of the subprime crisis through early 2009. The bulk of these losses occurred in the equity and corporate debt markets (around \$35-40 trillion) as well as the global housing market (\$4 trillion in the U.S. alone). The capitalization of major advanced markets plunged by 40-60% from mid-2007 until early 2009. Progressive recovery during the remainder of 2009 and early 2010 remains 15-30% below the pre-crisis peak (see figure below).

Stock market capitalisation (2007=100)



Source: Eurostat

<sup>1</sup> V. Rossi and R. D. Aguilera, *Inflation-Ghost of the Past of Upcoming Threat ?*, Chatham House, Dec 2009

Therefore, it seems that governments pumped in relatively little cash in place of radically contracted private wealth. The net effect on inflation was clearly negative. Anti-crisis measures are thus very unlikely to lead to inflation. This view is confirmed by demand and supply side forecasts of major economies in short-to-medium term horizons. The latest European Commission Spring 2010 forecast predicts a very slow recovery within the EU27. GDP growth is expected at 1.0% for 2010 and 1.7% for 2011, respectively. The U.S. and Japan are expected to grow slightly faster, by 2.8% and 2.5% in the U.S. and 2.1% and 1.5% in Japan, however, both are well below their potential. The output gap is thus predicted to remain negative and unemployment rates will continue to rise. According to the IMF's latest World Economic Outlook (April 2010) GDP growth will stabilise at 2.3-2.4% in advanced economies (2010-2015) and grow from 6.3%-6.7% (2010-2015) in emerging and developing economies. This is higher than the crisis years 2008-2009, but considerably less compared to the pre-crisis period.

### Influence on World Prices

No cost-push is likely to appear on the horizon. While key commodities including oil, metals and agricultural products are set for a consistent recovery throughout 2010-2015, it will take several quarters for prices to reach their pre-crisis levels amid moderate year on year growth dynamics.

The most likely developments in combined demand-pull and cost-push effects will produce inflation that is rising gradually from its low in recession-hit 2009 to more moderate levels within the next 2-3 years. The current European Commission Forecast (Spring 2010) suggests that inflation in the EU and euro zone will rise to 1.8% and 1.5% in 2010, respectively, and then fall to 1.7% in both areas in 2011. The U.S. is set for a steep upsurge in inflation in 2010 (1.7% vs. -0.5% in 2009) followed by a subsequent decline to 0.3% in 2011, while Japan is predicted to remain in deflation (-0.5% in 2010 and -0.4% in 2011, respectively).

The IMF's latest World Economic Outlook (April 2010) projections point to even lower price growth. Inflation in the euro zone is expected to reach 1.1% in 2010 and 1.3% in 2011,

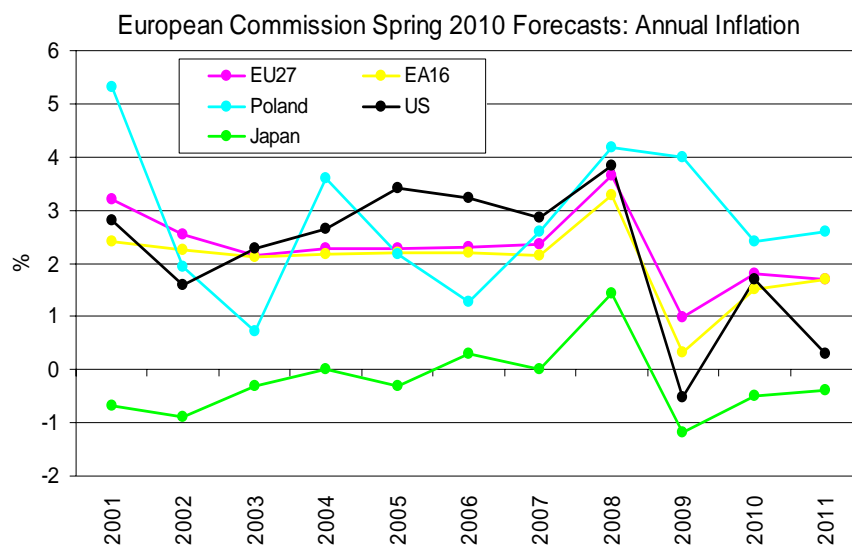
respectively, and then rise to a still low 1.8% in 2015. Inflation in the United States will rise progressively from 0.7% in 2010 to 1.5% in 2011 and 1.9% in 2015. In Japan, deflation is predicted to be deeper (-1.7% and -1.2%) with positive price growth resuming in 2015 (0.6%).

