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Inflation is looming on America’s horizon

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The US last week showed its first signs of deflation for 55 years, prompting inevitable fears of further deflation in the future. Yet the primary reason for the negative rate of US inflation is the dramatic 30 per cent fall of commodity prices. That will not happen again. Moreover, excluding food and energy, consumer prices are up 1.8 per cent from a year ago. That is the good news: the outlook for the longer term is more ominous.

The unprecedented explosion of the US fiscal deficit raises the spectre of high future inflation. According to the Congressional Budget Office, the president’s budget implies a fiscal deficit of 13 per cent of gross domestic product in 2009 and nearly 10 per cent in 2010. Even with a strong economic recovery, the ratio of government debt to GDP would double to 80 per cent in the next 10 years.

There is ample historic evidence of the link between fiscal profligacy and subsequent inflation. But historic evidence and economic analysis also show that the inflationary effects can be avoided if the fiscal deficits are not accompanied by a sustained increase in the money supply and, more generally, by an easing of monetary conditions.

The key fact is that inflation rises when demand exceeds supply. A fiscal deficit raises demand when the government increases its purchase of goods and services or, by lowering taxes, induces households to increase their spending. Whether this larger fiscal deficit leads to an increase in prices depends on monetary conditions. If the fiscal deficit is not accompanied by an increase in the money supply, the fiscal stimulus will raise short-term interest rates, blocking the increase in demand and preventing a sustained rise in inflation.

So the potential inflationary danger is that the large US fiscal deficit will lead to an increase in the supply of money. This inevitably happens in developing countries that do not have the ability to issue interest-bearing debt and must therefore finance their deficits by printing money. In contrast, when deficits do not lead to an increased supply of money, the evidence shows that they do not cause sustained price increases.

A primary example of this was the sharp fall in inflation in the US in the early 1980s at the same time that fiscal deficits were rising rapidly. Inflation fell because the Federal Reserve tightened monetary conditions and allowed short-term interest rates to rise sharply.

But now the large US fiscal deficits are being accompanied by rapid increases in the money supply and by even more ominous increases in commercial bank reserves that could later be converted into faster money growth. The broad money supply (M2) is already increasing at an annual rate of nearly 15 per cent. The excess reserves of the banking system have ballooned from less than $3bn a year ago to more than $700bn (€536bn, £474bn) now.

The money supply consists largely of government-insured bank deposits that households and businesses are holding because of a concern about the liquidity and safety of other forms of investment. But this could change when conditions improve, turning these money balances into sources of inflation.

The link between fiscal deficits and money growth is about to be exacerbated by "quantitative easing", in which the Fed will buy long-dated government bonds. While this may look like just a modified form of the Fed's traditional open market operations, it cannot be distinguished from a policy of directly monetising some of the government's newly created debt. Fortunately, the amount of debt being purchased in this way is still small relative to the total government borrowing.

The Fed is also creating a massive increase in liquidity by its policy of supplying credit directly to private borrowers. Although these credit transactions do not add to the measured fiscal deficit, the unprecedented Fed purchases of more than $1,000bn of private securities have led to the enormous $700bn increase in the excess reserves of the commercial banks. The banks now hold these as interest-bearing deposits at the Fed. But when the economy begins to recover, these reserves can be converted into new loans and faster money growth.

The deep recession means that there is no immediate risk of inflation. The aggregate demand for labour and goods and services is much less than the potential supply. But when the economy begins to recover, the Fed will have to reduce the excessive stock of money and, more critically, prevent the large volume of excess reserves in the banks from causing an inflationary explosion of money and credit.

This will not be an easy task since the commercial banks may not want to exchange their reserves for the mountain of private debt that the Fed is holding and the Fed lacks enough Treasury bonds with which to conduct ordinary open market operations. It is surprising that the long-term interest rates do not yet reflect the resulting risk of future inflation.

The writer is professor of economics at Harvard and president emeritus of the National Bureau of Economic Research. He chaired the Council of Economic Advisers under President Reagan and is a member of President Obama's Economic Recovery Advisory Board.