Monthly Commentary

October 2015

Deflation delusions

Perhaps I have grown cynical in my old age, but I have come to the view that most great economic policy campaigns are much like most great military campaigns – a great waste of human resources expended on battles not worth the fighting, wars not worth the winning, and waged with tactics that are largely counterproductive.

Such certainly seems to be the case with the Federal Reserve's campaign against deflation. The truth is, with or without further monetary "stimulus", there is little danger of the U.S. being engulfed in deflation. In addition, to the extent that the deflation threat manifests itself in lower commodity prices, it seems to be a positive rather than a negative for the U.S. economy. Finally, as we argue in a just-released paper[1], the first few interest rates hikes would actually stimulate, rather than suppress, aggregate demand in the U.S. economy and thus reduce any small risk of deflation.

Of course, the latest numbers on inflation have only stoked deflation fears. Recent data reveal that the consumer price index (CPI) fell for a second consecutive month in September and consumer prices are now unchanged from year-ago levels. The numbers dovetail with warnings from various Fed officials that inflation was likely to continue to undershoot the Fed's goals, a prospect that led two voting members of the FOMC, Lael Brainard and Charles Evans, to advocate an even more cautious approach towards raising short-term interest rates.

Dr. David Kelly, CFA
Chief Global Strategist
J.P. Morgan Funds

[1] "Avoiding the Stagnation Equilibrium: How raising rates from a low level can boost economic growth" by David Kelly and Ainsley Woolridge, October 16th 2015. https://www.jpmorganfunds.com/blobcontent/757/408/1323435781238_MI-WP-Stagnation.pdf

For investors, these warnings are important as they clearly have a bearing on the expected path of both short-term and long-term interest rates. However, it is also important to understand the truth about deflation fears. It appears that year-over-year overall inflation will rebound quickly in the months ahead, that falling commodity prices have been a positive rather than a negative for the American economy, and that somewhat higher short-term interest rates, far from increasing the very small risk of deflation in the U.S. economy, would actually reduce that risk.

On the first issue, a little math makes the point clearly enough. In September 2015, overall CPI was unchanged from a year earlier. However, between July 2014 and January 2015, crude oil prices fell by 54% and the U.S. dollar soared by 14%. With a small lag, this impacted U.S. consumer prices which fell a cumulative 1.3% between October 2014 and January 2015.

If, for the rest of this year, the dollar drifts very gently down and oil prices drift very gently up, (as they have been doing in recent weeks) then by January 2016, the year-over-year growth in CPI should be at 2% or higher for both the overall index and core CPI. The Fed's preferred measure, the personal consumption deflator, will very likely still be lagging a few tenths below 2.0% year-over-year, but the direction should be clear.

Second, even if commodity prices were to slump further, there is little reason to believe that this would be a negative for the U.S. economy. Low consumer prices boost real consumer income. Indeed, real average hourly earnings were up a very healthy 2.0% year-over-year in September, largely due to lower gasoline prices. This is boosting consumer spending with real consumer spending now tracking a 3.6% annualized gain for the third quarter of 2015.

In theory, very low inflation or deflation could cause unemployment to be elevated if some workers don't accept proportionately lower wages. In practice, with the unemployment rate at just 5.1% today, there is no evidence of this effect. In theory, low inflation can prevent the Fed from achieving negative real interest rates and thus stimulate the economy. In practice, there is precious little evidence that super-low real interest rates stimulate anything.

It is obvious why the Federal Reserve would want to target low unemployment. Every tenth of a percent reduction in the unemployment rate is equivalent to putting 160,000 people to work. However, there is simply no rationale for believing that adding a few tenths to the inflation rate would provide any gain in welfare for American households.

Finally, and most frustratingly, we believe that the maintenance of a zero interest rate policy is actually currently suppressing aggregate demand. If the Fed were to increase short-term interest rates by just 1% from current levels, we estimate that it would boost personal interest income less personal interest expenses by over $60 billion, would tend to boost confidence and the stock market, would cause borrowers to accelerate loan applications ahead of further rate increases and would have negligible negative price effects.

In short, deflation fears are no good excuse for the Fed to postpone rate hikes any further. However, we may still need to wait for firmer evidence of firming inflation before the Fed's most dovish members are tempted to act.

MI-Monthly_October2015