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The case for inflation

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The covid-19 crisis will be remembered for many things, and among them will be the long-awaited return of inflation in developed markets. Three factors will support this: macroeconomic policy, political preferences and structural trends.

Take macroeconomic policy first. The policy response to the coronavirus looks very similar to the last financial crisis, except on steroids. Central banks have injected unprecedented amounts of liquidity into the private sector through purchases of private and public sector securities, swap lines and direct lending to the real economy. The Fed's balance sheet has expanded more in the space of less than two months – from $4.29tn to $6.42tn – than in the four years following the 2008 financial crisis. The fiscal response has been just as aggressive. One calculation suggests that front-loaded US stimulus amounts to 9.1 per cent GDP, more than double that for the last financial crisis. Germany's discretionary fiscal response – when including deferred measures – amounts to a fifth of its entire economic output.[1]

The problem is that this crisis is very different from 2008, or for that matter 1929, where much of the macro playbook being used by policymakers today was written. 2008 was a classic demand shock caused by a loss of confidence in the banking sector. In a demand shock, fiscal and monetary tools should be used aggressively to bring confidence back.

The current economic crisis is not a demand shock, however. It is first and foremost a supply shock which is now spilling over to demand. Consumers did not start staying away from shops and restaurants because they were worried about their future economic prospects, but because governments told them to. Holidays were not cancelled to shore up household finances but because countries closed their borders. Workers were not furloughed from factories just because of insufficient orders but also because employers were worried about the risk of spreading disease.

Understanding this has very important implications for the policy response to the coronavirus. Most of all, it tells us that massive stimulus is not the answer. In economic parlance, policymakers are attempting to shift the demand curve back to where it was before the virus started, at the same time as holding the supply curve fixed. Less technically, the government is handing out $100 bills when there is nowhere open to spend them.

Government attempts to keep household incomes stable – through job retention schemes announced in Europe for example – have the best of intentions, but the result will simply be more money chasing after significantly fewer goods and services. The result of this will be inflation. Evidence is already growing. Our economists note that food prices in the United Kingdom have risen 0.8 per cent in the last week according to the ONS (an annualised rate of 54 per cent). Pet food prices have risen a truly hyperinflationary 6.2 per cent (annualised: 2,575 per cent). Of course, these two factoids don't settle the matter, but it is significant that prices on the few number of goods the statistical office can still collect appear to be gathering steam.[2]

[1] Bruegel blog: https://www.bruegel.org/publications/datasets/covid-national-dataset/

Critics of the view of higher inflation like to point out two big disinflationary forces: rising unemployment and an increase in precautionary savings. But unemployment doesn't have to lead to downward pressure on wages if the unemployed are simply shut out of the labour force which, in the case of workers in sectors such as hotels, restaurants, airlines and retail, is presently the case. For all intents and purposes those industries do not currently exist, and there is a major question mark as to whether they will return in anything like recognisable form for months, if not years, to come.

As for rising precautionary savings, households' spending and saving behaviour is, as every economist knows, about expectations. As soon as households perceive the price of everyday goods and services starting to rise, their rainy day funds will quickly be raided to buy them.

The second reason that coronavirus will lead to the return of inflation is political. At a very basic level, it is in governments' interests to generate inflation.

Many have invoked the spirit of the first and second world wars in the present coronavirus crisis. These two episodes in fact provide a useful history lesson as to the consequences of deflationary versus inflationary policy after large shocks. After the First World War, the British government pursued a deflationary macroeconomic policy aimed at shoring up its borrowing credibility, reducing its debt and returning the pound to the gold standard. The consequence was a decade and a half of misery, with persistently high unemployment rates and widespread industrial unrest. Worse, due to the unforgiving arithmetic of weak nominal growth and high interest payments, debt to GDP stood at roughly the same level by the end of the 1930s as it had two decades earlier.

After the Second World War, the British government took a different approach. Rather than seeking to reduce the deficit, it founded the modern welfare state, nationalised swathes of industry and pursued an incomes policy aimed at full employment. The result of this policy was relatively high levels of post war inflation (constrained only by the continuation of rationing) and strong nominal growth. Combined, these far outweighed ongoing budget deficits and interest payments, leading to a fall in the national debt from a peak of well over 270 per cent to below 50 per cent in the late 1970s.

Put another way, policymakers in the West (and for that matter China) simply cannot afford to go the way of Japan following the bursting of its real estate bubble in the late 1980s. Lacking Japan's high levels of GDP per capita, impressive social cohesion and rapidly declining demographics, perhaps with the exception of Italy in the latter case, a deflationary 'lost decade' would spell disaster both in terms of debt levels and at the ballot box.