### Inadequate Exit Strategies Pose Risk

With key organizations and International Financial Institutions (IFIs) predicting comfortable medium-term inflation forecasts, is there really nothing to worry about? Not quite, since there seem to be quite a few significant risks in the medium- to long-term horizons. Essentially they relate to inadequate exit strategies from crisis-era policies. Most notable was easy access to money and credit accompanied by consumption incentives. These extraordinary measures and their largely unique characteristics pose a major challenge for policymakers responsible for phasing them out and preventing new bubbles from emerging. Both premature and flawed exit strategies, along with imprudent prolongation of current measures may result in market destabilization. They may also fuel inflationary or deflationary pressures.

One of the major uncertainties in the U.S. relates to excess reserves that commercial banks hold in the Fed account.<sup>2</sup> The amount of funds voluntarily kept at the Fed (over mandatory reserves) has surged in the wake of the crisis from \$60 billion in September 2008 to \$767 billion at the end of 2008. Reserves grew less vigorously in relative terms in 2009 and 2010, but continued the progressive rise to peak at \$1.2 trillion by March 2010. The magnitude of this surge is even more impressive in GDP terms: they grew from 0.012% of GDP at the end of 2007 to 14.15% at the end of 2009. This massive increase of liquidity is disquieting

both due to its unprecedented scale as well as the fact that it is continuing at present (in spite of numerous signals indicating recovery). It goes without saying that an uncontrolled release of even a fraction of the \$1.2 trillion may lead to a build-up of enormous inflationary pressures in the U.S. and abroad.



Source: EU Spring 2010 Forecasts

<sup>2</sup> J.D.Foster, *Is the Inflation Threat Real?* Heritage Foundation, Feb 2010

Therefore, this issue calls for an extremely cautious, vigilant and forward looking exit strategy on the part of the U.S. Federal Reserve.

Other important risks are linked to inflationary threats in emerging Asia, particularly China and India. Both countries manoeuvred through the crisis relatively well with only minor deceleration in growth. However, they both relaxed their monetary and fiscal policies considerably in the wake of the crisis. China in particular implemented a wide-ranging fiscal stimulus package of over \$600 billion. India has to deal with its progressively widening fiscal deficit (that hit 11% of GDP in 2009) and ensuing inflationary pressures. This is exacerbated by looming food-price inflation due to poor crops.

Inflation pressures are even more pronounced in China. During the crisis, it saw its growth rate slow down only marginally. This was due to massive anti-crisis measures introduced by the government, particularly in the area of construction and infrastructure projects. Thanks to this stimulus, the government's investment in fixed assets became one of the key drivers of economic growth in the past few quarters. Moreover, domestic credit has not slowed down but actually accelerated. In fact, the buoying real estate market recovered very quickly from the late 2008 plunge in prices and is enjoying renewed demand by posting year on year residential price increases of over 10%.

### How Real is the Threat?

So how real does the global inflation threat appear? Certainly the inflationary effect of all anti-crisis fiscal programs combined pales with the deflationary pressure of the gigantic erosion of capital and wealth in late 2008 and early 2009. This ensures that cost-push and demand-pull effects will most likely be restrained in the medium-term owing to persisting negative GDP gaps and slack recovery in key advanced economies. The main inflationary threat stems from inadequate exit strategies from current lax monetary and fiscal policies. It is also related to policies dealing with the post-crisis phenomena, such as the Fed's build-up of voluntary reserves. In this case prudent and forward looking approaches are necessary to manage the eventual release of funds equivalent to 14% of GDP without severe inflationary consequences. Loose fiscal and monetary policies may be a problem in India. China will have to tighten monetary policy and restrain its government's appetite for fixed investments in order to avoid creating bubbles in the real estate market.

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