Inflation and Deflation Around the World

In the spring of 2003, I read in the paper that Alan Greenspan and others at the Federal Reserve System (Fed) were worrying about deflation, a decline in the average price level. Deflation was then more than a remote possibility. People in Japan had experienced four years of deflation in a row. In my lifetime we’d never had to deal with a prolonged deflation in the U.S., but maybe times were changing.

Not since the Great Depression have we had large and persistent deflation. From 1929 to 1933 the U.S. price level fell nearly 25%. Good, you say? Wouldn’t it be nice to have prices falling for a change? But wages are prices too, and if our wages fall more than prices, our purchasing power falls. If we have debt, and who doesn’t in the modern U.S. economy, the real value of that debt rises with deflation. We have to sacrifice more and more other goods to make our monthly mortgage payments. Even if interest rates on our debt fall to zero, principal payments rise in real terms with each fall in the price level. Just as an indebted farmer “lost the farm” in the 1930s, an indebted suburbanite might lose the house, if persistent deflation returns.

Inflation has been the norm in the U.S. economy for over sixty years. After WWII and the elimination of price controls, the U.S. price level rose like steam from a just uncovered boiling pot. In the 1950s, we had creeping inflation ranging from about 1% to 3%. Many worried about even this low rate of inflation. After all, at 2% inflation per year a dollar would lose half its purchasing power in 35 years. In the 1960s, tax cuts and increased government spending in Vietnam and increased domestic spending on “Great Society” social programs at home boosted demand in the economy, and the Fed
increased the amount of money in the economy to accommodate it. By December 1969, the CPI was 6.2% higher than a year earlier. In the 1970s and early 1980s, the rapidly expanding money supply together with supply shocks (oil price increases) drove the inflation rate to double digits. In the last 20 years, the average inflation rate has steadily declined.

Because we’ve had a lot of experience with inflation, we’ve adapted to it in a very rational way. No longer do we expect inflation to be zero. As lenders, we tack an inflation premium onto the interest rate we require borrowers to pay. In the late 1970s, my wife and I obtained a home mortgage with a 10.5% interest rate. Some people were paying much higher rates then. The high inflation of the period had led to expectations of high future inflation, and lenders protected themselves with an inflation premium.

In addition to the inflation premium on interest rates, we also now have explicit and implicit cost-of-living adjustments in wage contracts. Tax brackets are indexed for inflation, as is the standard deduction and personal exemption on U.S. tax forms. Banks offer variable interest rate loans with rates much lower than fixed rate loans. Bank portfolios were burned in the 1980s from the flames of unexpected increases in inflation. Banks, especially savings and loan institutions, were locked into assets with low fixed rates, as rising inflation drove their cost of funds higher and higher.

When inflation rates get very high, economists call it hyperinflation. How high is high? From August 1922 to November 1923 in the Weimar republic in Germany the average monthly inflation rate was 322%. But the well-known German hyperinflation is not the record. That honor goes to Hungary, when for a year after WWII inflation rates averaged 19,800 % per month. And hyperinflation is not confined to distant history. In
Bolivia, in the mid 1980s, well to do housewives had to take the maid along to the market to help carry the cash, which outweighed the goods brought home. Prices changed by the minute. Bolivian paper currency, printed in Germany, was the nation’s third largest import. In February 1984, the Bolivian price level was rising 184 % a month.

And Bolivia is not alone in recent hyperinflation. In the first seven years of the 1980s, Argentina averaged 346% annual inflation. Israel averaged 238%, Brazil 159%. In 1993 *Time* published a list of the ten most dramatic inflation rates of the previous year. Leading the list was the former Yugoslavia, still in an ugly transition to smaller nation states, with over 15,000 % annual inflation. Others on the list, Zaire (3,860 %), the former USSR (1,202 %), Albania (226%). Zambia (191%), Cambodia (177%) and Sudan (114%) rounded out the top ten in 1992.

This list of countries gives us a hint about the causes of hyperinflation. We would not pick any of these countries as examples of political and social stability. And that’s where hyperinflation starts, with a government in trouble and its hand on the money printing press.

Hyperinflation results as an attempted monetary solution to political problems faced by a shaky government. Most political problems suggest to politicians that some form of government spending is the answer. But tenuous political tenure does not lead to increased taxes to finance this spending. Hyperinflation starts with an increase in a federal government budget deficit. Massive deficit increases can only be financed one way, by the creation of money. In some countries, the government that has control of budget policy also controls the central bank. In this case, the government only has to write checks. If the central bank is separate from the government, hyperinflation can
result if the central bank is accommodative, i.e., they buy all the bonds the government issues to finance its deficit, what economists call monetizing the debt.

The distortions of price signals, the unwanted wealth redistribution, and the enormous “shoe leather” costs associated with keeping up with hyperinflation eventually brings it to an end. Stopping hyperinflation requires stopping the causes we noted above. The government has to get the budget deficit under control. The central bank has to make a credible commitment to a more modest rate of increase in the money supply. The medicine tastes terrible but it works. Latin America provides a good test case. In the last four years of the 1980s inflation rates in Argentina, Brazil, Nicaragua, and Peru averaged over 20% per month. In the last four years of the 1990s, inflation rates were well under 1% per month.

In the latter part of the 20th century, we didn’t have hyperinflation in the United States. And the credit goes to the Fed, our central bank, and not the federal government. We’ve certainly had the budget deficits to get high inflation started. But the Fed is too independent to monetize the government debt and allow persistent rapid inflation in this country. President Richard Nixon imposed wage and price controls in 1971 in an attempt to reduce inflation. A few years later, inflation rose again. His successor Gerald Ford handed out WIN (Whip Inflation Now) buttons in the White House. Inflation continued. Jimmy Carter had the energy crisis and hostages in Iran to worry about, not economic policy. Ronald Reagan capitalized on the bad economy of the Carter years, and after the 1980 election turned the cold war and tax cuts into the largest budget deficits in history.

The budget deficits of the early 1980s could have bred increased inflation had the Fed cranked up the engine of monetary expansion. Yet inflation declined in the 1980s in
the United States, largely because a Fed chairman named Paul Volker slammed on the U.S. monetary brakes. Volker passed the monetary baton to Alan Greenspan shortly thereafter, and inflation has trended downward ever since. In 2004, the Fed hoped that their efforts at price stability have not gone too far, and that the incredible dose of monetary stimulus injected into the economy since 2001 would have its predicted effect. Whatever the result, deflation, inflation and hyperinflation around the world in the last decade and a half have made monetary management very important and very interesting to watch, especially if you know a little economics.