And when it comes to the electorate, there is no doubt that maximum pressure will be applied on governments to maintain, if not increase, their generous handouts. That includes those for furlough schemes, deferred tax payments and unemployment benefit increases that have been enacted over the last two months to cope with the current and future economic shocks. The political zeitgeist had already turned firmly against austerity before this current crisis hit. Now a Pandora's Box of government activism has been opened: Reinhart and Rogoff have been replaced by Modern Monetary Theory when it comes to the prevailing mood not just among political commentators but respected economic institutions such as the IMF, who have called for fiscal activism and debt moratoria for well after the initial containment phase.[3]

The third reason to believe that inflation will be the standout macro result from the coronavirus concerns structural forces. Here, we can briefly discuss two: retreating globalisation and the distributional consequences of government policy.

It is now widely understood that one of the key factors behind the secular decline in developed market inflation from the mid-1980s onwards was globalisation. The effects of globalisation on supressing inflation were twofold: first, cross border immigration and the offshoring of production increased the global labour supply, putting downward pressure on workers' wages in developed economies, particularly among the lower skilled. Second, enhanced competition in the manufacturing sector led to a decline in costs of many consumer products.

[2] Focus Europe: European inflation outlook in a time of pandemic: it's complicated. Sanjay Raja and Marc de Muizon
[3] IMF blog on World Economic Outlook https://blogs.imf.org/2020/04/14/the-great-lockdown-worst-economic-downturn-since-the-great-depression/

Both of these are under threat from the coronavirus. As the World Economic Forum discusses in a recent blog, major companies are re-evaluating the commercial benefits of far flung supply chains in light of their fragility over the last two months.[4] Political forces are also at work, with the present US administration pledging to end the country's reliance on pharmaceutical products from abroad. Finally, immigration regimes are set to become significantly more restrictive, if not closed altogether, until a vaccine inoculates countries against the prospect of a second wave of infections.

Turning to distributional effects, a second round impact from both retreating globalisation and more expansionary fiscal policies is likely to be at least a partial reversal in the recent decline of the labour share of income. This should put upward pressure on inflation: the loss of labour bargaining power has been one important factor behind the weak relationship between labour markets and inflation over recent years.

It is difficult to think of any global event that has such a clear read across into future macroeconomic trends. Policy, political and structural factors all point to rising inflation as a result of the coronavirus. Of course, this has not stopped many economists and commentators from claiming the risk is deflation. In the near term, their argument has been buttressed by a price war between oil producers. The worry, however, is that this is a classic case of looking in the rear view mirror.

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[4] https://www.weforum.org/agenda/2020/04/covid-19-pandemic-disrupts-global-value-chains/

The case for deflation

Robin Winkler, George Saravelos

Following the extraordinary event of oil prices turning negative, it seems odd to make a case against inflation. Yet a recent dbDIG survey found that a majority of our clients expect the pandemic to be ultimately inflationary. Remarkably, the disinflation argument is anything but consensus.

Don't put the cart before the horse—this is a huge recession

Our starting point is that the current crisis is a bigger demand than supply shock. Let us assume that the virus disappears tomorrow or (more likely) a vaccine is in place by next year. Our ability to fly, build cars in factories, go to cinemas and football events will all be the same. Our willingness and ability to do so will not. Higher unemployment, more bankruptcies, greater "fear" of the unknown will scar our memories and wallets for many years to come. A group of Harvard economists that modelled the economy recently concluded the same.[1]

Still, even many of those arguing for inflation agree this shock is deflationary in the short run. Eventually, the argument goes, a supply shock will dominate. The problem is that in the long run, as Keynes famously said, we are all dead. For many households and corporates, balance sheet repairs will be imperative for years to come. Corporate debt levels were high before the crisis and are now exorbitant. Government support has mostly come in the form of loans and guarantees —a perfect recipe for a severe debt overhang. Tens of millions of Western households will emerge from the crisis unemployed.

Once deflation takes hold, even in the short-term, it can become self-perpetuating in the long-run. It will clobber already weak inflation expectations and create an irresistible incentive to save. Large-ticket and capital expenditures will be deferred until the risk of further pandemic waves has vanished beyond doubt. With central banks

[1] https://scholar.harvard.edu/straub/publications/indebted-demand

unable to take rates lower, there is no penalty on hoarding cash—classic conditions for a liquidity trap. It will take years for confidence to be fully restored. In the meantime, everyone will spend less. As recent Fed research has shown, the main effect of pandemics over the last 1,000 years has been a big rise in precautionary savings.[2]

Let's not over-hype the fiscal boost – it is neither big or permanent

Governments have an enormous task on their hands. The fiscal numbers announced are large because the economic shock is huge. To argue that fiscal stimulus is a game-changer is to put the cart before the horse. The important question is not about current stimulus but whether huge deficits will continue deep into the future.

The starting point should be that a big chunk of the fiscal measures announced are loan guarantees rather than fresh new money. There is nothing stimulative about adding more debt to corporate balance sheets. But even the direct stimulus is designed to be temporary and self-calibrating. Consider the employment protection schemes in Europe whose size is purely a function of the unemployment rate and will disappear once employment goes back to normal. The bulk of the US fiscal stimulus is also temporary – households have received a one-off paycheck, more likely to be saved rather than spent, like in 2008. As things stand, the fiscal stance is set to be massively contractionary next year, not expansionary.

