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SPP Roundtable Bulletin

WHITHER INFLATION?[1]

The dogged persistence of low inflation and falling prices in developed countries, in the face of unflinching efforts of their central banks to achieve publicly announced targets, has raised questions about the dynamics of inflation. The dominant view, reflected in market pricing, mainstream commentary and the current policies of these central banks, has been that price stability is well-anchored and will not be undermined by the present scale of government borrowing, which is unprecedented in peace time.

Yet there are contrarian voices. These have become louder in the recent past as commodity, consumer and housing prices have risen in the post pandemic recovery. Those who contend that inflation will re-emerge after decades of quiescence often have similar views about the basic forces that drive the inflationary process, but they assign different weights to them or see them interacting in a more malign manner. Some implicitly or explicitly endorse the sentiment that inflation is always and everywhere a monetary phenomenon and that the massive central bank financing of government borrowing will inevitably lead to inflation. Others point to slow but powerful changes in demographics that will ultimately alter the balance between savings and investment. Still others cite the unravelling of globalisation that threatens to disrupt supply chains, balkanise trade and reduce supply at the same time that the massive spending needed to cope with pandemics and climate change boosts demand.

Before considering these arguments, it is useful to recall that the impression garnered from the main industrial countries does not necessarily reflect the experience of a substantial minority of the world's population living in developing and emerging market economies. The May WEO put consumer price inflation at 1.6% in the advanced economies in 2021. However in other countries inflation has been much higher for decades. Over 40 per cent of the world's population live in countries where inflation was above 5% in 2020. At these levels rising prices may distort resource allocation and act as a regressive, unlegislated tax. These countries face a different inflation dynamic from the ones where expectations of price stability are firmly anchored.

Those who are of the belief that price stability is here to stay stress the following

Secular stagnation arising from the changing nature of innovation **will reduce the demand for investment finance.** While innovation shows no signs of waning, it is now focussed on altering consumption, particularly of services, rather than improving production, particularly of goods. Earlier waves of innovation did just the opposite, increasing the demand for investment finance. Secular stagnation may be given impetus by ageing and the accompanying rise in the share of workers providing care for the elderly, where productivity increases are difficult to realise. The ensuing reduction in the Wicksellian natural rate of interest helps to explains why nominal rates are historically very low.

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[1] Synopsis of themes considered at roundtable discussions in May 2021. The views expressed do not necessarily reflect those of the participants. Roundtable discussions take place semi-annually. Participants have included Vitor Constancio, Charles Goodhart, Stefan Ingves, Jacques de Larosière, Erkki Liikanen, Donald Kohn, Guillermo Ortiz, His Highness Mohammed Sanusi II, Andrew Sheng, Masaaki Shirakawa, Sir David Walker and Dr Zeti Aziz. The discussions are moderated by Dr Gavin Bingham and Sir Andrew Large.

Beyond the secular reduction in demand for investment finance, there are several other factors, both short and long term, that tend to boost savings and make the **savings glut** chronic. In the short term the uncertainty brought about by the pandemic has led to greater precautionary saving. Over a longer-term saving is boosted by the fact that economic growth is fastest in regions with the highest savings propensities. Despite the nominally communistic character of China's political and social system, significant savings are required by households if they are to meet their needs for health, education and old age. While things may change as the country becomes richer, household frugality can be expected to persist.

Copious **liquidity provision** by central banks through quantitative easing and other asset purchases has, in the face of lacklustre demand for investment finance, prompted investors to allocate assets to the two ends of the risk and maturity spectra. On one hand holdings of money, deposits and other secure but non-remunerative liquid instruments have ballooned. On the other, purchases of equities have soared. The 'safety valve' provided by increasingly deep and liquid equity markets may explain in part why the very easy monetary policies of recent years have not led to inflation. It also may help account for the savings glut. The rich tend to save more, and the rich are becoming richer thanks to the buoyancy of equity prices. Beyond that, the pandemic will generate greater precautionary saving.

There is **no shortage of labour**. Although China is already an upper middle-income country, almost a billion people in India live on less that $5 per day, and Africa, with the world's fastest population growth rate, contains huge amounts of untapped labour that can be integrated into the world economy through investment in health, education and infrastructure. China's Belt and Road initiative is intended to address the latter, the Gates Foundation's efforts the former.

