ECONOMIC VIEWPOINT. The consequences of expansion

The return of inflation?

Asset disinflation is still on the cards.

by Jean-Jacques Rosa

Not so long ago, amid the turbulence of the financial crises in Asia, Russia, and Latin America, the main fear was of the world economy falling prey to deflation. In some countries, in France in particular, the consumer price index nudged the zero growth mark, occasionally even dipping below. The price of industrials and commodities fell sharply on all markets throughout the world. And then oil prices picked up again and the Euro's devaluation of almost 17% in one year against the dollar pulled the European economies out of the lethargy into which punitive macroeconomic and exchange rate polices had been plunging them for more than ten years, while American economic growth marched on unabated. True, economic confusion reigned in Russia while Japan was unable to pull itself out of recession. Generally speaking, however, the world economy seems to have moved away from a state of vulnerability where a sharp stock market correction could, at any moment, have triggered a cumulative contraction of national economies.

Admittedly, the monetary authorities had no inhibitions about generating liquidity. While the European Central Bank opted for a strategy of competitive devaluation, Mr Greenspan edged his base rates up in gradual increments, appearing to dampen somewhat the exuberance – albeit irrational, as he remarked – of the stock markets. The fact that U.S. inflation, year on year, climbed from 1.6 % at the beginning of 1999 to 2.7 % at the end of the year, probably means he will further tighten his policy. At the same time in Europe, renewed growth in both France and Germany, following the standard Phillips curve with a slight fall in unemployment and a rise in inflation, got us out of the deflationary area about a year ago.

It is true then that the international context has changed, since the United States is no longer alone in sustaining growth. However, several factors suggest that the risk of inflation picking up in the next few months, assuming no changes in macro-economic policy, is very slight.

Firstly, the remarkable rise in U.S. productivity, which, we learnt this week, grew by 5% in the second half of 1999, a rate far above the trend observed since 1995 which came in at around 2.6% on average. At the same time, unit labor costs fell by 1% in the last quarter of last year, ruling out any possibility of wage-driven inflation. The upswing in productivity means that goods and services are flowing on to the markets at a rate which has outstripped wage increases. Increased supply has exceeded increased demand, which can only put pressure on prices.

Over the same period, an inverted yield curve has developed in the United States. Money market rates are now higher than the yield on thirty-year Treasury bonds, traditionally the forerunner of a business cycle turnaround. Some have also seen this as a reflection of a dip in long-term inflation expectations which usually impinge on bond rates. And it is likely that the inversion of the yield curve heralds at least some slow-down in growth and consequently a reduction in such pressure on prices as may be currently evident.

As far as Europe is concerned, one should not lose sight of the fact that growth remains moderate and that the full effects of the devaluation of the Euro have already been gathered in. It is unlikely that the currency will continue to depreciate. This being the case, there is no reason to believe that Europe will generate inflation in the coming year; what is more, long-term bond rates are falling slightly. This leaves Japan which, despite all the medication, is faced with the prospect of a further recession, which will be borne out if the last figures for 1999 confirm the drop in production for the second quarter running.

Overall, the world economy, which appears to have stabilized since the dangerous patch in 97-98, seems quite some way off from any quickening of inflation.

With one exception, however. The exceptional price rises on the asset markets are not losing momentum. Surplus liquidity from increases in the money supply exceeding the rate at which prices of goods and services are increasing, is thus fuelling the purchase of assets, financial and real. Yet the quantity of real assets hardly increases, while corporate restructuring, mergers and downsizing tend to reduce the quantity of shares in circulation and start-ups do not go directly to the stock market for finance. Demand is consequently tending to outstrip supply and prices are rocketing, so the low inflation in goods and services is counter-balanced by asset inflation.

Against this background, the increased intervention rates being considered in the United States and Europe might one day take the wind out of stock-market speculation, which would only further stabilize price expectations for goods and services.

This would not would not necessarily be a dangerous development. The stock market corrections in 1987 and 1988 demonstrated that contingencies in the financial world do not necessarily lead to real contractions when the monetary authorities act swiftly and energetically.

Consequently, it is difficult to envisage any widespread pick-up of inflation. It could at best develop, here or there, in particular countries experiencing above-average growth. Asset disinflation, however, is to be expected sooner or later. And in this respect, the diagnosis made in 1997 remains unchanged, even if, or indeed because, actual developments have not confirmed it.

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