Deflation threat poses new dangers to world economy

Nick Beams
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It has not taken long for the optimistic New Year forecasts of increased growth in the world economy in 2014 to suffer a severe blow.

In a speech at the National Press Club in Washington on Wednesday, International Monetary Fund Managing Director Christine Lagarde warned that strengthening deflationary trends posed a dire threat to the world economy.

"With inflation running below many central banks' targets, we see rising risks of deflation, which could prove disastrous for the recovery," she said. "If inflation is the genie, then deflation is the ogre that must be fought decisively."

But Lagarde offered no policy initiatives to meet the situation other than a continuation into the indefinite future of the "quantitative easing" programs of the US Fed and other central banks, which have placed trillions of dollars of ultra-cheap money at the disposal of the banks and finance houses, while doing nothing to bring about real economic expansion.

"Central banks should return to more conventional monetary policies only when robust growth is firmly rooted," she said.

The *Financial Times* noted that with central bankers afraid to even utter the word "deflation," Lagarde is the first high-profile policymaker to point to the growing international risk of falling prices and a deflationary crisis similar to that which has afflicted the Japanese economy for the past two decades.

The target inflation rate for most major central banks is 2 percent per annum. But inflation in the US is around 1.0 per cent and about the same in Japan, where it has risen to that point from levels close to zero only as a result of almost a year of so-called Abenomics, under which the Abe government and the Bank of Japan have committed themselves to a policy of doubling the country's money supply.

Inflation in Europe is even lower. The annual rate of price increases in the euro zone fell to just 0.8 percent in December, while the unemployment rate remained at 12 percent.

The central concern of Lagarde and other financial officials is that deflation threatens to undermine the foundations of the credit and financial system. If prices are falling or increasing at a very slow rate, potential borrowers are reluctant to go into debt, fearing that their real debt burden will increase over time. Likewise, deflation increases the debt burden of those who have already taken out loans.

Lagarde's warnings of the deflation danger came a week after European Central Bank (ECB) President Mario Draghi declared that it was "premature" to declare the European crisis over, taking issue with comments by European Commission President José Manuel Barroso, who said in 2014 the euro zone would put the financial crisis behind it.

Draghi said the European economy remained "fragile" and that the ECB "strongly emphasises that it will maintain an accommodative stand of monetary policy for as long as necessary."

While he did not mention the word, this was widely interpreted as a sure sign that the ECB president was becoming increasingly concerned about the deflationary pressures within the euro zone and the inability of the central bank to reverse them.

According to Stephen King, the chief economist at HSBC bank, writing in the *Financial Times*: "Mario Draghi may have offered reassurance last week that the euro zone is not facing a Japan-style deflationary lost decade, but, frankly, his reassurance is not terribly convincing."

He pointed out that with official interest rates at or near-zero, further declines in inflation "will raise real interest rates, make debt less digestible and, for the financial system, threaten an increase in non-performing loans. A financial system that is already fragile—as the euro zone's is today—will then end up in an even worse position. Initial signs of economic recovery may then prove to be no more than a false dawn."

Lower inflation leads to lower growth, he noted, while the "credit system is slowly asphyxiated."

Lagarde's insistence that now was not the time to end US central bank support for financial markets was replicated in a speech delivered on the same day as her National Press Club address by the president of the Chicago Federal Reserve, Charles Evans.

At several points in his remarks, he reiterated that the Fed's "highly accommodative" monetary policy had to remain in place "for some time to come," adding that, "we need extraordinary monetary policy to finish the task at hand."

In the official version, the "task at hand" is to return the US economy to what were once considered "normal" levels of economic growth and to bring down unemployment. But by any measure, the achievement of this task is not being met.

While the official US unemployment rate has fallen over the past year, this is largely because increasing numbers of people are simply dropping out of the workforce due to the scarcity of available jobs. In other words, the functioning of the US economy is becoming increasingly perverse, with a lower jobless rate actually indicating a worsening economic situation for millions of people.

The only beneficiaries of the Fed's program have been the ultra-wealthy, who are actually profiting from the ongoing and deepening crisis. On Thursday, the *Wall Street Journal* reported soaring bonuses for US bankers under the headline "Bankers' Stock Awards Jet Higher." Goldman Sachs bonuses, the newspaper noted, have increased $600 million over the past year due to the rise in the bank's stock price.

As Lagarde acknowledged in her address, since 2009 some 95 percent of income gains in the US have gone to the top one percent of the population. "This is not a recipe for stability and sustainability," she said.

Global growth was in "low gear," she warned, and there had developed an increasing reliance on emerging markets to "keep the global economy afloat." In the past five years, they had accounted for three quarters of world growth, but now a growing number of emerging markets were slowing down.

A report from the World Bank this week indicates that any sudden closure of the financial spigot in the major capitalist countries could see capital flows to these areas contract by more than 80 percent, causing major economic damage and driving countries into crisis.

Far from any "recovery" taking place, the first weeks of the New Year have made clear that the global breakdown of the capitalist system is intensifying, with further devastating consequences for the international working class.