A Return To Boom and Bust

Does the printing of money by central banks inevitably lead to inflation?

Is there good inflation and bad inflation?

Quantitative easing is now underway in most developed countries in some form or other, most notably in the US, UK and Europe. It hopes to make up for the decline in transactions for a given stock of money by increasing the stock of money for a given level of transactions. In fact it hopes to more than make up for it. If successful, what does it create in growth of price level and output? It should result either in higher prices for a given level of output, or a higher level of output for a given price level, or both. While on the one hand the stock of money and rate of transactions are scalar quantities, on the other hand the prices and outputs are vectors whose product is scalar. That means that not only are we uncertain about whether the impact of success of quantitative easing is on price or output, we don't know which markets are reactive to it. Common sense would imply that capacity constrained markets are more likely to see price inflation as opposed to real growth while the impact in markets with excess capacity are likely to be on output. Income and substitution effects complicate the analysis of the system as a whole. There may be no impact in some markets either in price or output. However, there must be at least one market in which either price or output rises.

Capacity utilization has fallen substantially in most industries and across most regions. The oil industry may be one example of an exception as refinery capacity constraints and an exhaustible resource constrain both upstream and downstream capacity. If quantitative easing is effective in boosting nominal demand, it may manifest in markets like oil. In other industries such as manufacturing, excess capacity is likely to cap inflation. Whether output rises is, however, uncertain. At an aggregate level, however, the scale of excess capacity created in the wake of the 2008 credit crisis is likely to keep aggregate inflation in check while allowing aggregate output to rise.

Inflation is not always a bad thing. It is damaging when it is the result of the debasing of a currency to the extent that there is a loss of confidence or serious erosion in purchasing power. Until such acute levels of inflation are felt, moderate inflation can be a sign of a robust economy. Generally, inflation isn’t a problem unless you can feel it without being told it’s a problem by an economist. You feel inflation relative to your rate of growth of wealth including your return on investment and wage growth.

Expectations as evidenced by the bond markets have oscillated between inflation and deflation. On the one hand capacity utilization has fallen precipitously and on the other monetary policy has bordered on the irresponsible.

With substantial excess capacity in the economy, fiscal and monetary policies have ample latitude to take effect without triggering rampant inflation. If anything there is risk of deflation which policy makers hope to mitigate. The view is supported by the fact that neither fiscal policy nor quantitative easing has managed to flatten or steepen yield curves to the any large extent. Assuming policy is effective in bringing employment back to acceptable pre crisis equilibrium levels, inflation is likely to settle in the mid single digits, an acceptable place to be. If not, deflation is likely. Given the scale of government intervention, success is more likely.

A by product of stabilizing the real economy through monetary policy is likely to be asset price inflation. In 2001 when the Fed cut interest rates sharply it fuelled an expansion in credit driven by the quest for yield and the availability of cheap credit creating asset bubbles in anything where leverage was feasible – real estate, structured credit, bank balance sheets. In 2008, the tool is not just lower interest rates but quantitative easing which is likely to have a more direct and mechanical impact in inflating markets where capacity is constrained. Commodities, equities, bonds and real estate are likely areas which are likely to face rapid price inflation , already underway. This will almost certainly lead to overvaluation.

The ultimate effect is likely to be period of boom and bust of increasing amplitude in asset markets, more volatility and uncertainty in monetary policy, and finally unstable prices in product markets.