The case for deflation

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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