The price paradox

By Robert Skidelsky
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In 1923, John Maynard Keynes addressed a fundamental economic question that remains valid today. "[I]nflation is unjust and deflation is inexpedient," he wrote. "Of the two perhaps deflation is…the worse; because it is worse…to provoke unemployment than to disappoint the rentier. But it is not necessary that we should weigh one evil against the other."

The logic of the argument seems irrefutable. Because many contracts are "sticky" (that is, not easily revised) in monetary terms, inflation and deflation would both inflict damage on the economy. Rising prices reduce the value of savings and pensions, while falling prices reduce profit expectations, encourage hoarding, and increase the real burden of debt.

Keynes's dictum has become the ruling wisdom of monetary policy (one of his few to survive). Governments, according to the conventional wisdom, should aim for stable prices, with a slight bias toward inflation to stimulate the "animal spirits" of businessmen and shoppers.

In the ten years prior to the 2008 financial crisis, independent central banks set an inflation target of about 2%, in order to provide economies with a price-stability "anchor." There should be no expectation that prices would be allowed to deviate, except temporarily, from the target. Uncertainty relating to the future course of prices would be eliminated from business calculations.

Since 2008, the Federal Reserve Board and the European Central Bank have failed to meet the 2% inflation target in any year; the Bank of England (BoE) has been on target in only one year out of seven. Moreover, in 2015, prices in the United States, the eurozone, and the United Kingdom are set to fall. So what is left of the inflation anchor? And what do falling prices mean for economic recovery?

The first thing to bear in mind is that the "anchor" was always as flimsy as the monetary theory on which it was based. The price level at any time is the result of many factors, of which monetary policy is perhaps the least important. Today, the collapse in the price of crude oil is probably the most significant factor driving inflation below target, just as in 2011 it was the rise in oil prices that drove it above target.

As British economist Roger Bootle pointed out in his 1996 book The Death of Inflation, the price-cutting effects of globalization have been a much more important influence on the price level than the anti-inflation policies of central banks. Indeed, the post-crisis experience of quantitative easing has highlighted monetary policy's relative powerlessness to offset the global deflationary trend. From 2009 to 2011, the BoE pumped £375 billion ($578 billion) into the British economy "to bring inflation back to target." The Fed injected $3 trillion over a slightly longer period. The most that can be claimed for this vast monetary expansion is that it produced a temporary "spike" in inflation.

The old adage applies: "You can lead a horse to water, but you can't make it drink." People cannot be forced to spend money if they have good reasons for not doing so. If business prospects are weak, companies are unlikely to invest; if households are drowning in debt, they are unlikely to go on a spending spree. The ECB is about to discover the truth of this as it starts on its own €1 trillion program of monetary expansion in an effort to stimulate the stagnant eurozone economy.

So what happens to the recovery if we fall into what is euphemistically called "negative inflation"? Until now, the consensus view has been that this would be bad for output and employment. Keynes gave the reason in 1923: "the fact of falling prices," he wrote, "injures entrepreneurs; consequently the fear of falling prices causes them to protect themselves by curtailing their operations."

But many commentators have been cheered by the prospect of falling prices. They distinguish between "benign disinflation" and "bad deflation." Benign disinflation means rising real incomes for lenders, pensioners, and workers, and falling energy prices for industry. All sectors of the economy will spend more, pushing up output and employment (and sustaining the price level, too).

By contrast, "bad deflation" means an increase in the real burden of debt. A debtor contracts to pay a fixed sum in interest every year. If the value of money goes up (prices fall), the interest he pays will cost him more, in terms of goods and services he can buy, than if prices had stayed the same. (In the reverse, inflationary case, the interest will cost him less.) Thus, price deflation means debt inflation; and a higher debt burden means lower spending. Given the huge levels of outstanding private and public debt, bad deflation, as Bootle writes, "is a nightmare almost beyond imagining."

But how can we stop benign disinflation from turning into bad deflation? Apostles of monetary expansion believe that all you have to do is speed up the printing press. But why should this be any more successful in the future than it has been in the last few years?

Avoiding deflation – and thus sustaining economic recovery – would seem to depend on one of two scenarios: either a rapid reversal in the fall of energy prices, or a deliberate policy to raise output and employment by means of public investment (which, as a byproduct, would bring about a rise in prices). But this would mean reversing the priority given to deficit reduction.

No one can tell when the first will happen; and no governments are prepared to do the second. So the most likely outcome is more of the same: continued drift in a state of semi-stagnation.

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