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Inflation - Ghost of the Past or Upcoming Threat?

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Key points

• Concern over inflation will escalate at the end of 2009. Preliminary figures for the Euro area suggest that positive inflation returned in November 2009 when year-on-year rates are compared with the drop in the price index in late 2008. US consumer inflation is likely to show a similar surge and could reach 2-3% by the end of 2009, causing consternation even if the actual level of the price index does not recover to its pre-Lehman levels until later in 2010.

• Is inflation really a threat? While most analysts agree that there is little cost-push or demand-pull inflation in sight, there has been persistent unease over the potential impact of bailouts, fiscal stimulus packages and an exceptional monetary policy stance, including quantitative easing.

• However, this paper puts the case that inflationary pressure from currently lax policy was in the past, not the future. Current bailouts funded excess spending and inflationary pressure in the boom years. Households and financial institutions were encouraged to pile up debt in part because they expected that even if a crisis were to occur, they could either default or be bailed out by governments and central banks. So, currently lax policy represents late payment for goods already consumed rather than new spending.

• In fact, even if all the government injections of cash into the economy are potentially inflationary, this impact would have to be weighed against the deflationary effect of wealth losses during the economic crisis. While figures quoted are often inflated by the inclusion of various guarantees and other money not actually disbursed, the global total for all forms of official direct interventions, bailouts and fiscal packages is estimated at around $5 trillion (just under 10% of world GDP). This sum is small compared with losses in property values (over $4 trillion in the US alone) and global equity markets - down by more than 50%, as much as $30-35 trillion, from peak to trough but still well below peak.

• The effect of wealth losses and weak income growth will repress inflation unless governments continue pumping money into the global economy regardless of changing conditions. Governments
are unlikely to pursue easing this far - and, in any case, this point is still some way off.

What inflationary pressure?

Inflation disappeared off the agenda in late 2008, as those who expected a steep economic downturn warned it would. In fact, the US and the Euro area have seen a dip into deflation which will only gradually peter out by the end of 2009. Even countries where weakening currencies have raised import prices still have acceptably low inflation rates below the normal target rate – for example, in the UK, consumer price inflation has dropped to just over 1%. And it’s not certain that a much weaker dollar would significantly raise US prices as the US market tends to be a price setter rather than taker in world markets, curbing impacts even on import prices. In fact, it is possible to point to the evidence from past episodes of rapid dollar decline, such as the mid-1980s, to show that US inflation failed to ignite in spite of fears to the contrary at the time.

Figure 1: US and European inflation

![Graph of US and European inflation rates](image)

Source: St. Louis Fed, ECB

1 See, for example, the article by Vanessa Rossi in the Chatham House publication *The World Today*, 'Bumpy Ride for Britain', June 2008
However, concern will be exacerbated as low base year effects in late 2008 will kick in and year-on-year inflation rates turn positive again. This may happen as soon as November in the US, and rates could even jump to 2-3% over the following six months. In fact, the situation will not be as serious as the level of the consumer price index will remain well below its pre-Lehman levels until the spring and inflation rates will remain modest. Unfortunately, this could cause jitters in the market (and possibly among some susceptible policymakers) if year-on-year rates suddenly shoot up after months of deflation.\(^2\)

**Figure 2: Different measurements of US inflation**

Notwithstanding the possibility of a year end “spike”, current monthly price increases suggest that the rate will pick up to the low end of central banks’ normal target range of around 1.5-2.5% rather than pushing up to 3% or more. Setting aside the monetarist arguments for inflation and looking at the direct causes of price pressure, both cost-push and demand-pull, there is no reason to look for a greater surge in goods and services prices inflation:

\(^2\) According to the latest flash estimate for the Euro area, the region moved out of deflation in November, registering a year-on-year price increase of 0.6% - the first in 5 months. The US CPI should show a similar surge in November, due mostly because of base year effects as well.
• Future OECD growth looks likely to remain anaemic as the recovery will be restrained by many factors including the need to restore fiscal and monetary discipline by 2011-2012. So demand pressure is unlikely to reignite price inflation in the foreseeable future. Weak OECD growth will also ease the pressure on commodity markets.

• With demand effectively depressed throughout the recovery period, advanced economies will be operating well below full capacity. Both the US and Europe have seen capacity utilization rates drop below 70% over the course of 2009 - down 10-15% from their pre-crisis averages leaving ample room for a resurgence of productive activity with minimal inflationary impact.