The unrelenting pressure for mass migration into the richer countries is prima facie evidence of the vast labour reserves in the developing countries. It will be many decades before all the unemployed and underemployed in the poorer countries are either absorbed into the local economy or find jobs in richer, more stable economies. By this time, robotics and AI, which are already replacing both unskilled and skilled workers, will help to alleviate labour shortages. Moreover, the gig economy has led to greater flexibility in labour markets and changed the meaning of "full employment". It has also sapped strength from unions so that pressure for wage increases will be attenuated even if labour shortages arise. Amazon's recent success in defusing an attempt to unionise its workforce shows that organised labour is on its backfoot despite the favourable attitude of the current US administration to labour embodied in its Blue-Collar Blueprint for America.

Demographic changes are slow but have a major impact on the factors driving inflation. Even if lower birth rates eventually trump increasing life expectancy so that the supply of labour declines and wage pressure drives prices up, the process will take time. In the interim some of the developments will reduce the prospects for inflation. The transition of an economy with a high dependency ratio for children to a high dependency ratio for the elderly entails a wave that increases the working age population. Initially there is a larger cohort of younger workers whose skill sets are up-to-date and whose consumption and savings propensities differ from the middle aged and elderly.

When eventually the total population begins to shrink, total consumption may decline, which will tend to dampen inflation.

Expectations are firmly anchored. Those whose expectations are shaped by the recent past tend to see little prospect of inflation returning any time soon. Those who experienced the tenacious episode of rising prices in the 1970s cannot forget either the damage that was done or the difficulty of extirpating inflation. The longer a particular regime persists, the deeper the roots of expectations. Those who are more sanguine say that this hysteresis will permit more expansive polices without triggering inflation and indeed that recent increases in inflation in

the US and Europe will be temporary blips. They point to the fact that massive monetary easing has failed to restore inflation to target. Beyond that, supply shocks are likely to be smaller because the pandemic and trade wars are leading countries to stockpile essential supplies and to develop contingency plans for local production. The conversion to sustainable energy will also reduce the impact of oil shocks.

Those who contend that we are on the cusp of inflation stress the following

The recent notable surge in commodity prices may be a harbinger of things to come. The pandemic initially reduced pressure on prices by cutting demand and boosting savings. Oil prices fell sharply, becoming negative for a short period. Commodity prices have now reversed across the board and consumer prices are now rising sharply In the United States, consumer prices rose by 5 % on a year-on-year basis in May. On three-month percentage basis, it reached 10%. Core consumer price inflation, an indicator closely monitored by the Fed, climbed to 3.8 per cent in May. This is less dramatic than the headline figures, but it is the highest level in a generation and, given the way the measure is compiled, does not reflect the surge in housing prices that has occurred.

The vast pools of labour brought into the international marketplace by the integration of China and India into the global economy are drying up. China has already moved up the food chain; production has shifted to other parts of Asia where wages are lower but rising. Beyond that, ageing of populations following on from earlier significant declines in birth rates will lead to a drop in the share of working age and an increase in the share of the elderly whose care is not amenable to significant increases in productivity. Africa does not have the political maturity or institutional robustness to alleviate the emerging shortage of labour. And future pandemics may take a greater toll than the present one.

The **antipathy to globalisation** now in evidence in the form of trade wars and restrictions on the movement of goods, services and people will put upward pressure on prices. Pockets of shortages will become more common, pushing up prices in particular sectors and creating an inflationary dynamic. There was clear evidence of this Balkanisation prior to the pandemic, but it may contribute to it as countries seek to shore up their own capacity to produce at home. The resulting inefficiencies may drive up prices.

Climate change will potentially also cause inflationary shocks. Investment in technologies to address the degradation of the environment will increase demand. In addition, growing pressure on agricultural land and more extreme weather conditions resulting from global warming could lead to prolonged increases in food prices. Although these are relative price shocks – potentially offset by lower energy prices as renewables become more competitive with fossil fuels – such shocks may be accommodated.

The political economy and public perception dimensions also warrant attention. Although changing patterns of production and globalisation have lifted billions out of abject poverty, the **distribution of wealth and income** within many countries has become more skewed. At the same time lifestyle differentials have become much more evident. Concern about inequality can lead to policies that affect inflation by their influence on savings and consumption.

