

Inflation – the real threat to sustained recovery

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The rise in global stock prices from early March to mid-June is arguably the primary cause of the surprising positive turn in the economic environment. The \$12,000bn of newly created corporate equity value has added significantly to the capital buffer that supports the debt issued by financial and non-financial companies. Corporate debt, as a consequence, has been upgraded and yields have fallen. Previously capital-strapped companies have been able to raise considerable debt and equity in recent months. Market fears of bank insolvency, particularly, have been assuaged.

Is this the beginning of a prolonged economic recovery or a false dawn? There are credible arguments on both sides of the issue. I conjectured over a year ago on these pages that the crisis will end when **home prices** in the US stabilise. That still appears right. Such prices largely determine the amount of equity in homes – the ultimate collateral for the \$11,000bn of US home mortgage debt, a significant share of which is held in the form of asset-backed securities outside the US. Prices are currently being suppressed by a large overhang of vacant houses for sale. Owing to the recent sharp drop in house completions, this overhang is being liquidated in earnest, suggesting prices could start to stabilise in the next several months – although they could drift lower into 2010.

In addition, huge unrecognised losses of US banks still need to be funded. Either a stabilisation of home prices or a further rise in newly created equity value available to US financial intermediaries would address this impediment to recovery.

Global stock markets have rallied so far and so fast this year that it is difficult to imagine they can proceed further at anywhere near their recent pace. But what if, after a correction, they proceeded inexorably higher? That would bolster global balance sheets with large amounts of new equity value and supply banks with the new capital that would allow them to step up lending. Higher share prices would also lead to increased household wealth and spending, and the rising market value of existing corporate assets (proxied by stock prices) relative to their replacement cost would spur new capital investment. Leverage would be materially reduced. A prolonged recovery in global equity prices would thus assist in the lifting of the deflationary forces that still hover over the global economy.

I recognise that I accord a much larger economic role to equity prices than is the conventional wisdom. From my perspective, they are not merely an important leading indicator of global business activity, but a major contributor to that activity, operating primarily through balance sheets. My hypothesis will be tested in the year ahead. If shares fall back to their early spring lows or worse, I would expect the “**green shoots**” spotted in recent weeks to wither.

Stock prices, to be sure, are affected by the usual economic gyrations. But, as I noted in March, a significant driver of stock prices is the innate human propensity to swing between **euphoria** and fear, which, while heavily influenced by economic events, has a life of its own. In my experience, such episodes are often not mere forecasts of future business activity, but major causes of it.

For the benevolent scenario above to play out, the short-term dangers of deflation and longer-term dangers of inflation have to be confronted and removed. Excess capacity is temporarily suppressing global prices. But I see inflation as the greater future challenge. If political pressures prevent central banks from reining in their inflated balance sheets in a timely manner, statistical analysis suggests the emergence of inflation by 2012; earlier if markets anticipate a prolonged period of elevated money supply. Annual price inflation in the US is significantly correlated (with a 3½-year lag) with annual changes in money supply per unit of capacity.

Inflation is a special concern over the next decade given the pending avalanche of government debt about to be unloaded on world financial markets. The need to finance very large fiscal deficits during the coming years could lead to political pressure on central banks to print money to buy much of the newly issued debt.

The Federal Reserve, when it perceives that the unemployment rate is poised to decline, will presumably start to allow its short-term assets to run off, and either sell its newly acquired bonds, notes and asset-backed securities or, if that proves too disruptive to markets, issue (with congressional approval) Fed debt to sterilise, or counter, what is left of its huge expansion of the monetary base. Thus, interest rates would rise well before the restoration of full employment, a policy that, in the past, has not been viewed favourably by Congress. Moreover, unless US government spending commitments are stretched out or cut back, real interest rates will be likely to rise even more, owing to the need to finance the widening deficit.

Government spending commitments over the next decade are staggering. On top of that, the range of error is particularly large owing to the uncertainties in forecasting Medicare costs. Historically, the US, to limit the likelihood of destructive inflation, relied on a large buffer between the level of federal debt and rough measures of total borrowing capacity. Current debt issuance projections, if realised, will surely place America precariously close to that notional borrowing ceiling. Fears of an eventual significant pick-up in inflation may soon begin to be factored into longer-term US government bond yields, or interest rates. Should real long-term interest rates become chronically elevated, share prices, if history is any guide, will remain suppressed.

The US is faced with the choice of either paring back its **budget deficits** and monetary base as soon as the current risks of deflation dissipate, or setting the stage for a potential upsurge in inflation. Even absent the inflation threat, there is another potential danger inherent in current US fiscal policy: a major increase in the **funding** of the US economy through public sector debt. Such a course for fiscal policy is a recipe for the political allocation of capital and an undermining of the process of "creative destruction" – the private sector market competition that is essential to rising standards of living. This paradigm's reputation has been badly tarnished by recent events. Improvements in financial regulation and supervision, especially in areas of capital adequacy, are necessary. However, for the best chance for worldwide economic growth we must continue to rely on private market forces to allocate capital and other resources. The alternative of political allocation of resources has been tried; and it failed.

The writer is former chairman of the US Federal Reserve

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