• Stiff international competition will keep manufacture’s prices soft in dollar terms while the dollar has also trended down, implying even lower prices in say, euro or yen terms. Indeed, the Euro area could follow the path previously seen in Japan, where near-zero inflation persisted for many years following the 1990s crisis.

• Annual pay rises have dropped due to the recession and higher unemployment, which is expected to continue rising in 2010 before stabilising in 2011.

• Weaker exchange rates may mean that some countries have higher inflation than others however, rates of consumer price inflation still remain very low and the US and Euro area as well as Japan have seen deflation in 2009.

Bearing in mind that the major developed economies are still functioning with industrial production 15-30% below their 2007-2008 peaks, then a recovery of just 2-3% in GDP over the next couple of years will not bring demand back up to anything near full capacity rates. This is why companies are finding recovery prospects tough, implying continued weakness in new investment. And unemployment is expected to rise further in 2010 before starting to stabilise; a substantial reversal may not emerge until 2012 and beyond. These circumstances argue against inflation being a cause for concern for some time ahead.
What about the effects of bailouts and easy policy?

What about the impact of the massive bailouts and stimulus measures implemented over the last year, including unconventional policies that are the equivalent of monetizing government debt – effectively printing money? Does all the liquidity pumped into the economies of the US and EU point to a surge in inflation yet to come?

Certainly evidence from Japan suggests that inflation is not inevitable. In fact, Japan has seen near zero inflation since the mid-1990s despite following a course that many would have predicted to lead to inflation, a collapse in the yen and soaring bond yields. The Bank of Japan has operated a zero interest rate policy (supplying almost free cash to the banks) for most of the last decade and public finances have moved into practically uncharted territory for a stable, mature economy (with gross public debt now around 200% of GDP). Perhaps this is an anomaly confined to Japan - but maybe not.

There are at least two good reasons for dismissing the concept of easy monetary and fiscal policy leading to inflation. Firstly, there are substantial negative impacts from losses in wealth that offset official cash injections (i.e. net new money is the key issue). Secondly, it can be argued that official bailouts are the equivalent of paying for past inflation (past debt-financed spending) rather than stoking up future inflationary risk.

Looking at the net new money position, even if all the stimulus packages, bailouts and government guarantees are included in the total “spent” by governments, this total is much less than the loss in wealth caused by collapsing asset prices (the figures are examined in more detail below). Private financial wealth alone probably fell from around $200 trillion at peak to as low as $150-160 trillion in early 2009. Property wealth has also dropped substantially, especially in the US. It is hardly surprising that the impact on US consumers has been so large, even if this is just roughly calculated using low estimates for households’ propensity to consume out of wealth.

At the macro level, governments have simply pumped in a partial cash replacement for lost wealth – although they have actually provided little or no help for savers versus the benefit of bailouts for banks and debtors, an unfortunate message to send to the thrifty. Weighing the two effects together, the debtors’ bailouts versus the savers’ wealth losses, then the net wealth impact is clearly negative and deflationary rather than inflationary. Looked at another way, neither world equities nor property prices are back above peak and no one is refunding losses such as those caused by ‘Bernie’ Madoff.
The Madoff scandal can also be used to illustrate the second argument concerning the effect of current policies on past rather than future inflation. Just like defaulting debtors, Madoff (and associates) had already pre-spent most of the funds that disappeared: this was inflationary at the time when Madoff drew on his investors’ wealth to fund his own (and others) lifestyles. Now there is a demand shortfall as these investors have lost the money that would have been spent in the future. Even if central bankers took pity on them and printed up a few billion in dollar bills to hand back, this would not make up for the lost wealth and consumption. This example can be applied to all those who have lost wealth in this crisis and will never regain it – not just the super rich but people in or nearing retirement and ordinary savers of all kinds.

**Figure 3: The “Madoff Effect”: stealing the saver-consumer’s future consumption**

![Diagram showing the impact of pre-spending on future consumption](image)

In aggregate, consumers in the developed world brought forward spending by raising their level of debt and consuming more in the pre-crisis years – and now they are facing a long period of low consumption to make up for this.