The **nature of technical pro**gress is different from what it was in the past. While arguably it is as momentous, it now has more of an impact on patterns of consumption, the use of time and the functioning of society than on the nature and efficiency of production. The AI algorithms developed and applied in social media are meant to capture attention, in part because revenue arises from advertising. By exploiting confirmation bias and offering a filtered set of choices designed to entice the user to click just one more time, they produce bubbles and rabbit holes and permit partisanship to flourish. They change society but do not increase productivity. There is no sign that this will stop any time soon.

Expectations are a powerful force. When prices are stable, they help to keep them stable. However, once inflation is unleashed and expectations of rising prices firmly entrenched, it is very difficult to eradicate them. Inflation is now re-emerging, and it can easily take on a self-re-enforcing dynamic of its own. It is impossible to determine ex ante when it will do so, but when it does, it could well propel real asset prices still higher. The long history of crises suggests that an unrelenting rise in asset prices eventually confronts the harsh reality of intertemporal discounting even when interest rates are very low.

Debt will then prove unsustainable, and inflation will result either because an explicit policy choice is made that moderate inflation is the least harmful way to deal with unsustainable debt or as a consequence of a shift in the social consensus about the desirability of central bank autonomy and the types of monetary policy that are most usefully pursued. Modern Monetary Theory calls for the government to make decisions affecting price stability. And eminent former policy makers such as Bob Rubin and Mervyn King have advocated the abandonment of policy approaches that rely on rules and mechanistic models. They call for the use of discretion and judgement in dealing with the prospect of greatly increased debt and the radical uncertainty associated with it. While this is not tantamount to advocating inflation as a means to deal with debt, it denotes greater tolerance of policy approaches that could permit it.

Inflation could emerge sooner in the EME than in the industrial countries because expectations of price stability are less firmly anchored and because some of them are experiencing the brunt of the boom in commodity prices and are more heavily hit by the pandemic. Inflation is already at 6% in Mexico. If price expectations become unanchored, central banks in these economies will be able to act resolutely because overall debt levels are lower and concern about the impact of tighter monetary policy on financial stability is not as great an impediment as in some industrial countries.

Which is right?

We don’t know. The theories of the past provide little guidance. Phillips-curve type relations have been pummelled by globalization and the tendency for analysts and policy makers to apply them in an autarkic fashion. Monetary explanations have been battered by the breakdown of the relationship between monetary base and monetary supply. In a number of currency areas, the relationship between commercial bank reserves held at the central bank and banks’ total deposit liabilities has increased many times over and become much less stable in the last ten to twenty years.

If and when inflation will re-emerge as a serious economic problem depends on the interplay between short-term developments such as policies undertaken to counter the adverse economic effects of the pandemic and longer-term trends in population growth, ageing, innovation and globalization vs. Balkanisation.

Expectations are the joker in the pack. If the belief that prices will remain stable is widespread and unshakeable, expectations can forestall and perhaps even prevent another prolonged period of chronic inflation like the one experienced in the 1970s. By contrast, in expectations of inflation become firmly entrenched, even a minor monetary or real shock could unleash a serious, adverse inflationary dynamic.

What should be done?

Before considering what should be done, it is useful to consider what can be done. Views have changed over time. In the decades before and directly after the restoration of price stability in the advanced economies, the predominant view was that it would be easy to generate inflation but costly to stanch it. Now views are inverted. It has proved devilishly difficult to produce even

modest inflation despite almost Herculean efforts to do so. Humility is in order. Our understanding of the dynamics of price inflation is woefully limited.

This stark, sad fact does not absolve policy makers of responsibility for making decisions. The decision to do nothing is as much a policy choice as the decision to act. The authorities developed elaborate contingency plans to deal with financial crises following the shock of the first decade in this century. They have not devoted as much effort to dealing with the eventual re-emergence of inflation. Such complacency is not warranted. We are all prisoners of the past, but to be locked in the cell of the recent past is to be doomed to suffer myopia.

