After Coronavirus: Deflation or Inflation?

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The path of the recovery from the pandemic will depend on the availability of vaccines and other potential cures, which remains unknown. But most economists are agreed that we will eventually return to reasonably full employment, though output growth may remain low.

However, there is great uncertainty about the future path of inflation, once the recovery occurs. Before discussing the main alternative viewpoints, it may be helpful to remind oneself that the last 70 years have been extraordinary in comparison to previous centuries.

Understanding the past

Prior to World War II, inflation and interest rates remained relatively low and constant, except during war time, and periods of bad, or disturbed, governance. Inflation was relatively variable on a year-to-year basis, because food was by far the largest component of most people's expenditures, and food prices depended on the variable success of the harvest. Also, at least until 1815, the history of the Western World was punctuated by frequent, but relatively short-lived, warfare. But once peace returned, e.g. after the Napoleonic wars were over in 1815, there was a long period of stable prices. The moneys of the world's economies were on a metallic standard, mostly gold after 1873; and some combinations of silver and gold before then. There were some minor trends in inflation, or deflation, depending on the relative growth rates of output on the one hand, and of gold/silver production on the other. The disruption of WWI led to inflation, but with the world attempting to return to the Gold Standard thereafter, there was a period of severe deflation in the inter-war period.

But after WWII, there was first a massive trend increase in inflation, culminating at the end of the 1970s, followed by some 40 years of falling inflation, from 1980 through to the present.

This is perhaps most dramatically shown in the diagram of long-term interest rates in the United Kingdom, below.

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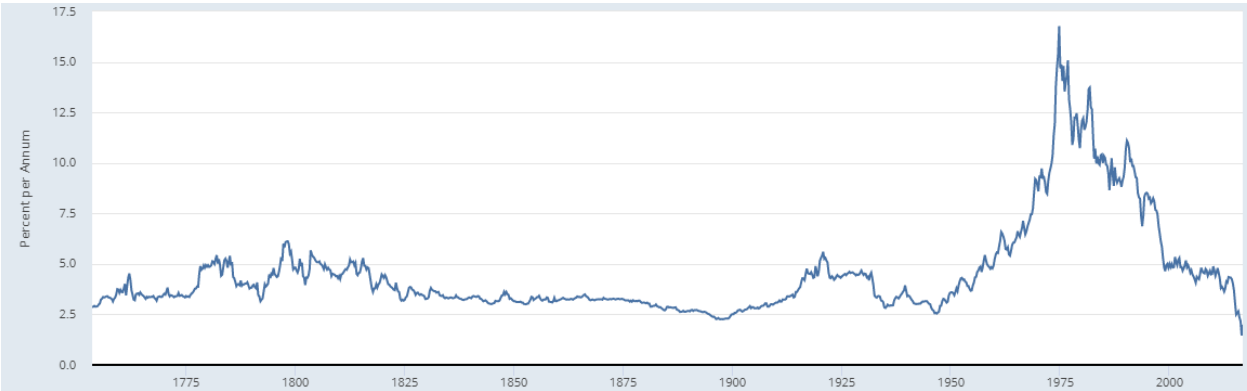
Figure 1. Consol (Long-term bond) yields in the United Kingdom



Source: Bank of England and FRED.

Why did these two trends occur?

The attempt to return to the Gold Standard in the interwar years had been a disaster, and so, after WWII, countries moved onto a managed exchange rate system, initially the pegged, but adjustable, Bretton Woods system, under the management of the IMF. But by then the Keynesian view that the economy should be primarily managed to maintain full employment had become dominant. Moreover, the politicians of that generation had grown up during the Great Depression of the 1930s and were keen to maintain unemployment as low as reasonably possible. So, they sought to run the economy at a higher rate of employment than was, in practice, consistent with price stability. In many countries the hope then was that inflation could be contained by direct controls on prices and wages. This turned out to be impossible. Meanwhile, monetary policy accommodated the growing inflationary pressures. As a result, inflation steadily rose. Eventually everybody in the economy came to expect higher inflation and, therefore, put in claims for wages and price increases that would maintain their real value in the more inflationary context that was expected.

That, in turn, led to ever-faster inflation, which culminated in the horrible years of the 1970s, which were characterised by stagflation, i.e. every-increasing inflation and policy restraint that was sufficient to reduce output growth, but insufficient to check the inflationary spiral. It was made much worse by the spikes in oil prices in 1973/74 and 1979.

