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/