If stimulus is extended next year, it will be because unemployment and demand are still weak. Yet even the extension of the stimulus is not a given. The UK Chancellor is already in discussions about winding down the employment protection scheme. Germany suspending the debt brake to deal with a natural catastrophe doesn't imply Germans are no longer committed to it or indeed bound by law. If things improve, the government will tighten back. Divided US government – as is likely following the US election – is just as likely to lead to partisan politics and restricted spending like the big fiscal tightening experienced during the Obama years. Austerity on public services may be more toxic than in the past. Indeed, the UK's National Health Service is unlikely to ever be short on funding again. Yet, there is already a debate about raising taxes. This crisis has caused a massive redistribution of income from the young to the older generations. Higher taxation – especially on wealth – should be a far bigger concern that unlimited spending.

And let us not forget China. The Global Financial Crisis is a misnomer insofar as China came through it relatively unscathed thanks to truly massive stimulus. As the Chinese growth boom continued, it provided crucial support to the global economy in the wake of the financial crisis. The rise in commodity prices helped support inflation expectations. Today, China is a less reliable engine for global growth. For one, its growth mix has transitioned toward domestic services in the last decade. And more importantly, there is simply too much leverage in the Chinese system to pump prime the economy at the same rate as a decade ago. Other emerging markets, meanwhile, will likely face an even greater pandemic recession than the developed world. Add the global oil price war into the mix and the environment is highly deflationary. The West is truly on its own.

Deglobalisation—it is very slow

If the cycle won't help inflation that leaves us with the trend. Where we have most sympathy with the inflation argument is that the pandemic will structurally raise business costs over time. Western manufacturers will need to reconsider their supply chains. The integration of global value chains reduced manufacturing costs by shifting production to locations with cheap labour (see our piece 'Undermining global value chains'). Yet businesses will face pressure from shareholders, regulators, and governments to make supply chains more local and resilient to future shocks.

An unwinding of global value chains should strengthen the position of workers in Western economies. If Western workers have been the main victim of globalization, they stand to benefit from deglobalisation. But this structural effect will take decades, not years to feed through. It is unlikely to play any immediate role in driving up wages during the deepest labour market shock since the Great Depression. German trade unions will not emerge from this crisis pressing for higher wages just because the next generation of car factories is less likely to be built in Eastern Europe or South America.

[2] https://www.frbsf.org/economic-research/files/wp2020-09.pdf

And what about business costs? A negative productivity shock would indeed raise costs of production. But, in a recent paper, our economics colleagues have estimated that even a return to a pre-WTO trading regime will bump up inflation by a moderate amount.[3] And it still doesn't follow logically that higher costs will be passed on to consumers. With weak demand, price rises are more likely to be absorbed into profit margins. And even if they are passed on the last ten years have shown that weak and entrenched inflation expectations are extremely difficult to move up again--a very different story to the cost-push inflation of the 1970s.

Who really wants inflation?

Ultimately, to move back to a high inflation regime we need unlimited fiscal and monetary easing. Yet we would dispute the shift in thinking on both fronts. On the monetary side, central banks have not given up on their commitment to inflation targets and their independence does not seem jeopardised. Recently, the Bank of England governor authored a piece in the Financial Times emphasising the central bank's independence. There is little reason to think that central banks could not turn around policy stance on a dime if inflation reared its head.

More importantly, what about politicians? The commitment to reduce unemployment rates should be indisputable. Yet to posit that this is the same as generating a shift in inflation thinking is an argument too far. Prime Minister Abe succeeded in reducing the Japanese unemployment rate to record lows and stepped off the fiscal gas pedal once this was achieved. The thought of inflation in Japan did not prove very popular. The Germans – with very poor demographics - would almost surely not welcome inflation and neither would Italy with the tighter ECB policy and explosive debt paths it would entail.

With the policy response already succeeding in averting an economic meltdown, the question is not whether policymakers will sign up to a 1920s depression but whether a disinflation environment similar to what prevailed in the global economy for centuries before the second world war would be attractive. As global demographics deteriorate, so disinflation becomes politically attractive; old people prefer low prices to protect their savings.

Monetary and fiscal policy-makers received much flak for rewarding moral hazard and sowing the seeds of inflation during the financial crisis. In the event, no advanced economy has managed to hit its inflation target. Today, critics argue this time is different because the pandemic is also a supply shock. That is true and will have ramifications for the global economy in the next decade. However, the demand shock is even greater, the slippage in inflation expectations is more dangerous, and the shift in fiscal policy over-hyped. If inflation did overshoot against all odds, there is little reason to think governments and central banks in particular would be more tolerant of it than in the last forty years. The world has lived with disinflation for centuries. We should worry about turning into Japan, not Zimbabwe.

[3] https://research.db.com/research/research/Document?rid=b6f51e78_02c2_47b0_aa71_bdcff75e4bd7_604&kid=ESN001&wt_cc1=ind-1823-4112