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On the Money: Deflation now, inflation later?

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Highly levered balance sheets caused a near death experience for the U.S. economy as the housing bubble burst and the value of derivative securities tied to the housing market plummeted.

In the wake of the crisis, a new debate emerged. Will the U.S. economy find itself suffering through deflation because of continued deleveraging? Or, will the massive amount of liquidity and easy monetary policy implemented by the government in response to the crisis result in rapidly rising inflation?

Economists siding with deflation argue that deleveraging, minimal wage growth, a weak housing market, excess capacity and high unemployment will result in falling prices. Falling prices cause consumers to postpone purchases, which cause prices to fall even further. Businesses then suffer from a decline in sales and smaller profit margins, which incentivize them to cut production and layoff employees. This vicious deflationary cycle is difficult to recover from.

Rampant inflation is also a concern because of the unprecedented actions taken by the government during the financial crisis. Enormous amounts of stimulus and deficit spending left the Fed with over $2 trillion in assets and the Fed Funds rate hovering near 0 percent. To be sure, low levels of inflation have proven to be beneficial over time, especially for borrowers repaying debt.

Two teams at Cleary Gull recently debated both arguments. The teams reached consensus that:

1. The U.S. will not fall into the same deflation trap as Japan because the U.S. responded much quicker and more aggressively.
2. Disinflation is more likely than outright deflation.
3. There is a low probability of runaway inflation in the short-term.

We believe the Fed will keep accommodative policies in place longer than necessary to ensure the economy is on solid ground, jobs are being added and consumers are spending. Whether or not the Fed will have the conviction to respond aggressively once inflationary pressures build has yet to be seen. If they act soon enough and aggressive enough, inflation should remain subdued. However, that is a big “if” and one where the Fed does not have history on its side.