Certain principles can help navigate in these conditions. First, technocratic central banks should avoid seeking to allocate resources. If they do, they will find themselves embroiled in politics and soon be stripped of the autonomy needed to achieve their mandated objectives. Secondly – a closely related point – central banks should not substitute for market forces, particularly in the long-term financial market. Instead, they should make markets work by appropriate regulation, provision of infrastructure and acting when needed as market makers of last resort and ultimate sources of liquidity. Thirdly, it is wise to have sound contingency plans in place. The pandemic demonstrated their existential importance. They are no less important in central banking. Complacency arising from decades of price stability can be as damaging as groupthink about the causes of inflation or the reluctance to demonstrate crisis preparedness out of concern that such action might unleash adverse, self-re-enforcing inflationary expectations. Properly communicated, crisis preparedness should have just the opposite effect. It should also help to contend with the risks to financial stability that could be unleashed by expectations of unchecked inflation.

If inflation re-emerges, the authorities will need to find ways to **unwind QE** and exit from low for long without either precipitating a financial crisis or permitting inflation to accelerate. Quantitative easing was originally seen to be both exceptional and temporary, but economic conditions and market reactions such as the taper tantrum have meant that central bank balance sheets remain bloated. Scaling them back will not be either quick or easy even though this could help to avoid financial crises. The monetary policy frameworks now commonly in use are largely shaped by experience over the last two decades.

There is now less of a desire to be pre-emptive and more of a conviction that action is warranted only after clear signs of actual inflation. The scaling back of central bank balance sheets will therefore begin later than it would have in the past. Given the huge stock of debt and just how widespread the belief is that nominal interest rates will remain low. rapid scaling back of central bank holdings of securities and raising interest rates would make financing more precarious. Ageing is a further factor complicating the unwinding of QE as the elderly are unlikely to want to dispose of the fixed income asset holdings in favour of equities.

While it is likely to prove to be difficult to reduce central bank balance sheets quickly, this does not deprive central banks of the capacity to conduct sensible monetary policy. The impact of even a small – say 25bp – increase in the policy rate could be much larger than it was in the past, given higher debt levels. Central banks will not have a solid empirical basis for determining the impact of policy tightening. So rates would likely rise slowly, and asset holdings be reduced in a measured and systematic way, as foreshadowed by the Fed's partial unwinding of its balance sheet over 2018-19.

The **cancellation of debt** owed by governments to central banks would allegedly reduce central bank balance sheets at the stroke of a pen. Over a 100 economists, politicians and public thinkers have made such a claim when calling for the cancellation of debt owed by governments to the ECB, arguing that repayment of such debt will impose a heavy and unjustified burden on future generations. At first sight, cancellation of government debt owed to the central bank might seem like a free lunch – a simple bookkeeping operation with no

economic consequences. But cancellation of debt owed by the government to the central bank would inflict a huge capital loss on the central bank. It would need to be recapitalised. If this was not done by selling off the central bank to the private sector, the government would have to provide the capital. negating the cancellation and leaving no change to the consolidated public sector balance sheet. The one thing that debt cancellation would change – assuming that the debt was replaced by some other government IOU - is that the central bank would have a non-tradeable asset rather than a tradeable one, seriously hampering any future attempt to manage its balance sheet.

An alternative to replacing the central bank's assets – although extreme - would be some enforced reduction in the central bank's liabilities (such as cancelling banknotes or commercial bank deposits) dramatically reducing the monetary base and inflicting capital losses on the private sector. Debt cancellation is not a free lunch.

By the time inflation re-emerges, central banks may longer have the degree of autonomy needed. They could find it difficult to rebuff the charge that they are risking economic growth and financial stability. And just as low interest rates are seen as making the rich richer by pushing up asset prices, so too higher interest rates may be seen as making the rich still richer by increasing the return on assets (a "heads they win, tails we lose' argument). Polemics can add to populism, creating an environment where it is difficult to conduct technocratic policies that need to strike a balance between competing interests and divergent risks.

If inflation does not emerge, life will not be any easier for central banks. Debt will continue to grow, increasing leverage in the system and making it more fragile. This will make their financial stability responsibilities still more important. Since these can only properly be exercised in collaboration with other authorities, the rationale for central bank autonomy will no longer be so strong.

Either way, and even if modest inflation assists the process of exiting from the trap of high debt and low rates the golden age of central banking – if it ever existed - is a thing of the past.