My contributions to Economy Lab are based on some understanding of where and how transportation and energy issues intersect rather than on any economic expertise. Nonetheless, as the economy roils around us, it’s hard not to be caught up in controversies that occupy economists. One that fascinates me in these difficult times concerns the value of inflation as a tool to address the numerous challenges faced in the U.S. and elsewhere.

The strongest proponent of using inflation appears to be Harvard economics professor Kenneth Rogoff, who in December 2008 made the case for “Moderate inflation in the short run – say 6 per cent for two years …” in a commentary at the Project Syndicate website. He noted, “… inflation is an unfair way of effectively writing down all non-indexed debts in the economy. … But it would significantly ameliorate the problems, making other steps less costly and more effective.”

Rogoff repeated and amplified the appeal in a Globe and Mail article this month: “… the only practical way to shorten the coming period of deleveraging and slow growth would be a sustained burst of moderate inflation, say, 4 per cent to 6 per cent for several years.” (Deleveraging, I discovered, refers to the process of reducing debt, whether done by a household, business or government.)

Inflation has advantages in addition to making debts easier to pay down. For the U.S., suffering chronically high unemployment rates, perhaps the most important could be the cheapening of the U.S. dollar. This could provide a stimulus to domestic manufacturing by making foreign
goods more expensive. Another well-known U.S. economist, Paul Krugman, wrote, “By selling more to other countries and spending more of our own income on U.S.-produced goods, we could get to full employment without a boom in either consumption or investment spending.”

Lowering the value of the U.S. dollar could be particularly beneficial in respect of petroleum and petroleum products. After reaching a peak reliance on net imports of over 75 per cent in 2005, by June 2011 they had fallen to 63 per cent of U.S. consumption. However, oil and oil products were still responsible for more than half of the U.S. trade deficit. Lowering the value of the U.S. dollar would effectively increase the price of these imports, further spurring the ongoing reduction in U.S. oil consumption (which fell 13 per cent between May 2006 and June 2011 – even more per capita – mostly because of increases in the price of oil).

Another advantage of using inflation as a tool would be the avoidance of the greater evil of deflation, which tends to be associated with reduced economic activity, and the resulting high unemployment that reduces economic activity further.

Inflation can be a two-edged sword as far as economic inequality is concerned, also seen in the U.S. as a growing problem. Inflation favours borrowers, who tend to be poor, over lenders, who tend to be rich. Inflation also means that prices rise, which can be a disproportionate burden on the poor. However, if a sustained burst of inflation were initiated or were otherwise to occur, and it stimulated the economy, then poor and rich could benefit, offsetting some of the disadvantages of inflation.

Inflation does not always reduce unemployment. When both are high we have stagflation. A case can be made that stagflation has resulted from failing to anticipate high oil prices – but that requires another posting.

Major losers from U.S. inflation would be the foreign countries that hold about 40 per cent of the U.S. federal government’s debt. China and Hong Kong hold about a quarter of this. Japan holds about a fifth. Their holdings would be devalued. These lenders could become less inclined to assume further debt. Further debt may have to be raised within the U.S. – where the other 60 per cent of the current debt is now held. Because a main reason for inducing inflation would be to reduce effective indebtedness, this might not be such a bad idea.

How would inflation be induced? According to Rogoff, “… creating inflation is not rocket science. All central banks need to do is keep printing money to buy up government debt.”

So it seems pretty easy: Induce 5-per-cent annual inflation for 10 years and the current debt could fall in value by 39 per cent (what you get from compounding). Induce 10 per cent inflation and the value of the debt falls by 62 per debt. Induce 20 per cent inflation and the value falls by 84%.

Inflation above 10 per cent has happened in the U.S. before: for most of 1979, 1980, and 1981.

For the record, the U.S. monthly year-on-year inflation rate between January 2009 and June 2011 averaged 1.1%, ranging between -2.1 in July 2009 and 3.6 per cent in June 2011. Between January and June 2011 it rose every month, from 1.6 to 3.6 per cent. Thus, the U.S. economy
may already be doing what Rogoff says should be done to it. Nevertheless, the deliberate use of inflation as a tool may be worth exploring further.

China’s inflation rate has been rising more steeply, from a trough of -1.8 per cent in July 2009 to 6.4 per cent in June 2011. Japan’s, by contrast, has changed little: from -2.2 per cent in July 2009 to 0.2 per cent in June 2011.

In relation to the U.S. dollar, China’s renminbi gained in value by 5.4 per cent across these two years. Japan’s yen gained 16.7 per cent. On the face of it, inflation does seem to reduce a currency’s relative value, but not in a mathematically precise way.

Canadians hold little U.S. government debt. Important effects of inflation in the U.S. could be to elevate the Canadian dollar, reduce oil imports, and make Canadian goods and services generally less competitive. These consequences in themselves would not be good for Canada. However, they could be offset by the benefits of an inflation-fuelled boost to the U.S. economy.

I look forward to comments on what are likely numerous errors of sentiment and analysis.

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