In view of the unacceptably brutal adjustment of a free fall into depression, there has been a massive smoothing operation by governments, who have effectively spread the painful adjustment over the next decade by supporting a more orderly work out of debt than the market could have implemented on its own. Consumers raided the shop and left the government to pay later – but future rationing will be imposed. Inflationary? Yes, there was a mild bout of higher inflation at the end of the boom years but this was in the past and prospects for the future look decidedly downbeat.
Figure 4: Explosion in US debt

How much wealth has been lost?

Private wealth has seen staggering losses during the crisis: possibly $40-50 trillion was wiped out from the beginning of the US housing market downturn in late 2006 to the trough in financial markets in early 2009. These losses were mainly in equity markets and corporate debt (about $35-40 trillion), with the US and European markets accounting for roughly 2/3 of this. Equity losses are still substantial in spite of the steep recovery in markets from the low point in early 2009. Additional financial losses through asset write-downs may take off another $3-4 trillion, mostly among banks. Lastly, housing wealth — a major contributor to the pre-crisis consumption boom — has also fallen back, to the tune of $4 trillion in the US alone. There have been lesser but not insubstantial losses in other countries that went through a housing boom during the last decade (e.g. Spain, Ireland, the UK and much of emerging Europe).

It is certainly true that most markets have bounced back from their early 2009 troughs yet the gains compare unfavourably with the scale of previous losses, which notably started well before Lehman’s collapse in September 2008 (a

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3 The traditional income losses in a recession have been swamped by the enormous wealth losses in this particular crisis, although clearly they still are negative factors.
fact frequently overlooked in comparing markets’ performance with a year ago. The US housing market, for example, has only recovered by an estimated $150 billion in recent months (thanks to a very slight uptick in house prices) whereas the peak-to-trough loss was around $4.4 trillion. Furthermore, prices are unlikely to regain their pre-2006 peaks anytime soon.

**Figure 5: US wealth losses 2007-09 from peak to trough**

![Chart showing US wealth losses 2007-09 from peak to trough](chart)

*Note: US bond gains have been mostly from government*

*Sources: BIS, WFE, IMF-IFS, US Federal Reserve*

Stock markets are far more capable of generating rapid upwards momentum but, despite enjoying a strong rally from early 2009, they remain at only around 60% of their 2007 peaks. And should investor sentiment reflect the more cautious attitude towards a general economic recovery, it is likely that equity losses will persist for some time to come.
How much has been spent?

Unprecedented amounts of money have been spent or pledged by governments worldwide in the form of bank bailouts, monetary interventions and fiscal stimulus packages. Despite this, the net new money may be less than many quotes suggest and the total is probably considerably less than actual losses in wealth. A precise figure for the total cost of bailouts is difficult to obtain due to the bewildering variety of different sources and programmes (in the US, for example, they come from four agencies and amount to almost 40 different programmes). It is often unclear what exactly the figures include: purely upfront costs or guarantees as well? Are these costs taking into account repayments or gross values? It is easy to inflate the figures by considering hypothetical maxing out of funds or worst-case scenarios which are unlikely to ever materialize.

Nevertheless, the most reliable estimates point to roughly $20-25 trillion on a global scale,\(^4\) of which around half are provided by the US alone ($11-12 trillion)\(^5\) and most of the rest originates from other advanced economies. Of

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\(^5\) Bloomberg (2009), ‘Fed’s Strategy Reduces U.S. Bailout to $11.6 Trillion (Update2)’, 25/09/09
this total, 90% is the monetary component (liquidity injections, bank bailouts and guarantees) and the remaining 10% involves fiscal stimulus plans.

Figure 7: Scale of government support

But accepting the $20 trillion figure at face value ignores the fact that only a fraction of this - perhaps less than $5 trillion - represents actual spending:

- The bulk of bank bailouts represents guarantees, rather than upfront costs. These guarantees on loans and deposits amount to around 80% of total government support and are basically funds which may or may not be claimed. After all, a guarantee on a deposit will only be disbursed if the deposit is actually threatened - say if the bank goes bust - just like a guarantee on a loan is only drawn upon if the debtor fails to repay. In the meantime, there’s no actual “spending”.

- There is also the Fed’s intervention in the US commercial paper market. While the sums may appear exorbitant (as much as $1.8 trillion of the Fed’s balance sheet had gone into the CP market at one point), these short-term debts are constantly being rolled over and hence repaid. Although the risk of non-payment exists, it should be noted that these Fed commitments (much like those in other funding programmes) are backed by collateral rather than being lent unsecured. And although there have been questions over the
transparency and value of this collateral, it at least ensures that in the event of default, some of the investment will be recovered.

