

There is a growing threat of deflation, in which case t...

Published: January 13, 2026, 7:43 am

The [FT has just reported](#) that:

Market measures of short-term inflation expectations remain at the lowest levels since the financial crisis, putting pressure on the Federal Reserve to address deflation risks at its meeting this week.

Investor expectations are reflected in prices for derivatives that can be used to hedge inflation risks. One-year inflation swaps indicate an inflation rate of minus 1 per cent, while two-year inflation swaps are pricing in an inflation rate just below zero - the lowest levels since 2008.

I share this expectation: I [said some time ago](#) that I saw no risk of inflation in the current environment. I noted [Gavyn Davies](#) agreeing with the suggestion a few days ago in the FT. I think his explanation important to note:

The relative behaviour of supply versus demand will be crucial in the 2020s. This question has recently been addressed in an important paper by Veronica Guerrieri and others. They start with a simple model that treats the economy as if it has only one type of production. They establish that an adverse supply shock is likely to lead to a larger drop in supply than in demand. As Keynes argued, this is likely to raise inflation.

But the authors make the model more relevant to current conditions by assuming that the economy consists of two different sectors, but only one is subject to supply lockdowns. In such conditions, the absence of the consumer goods and services normally supplied by locked-down industries can lead to an overall drop in demand. Households set aside some of the money they cannot spend in the missing sectors. Deprived of the ability to visit restaurants, people do not buy extra motor cars instead. They save the difference, and total economic activity drops.

This does not necessarily establish that lockdowns must inevitably reduce demand more than supply in a pandemic economy, but it does establish that this result could occur, and also could persist for a long period.

This is what I suggested would happen. The reaction to this crisis will not be a spending boom when the crisis ends. People will be living in fear for their jobs. They will save. And the result could very easily be deflation risk, despite the significant government spending now taking place. As I said nearly a month ago:

Precisely because no one wishes to reduce official interest rates any further, largely because there is considerable uncertainty as to the impact of negative interest-rates, quantitative easing (whose purpose is to reduce rates) is no longer needed because the type of liquidity it created was otherwise unhelpful. Instead, the process of direct funding from central banks to governments can be used instead.

And, importantly, and to return to the theme of this post, this will not be inflationary unless three situations occur.

The first is that full employment is restored and the policy is perpetuated. Then there will be wage inflation. It's a risk, of course, but not for a long time to come.

The second is banks start recreating money by lending again. They will, eventually, but again not for a long time to come, I suspect. Everyone's balance sheet is going to be very weak after this crisis and that's always bad for voluntary rather than government backed bank lending.

And the third is that governments do not react to the first two situations when they arise by then (and only then) beginning to withdraw the cash that they have created from the economy, with the effect of cancelling it.

I elaborated saying that it's only when full employment is reached and bank lending is in full flow again that tax increases will be needed. I gave my reasons:

Until then they're wholly counterproductive, because they will drag money out of the economy and destroy it when that money will still be required to provide the essential liquidity that the economy needs to function as it returns to full employment, which should be the goal of any government.

So, there is an inflation risk, but it's at some time in the future. And we know how to deal with it then. That will not be by increasing interest rates — which creates debt insolvencies — but by tax increases, but these are required only when the pressure to control inflation is apparent.

What chance is there of significant inflation in a year or so then? I'd call it zero, for all practical purposes. In fact, I would suggest that the chance is very low indeed for several years to come.

So might we do two things then? One is let's stop discussing inflation risk.

And the other is to stop discussing the need for tax increases unless those are designed to redistribute income and wealth i.e. the increases for those with higher incomes and wealth are matched by cuts for those with less of both. But generic overall tax increases are simply not required now.

There is much that we need to fear about this crisis. Inflation and tax rises do not need to feature on a list of those things.

I am seriously hoping that this narrative becomes commonplace, and with it all talk of austerity also ends.