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The IMF warns of “demons and ogres”

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Falling prices pose a threat just as rising prices.

Inflation hurts fixed income earners and reduces purchasing power; it destabilizes the markets. On the other hand, steady fall in price levels leads to unemployment, decreasing incomes and spread of poverty.

Inflation and deflation adversely affect aggregate demand. While inflation distorts the future returns of investors thereby reducing investment, falling prices leads to expectations of further fall in prices. As a result, consumers postpone consumption; and stocks build up. Retailers slash prices and profits decline. Manufacturers cut production, lower wages and lay-off the labour force. There is hesitation all around for new investments.

While central banks in the past were preoccupied with inflation, the concern since the global economic downturn of 2008 is with deflation.

"If inflation is the genie, then deflation is the ogre that must be fought decisively", said Christine Lagarde, International Monetary Fund (IMF) chief.

Risks of deflation

Most of southern Europe is experiencing deflation. Britain’s inflation is only 2 percent. It is feared that it might fall further below Bank of England's target rate of 2 percent.

The IMF is worried: the US recovery may not be followed by recovery in Europe and Japan, if governments and central banks fail to keep up the momentum.

The US Federal Reserve (the Fed) has been pursuing an expansionary monetary policy through monthly additions to money supply by US$ 85 billion ever since 2010. No doubt, there was growing criticism that the Fed policy measure would be inflationary and it would debase the currency.

The US dollar has depreciated against most of the currencies since then.

The Fed’s “Forward Guidance”

Fortunately, US inflation is low. It is still well below the Fed's 2 percent target. The Fed’s policy benchmark rate is close to zero. It also informed the public well in advance that it would keep up the expansionary policy until it brings down the unemployment rate to 6.5 percent.

The Fed’s forward guidance policy since December 2012 has paid dividends.

Through "forward guidance," the Fed “provides an indication to households, businesses, and investors about the stance of monetary policy expected to prevail in the future”.

The forward guidance is now seen “to put downward pressure on longer-term interest rates and thereby lower the cost of credit for households and businesses, and also help improve broader financial conditions”.

Change in the Fed leadership

Professor Bernanke is leaving office on January 31.

He will be succeeded by another academic, Dr Janet Yellen. Dr. Yellen has more than a decade of experience in various Fed positions, including the Fed vice-chair. She has the same concern about high unemployment as that of outgoing Bernanke. She supported the Fed bond- purchasing program as the vice-chair.

President Obama, who nominated her to succeed Bernanke expressed confidence that “Janet will stand up for American workers, protect consumers, foster the stability of our financial system, and help keep our economy growing for years to come."

An assessment of Bernanke’s role

History alone will judge Bernanke’s eight-year tenure as the Fed chair.

Former chairman Greenspan who ruled the Fed as colossus for nearly 17 years was hailed during his tenure as a financial wizard. After his exit, the “financial bubbles” began to burst as the “irrational exuberance” evaporated. Soon his reputation also began to decline.

Bernanke is an expert on business cycles, as his doctoral research was on Great Depression of the last century. He implemented the lessons which were documented by the monetarist Milton Friedman. He avoided those mistakes which were committed by the Fed during the Great Depression of the 1920s.

By pumping in money, he saved the financial system. The US economy is doing better than Europe. Though a Republican, he supported President’s fiscal policy measures to step up aggregate demand, as banks were reluctant.

In a parting interview at the Brookings Institution last week, Bernanke recalled his stressful times: takeover of mortgage giants Fannie Mae and Freddie Mac; and the end of Lehman Brothers.

"If you're in a car wreck or something, you're mostly involved in trying to avoid going off the bridge. And then, later on, you say, ‘Oh my God!"’ Bernanke said.