- Even some of the upfront costs are meant to be repaid; hence there is potentially less cost to the taxpayer. For example, as bank shares recover their lost value, governments stand to make a profit once they resell these shares to private hands. Something similar can be said of the purchases of toxic assets, many which are currently worthless due to mark-to-market pricing but may nevertheless recover some of their value once securities markets revive (the main reason given for the IMF’s favourable revision to expected global write-downs). Lastly and most notably, some of the support to financial institutions via the TARP has already been repaid by the healthier banks such as Goldman Sachs and JPMorgan.

This leaves the actual “spending”. This is likely to be no more than $5 trillion, roughly divided equally between upfront bank bailouts (under the unrealistic worst-case scenario that there are no further repayments) and the fiscal stimulus plans. Yet it is even questionable whether the full amount of the stimulus plans could be deemed inflationary. For example, 30% ($237 billion) of the US plan goes to tax cuts and credits for individuals, money which might well be saved rather than spent (and the money spent will make up for some lost demand rather than add new demand). A further 18% ($144 billion) goes to local and state fiscal relief - again, making up for lost revenue rather than adding to it.

In summary, disaggregating government spending (see also Table 1) shows just how little of this money has actually been “spent”. It reveals how most of the money has been either:

A. not spent at all but merely pledged,

B. spent but is most likely to be recovered,

C. spent but used to help compensate lost expenditure in the economy.

Therefore claiming that governments have forked over $20 trillion is both inaccurate and misleading: the true figure is likely no more than one quarter of this total. And, as we argue above, this has to be seen in relation to much larger declines in wealth, the net effect being an overall loss and a deflationary impact on the economies concerned.
### Table 1: US provisioning vs. expenditure (as of 25 Sep 2009)

<table>
<thead>
<tr>
<th>Major programmes ($ bn)</th>
<th>Provided</th>
<th>Spent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Paper</td>
<td>1,200.00</td>
<td>42.44</td>
</tr>
<tr>
<td>Term Auction Facility</td>
<td>375.00</td>
<td>196.02</td>
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<tr>
<td>GSE MBSs</td>
<td>1,250.00</td>
<td>693.60</td>
</tr>
<tr>
<td>TARP</td>
<td>700.50</td>
<td>372.43</td>
</tr>
<tr>
<td>Stimulus (Bush)</td>
<td>168.00</td>
<td>168.00</td>
</tr>
<tr>
<td>Stimulus (Obama)</td>
<td>787.00</td>
<td>303.60</td>
</tr>
<tr>
<td>Fannie/Freddie support</td>
<td>400.00</td>
<td>200.00</td>
</tr>
<tr>
<td>FDIC Credit</td>
<td>500.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Public-Private Investment</td>
<td>1,000.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Temp. Liquidity Guarantees</td>
<td>1,400.00</td>
<td>301.00</td>
</tr>
<tr>
<td>Federal Reserve Total</td>
<td>5,870.65</td>
<td>1,590.11</td>
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<tr>
<td>Treasury Total</td>
<td>2,909.50</td>
<td>1,075.91</td>
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<tr>
<td>FDIC Total</td>
<td>2,477.50</td>
<td>356.00</td>
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<td>HUD Total</td>
<td>306.00</td>
<td>3.25</td>
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<tr>
<td><strong>US Total</strong></td>
<td><strong>11,563.65</strong></td>
<td><strong>3,025.27</strong></td>
</tr>
</tbody>
</table>

*Source: Bloomberg*

### Conclusions

Most of the money allegedly spent by governments has not in fact been spent (and never will be), while the total sum actually disbursed is really rather small compared with the scale of wealth losses. So the net impact of the crisis on a global balance sheet is still negative. And, arguably, governments are bailing out debts from past profligate spending rather than adding a net impetus to future spending – so they are paying for past spending binges and inflation rather than stoking up future inflationary risk.

So far it is possible to argue that there is a net deflationary impact from the massive net loss in wealth. If governments run amok and the next few years see a continuation of the printing press approach to bank bailouts and bad debt, then the net wealth effect could turn positive and the profligate could be back in the shopping malls. However, policy is unlikely to be so foolhardy and such a turnaround is still a long way off. Indeed, given current discussions over exit strategies, the risks may still be weighted towards governments tightening too soon rather than too late.