DEFLATING INFLATION FEARS

The world economy has come to a halt in the wake of government policies aimed at reducing the impact of COVID-19. Hundreds of millions of lives have already been transformed and the massive short-run disruption is leading many to conclude that the future will also be transformed. In particular, there is a growing fear that wartime levels of fiscal deficits and massive expansions of the money stock will combine with lasting reductions in supply and a sharp recovery in demand to bring high inflation when the epidemic passes.

But it is far from clear that we will see high levels of inflation as a consequence of current government policies. For sure, the immediate response to the virus has created a simultaneous sharp fall in both supply and demand. But that the demand for goods and services may come back more strongly than supply is not obvious. The ‘end’ of the pandemic will not be an event like the end of a war when we have often seen inflation surge as demand outstrips supply. In this case, a return of demand will likely happen gradually over time as the economy gradually reopens.

Of course, high government debt levels as a percentage of GDP are uncomfortable, but those debt levels in and of themselves do not necessarily mean we are in for double digit levels of inflation. Given the historical strength of our economy, our willingness to pay, we can subsist with a higher level of debt in the short- and intermediate-term and know that debt reduction can occur over the long term. Arguably, if this is really a once in 50 years pandemic, then it should also be financed over a 50-year horizon.

There is also the question about the current surge in liquidity and the expansion of the Fed’s balance sheet. The Fed has launched another quantitative easing program that has it buying bonds of all varieties, including the most recent step to purchase junk bond ETFs. These purchases are intended to increase the money supply while decreasing the supply of the longer-term assets. In theory, this should put upward pressure on these assets’ prices (due to less supply) and decrease their yield (interest rates have an inverse relationship with bond prices). This worked well in the aftermath of the Great Financial Crisis, as it allowed interest rates to stay low and feed a return to a more normal level of demand and consumer and business debt.

Ultimately, as we learned from the economist John Maynard Keynes, it is the velocity of money (i.e. the rate at which money changes hands) that matters most when it is comes to inflation, and not the supply of money itself. Governments and central banks have rightly intervened in order to prevent the absolute certainty of a deflationary depression. As demand returns and velocity picks up, there will rightly be an unwinding of current policies but at a pace we can accommodate, as was happening in the aftermath of the Great Financial Crisis. No doubt it will be a delicate balance, but one we will manage given the resilience of our economy, the confidence in our currency, and the sophisticated management of the process by skilled central bankers. Among our current worries, hyperinflation should be the least of our fears.

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