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Deflation Fears Are A Distraction

No matter what happens these days, deep fears, driven by breathless newscasters, take things to the extreme. As a result, slight gains in inflation create forecasts of “hyper-inflation,” while slowing or low inflation leads to fears of “deflation.”

As we predicted, hyper-inflation never occurred, so, let’s make another forecast – *deflationary fears are overblown, too*. The world is highly unlikely to have a deflationary spiral, where the “real” (inflation-adjusted) value of debts would increase, leading to destabilizing defaults, with “sticky” wages leading to much higher unemployment. This would be a deflationary recession, or depression, which, for the record, is so rare it could be labeled a Black Swan.

One thing driving these forecasts is falling oil prices, but oil prices are dropping because of increased supply (thank fracking). Therefore, any slow or falling inflation due to oil is a supply-side, or “good” type of deflation.

Some of those worried about deflation are the same forecasters who predicted that Quantitative Easing would cause hyper-inflation. But it’s M2 – all deposits in all banks – that drives inflation and deflation, not a Central Bank balance sheet. In the U.S. the M2 measure of money is rising at roughly a 6% annual rate. Overall spending (nominal GDP – real GDP growth plus inflation) is rising at close to a 4% annual rate. There is absolutely no sign of monetary deflation.

And even when short-rates eventually move up next year, they’ll still be low relative to key economic fundamentals. The Fed will be less loose, but not tight; not deflationary.

It is certainly possible that some broad price measures may move down temporarily due to lower energy prices. For example, we are forecasting that consumer prices slipped 0.1%

in October. But they will still be up 1.5% from a year ago and, as we already said, this is a supply-induced dip in inflation.

Fears of Eurozone deflation seem more realistic, with consumer prices up a scant 0.4% in the past year. But Eurozone M2 is up 3% in the past year even though the European Central Bank has yet to commit to Federal Reserve-style Quantitative Easing.

Also, it’s important to recognize that a zero change in prices is not a magical number, on one side of which everything is OK, but the other side of which means doom.

Population growth in Europe (and Japan) is weak, which is holding down nominal GDP growth. Meanwhile, bloated governments are holding down overall real growth while productivity growth in the private sector is keeping a lid on inflation. In this environment, using monetary policy to artificially boost nominal growth is going to just push up inflation, not boost real growth, job creation, wages, or living standards.

Fears about deflation are a distraction in Europe, which needs supply-side fiscal and regulatory reforms that would increase potential economic growth and make the current stance of monetary policy looser without having to resort to gimmicks like quantitative easing.

The same goes for Japan. The Bank of Japan is boosting the size of its balance sheet, but its economy is contracting. “Abe-nomics” – easy money, higher taxes and more government spending – is a Keynesian wish-list of failed ideas which cannot possibly boost growth.

The bottom line: fears of hyper-inflation or deflation are a distraction from the real problem of bad government policy.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
11-17 / 7:30 am	Empire State Mfg Survey – Nov	12.0	13.5	10.2	6.2
8:15 am	Industrial Production – Oct	+0.2%	+0.2%	-0.1%	+1.0%
8:15 am	Capacity Utilization – Oct	79.3%	79.4%	78.9%	79.3%
11-18 / 7:30 am	PPI – Oct	-0.1%	-0.1%		-0.1%
7:30 am	“Core” PPI – Oct	+0.1%	+0.1%		0.0%
11-19 / 7:30 am	Housing Starts – Oct	1.025 Mil	1.030 Mil		1.017 Mil
11-20 / 7:30 am	Initial Claims – Nov 15	284K	285K		290K
7:30 am	CPI – Oct	-0.1%	-0.1%		+0.1%
7:30 am	“Core” CPI – Oct	+0.1%	+0.2%		+0.1%
9:00 am	Existing Home Sales – Oct	5.150 Mil	5.180 Mil		5.170 Mil
9:00 am	Philly Fed Survey – Nov	18.5	25.8		20.7
9:00 am	Leading Indicators – Oct	+0.6%	+0.8%		+0.8%