This inflationary spiral was finally broken at the beginning of the 1980s by Paul Volcker, Chairman of the Federal Reserve Board, with the support of Reagan in the US and Thatcher in the UK. They temporarily abandoned the overriding pursuit of full employment and allowed Volcker to tighten monetary policy sufficiently to break the inflationary spiral. But this led to short-term interest rates in the US temporarily of over 20%, a severe world-wide recession and the most dangerous financial crisis in the world prior to that of 2008-2010. One of the conclusions of the time was that the politicians, in pursuit of reelection, would always be too expansionary, despite claiming that they wanted to achieve low and stable inflation. This was dubbed 'time-inconsistency'. To counter this, towards the end of the 1980s and the beginning of the 1990s, Central Banks were given independence to set monetary policy, in practice short-term interest rates, to achieve price stability, independent of government control. After CBI was introduced in the early 1990s, the world then saw the best 17 years of economic development ever; this was known as the NICE years (Non-Inflationary and Continuous Expansion). Inflation expectations came back into line with the inflation target, generally about 2%, and as a result, nominal interest rates returned to a roughly normal level of about 3% to 4%.

But the continuous expansion and declining interest rates led to asset price bubbles, (Minsky), especially in housing, and the authorities failed to note how fragile the financial system had become. A downturn in housing prices then led to the Great Financial Crisis (GFC), and this led to even more expansionary monetary policy, in order to offset the recession that then occurred. Underlying the general deflationary pressures was the effect of globalization in shifting production to cheaper parts of the world, especially China and the other Asian countries.

So where are we now?

Low for longer?

The most widely accepted view, and that with most influence on current markets, as evidenced, for example, by longer term and forward interest rates, is that inflationary pressures will remain very subdued, and hence monetary policy strongly expansionary, for at least the next five years, or so. The pandemic has led to sharp increases in unemployment and/or underemployment, and, even should a vaccine be found, the dislocations occasioned by the crisis and lockdown will probably cause major shifts in the pattern of employment, making it harder to reabsorb those who have currently lost their jobs. A virtual economy may well be cheaper and less labour intensive than the old flesh and blood economy. Uncertainties are likely to remain elevated, raising desired savings ratios, while depressing investment. It may be years before many of us regain the confidence to travel; anyhow why do so when you can visit friends and far-off places more cheaply and safely though zooming over the internet? As we shop online rather than in high-street stores, the valuations of previously scarce urban land may tumble. We will watch theatre plays and operas on our computers, not in situ. For all such reasons the mainstream view is that inflation will remain low, probably below target, for as long as the eye can see.

Inflation is a Monetary Phenomenon?

"Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output." Thus, wrote Milton Friedman in 1970 (The Counter-Revolution in Monetary Theory). And for much of the rest of the last century that doctrine was treated as almost self-evident, and taught in most macroeconomic classes at our universities.

In the first two quarters of 2020, when the Coronavirus pandemic struck, monetary growth has surged, almost everywhere, under the combined influence of a precautionary demand for liquidity in the private sector, a 'dash for cash', a massively increased deficit in the public sector, and the aim of Central Banks to support the economy via extremely expansionary policies. In the USA broad money growth has surged to its fastest ever recorded growth rate of 32% year on year. To a monetarist that means that a sharp rise in inflation in future years is now almost inevitable.

Qualifications

We are, of course, currently in a context where the velocity of broad money is dropping just about as fast as its overall supply is being expanded. This arises from a combination of massive involuntary saving (people cannot go on holiday, attend theatres, buy new clothes, etc., etc.), equivalent falls in the incomes of those supplying such services, (offset by various forms of fiscal expansion, such as paid furloughs), and precautionary savings. Yes, indeed, but that will not last. Sometime in the foreseeable future shops, hotels, even theatres, will reopen, and the related workers will be rehired. At this point, velocity could revert back towards normality. And what then?

The second qualification is that Central Banks could then try to reverse the current monetary expansion, for example by allowing some of their current bloated holdings of government debt to run off. But that would put pressure on debt markets, at a time when debt ratios everywhere will be historically high and still rising fast. Even if official short-term rates were held down to present extraordinarily low levels, longer-term rates would, probably, be forced upwards. Central Banks could come under political pressure not to reverse course too abruptly.

There are other grounds for expecting higher inflation. The reversal of globalisation, and greater national protection, will disrupt supply chains, shift production to more expensive sites and strengthen labour (Trades Union) bargaining power in each country. Worsening debt burdens, in a state of high uncertainty, could lead business to seek higher profit margins, rather than competitive expansion. Nevertheless, the key determinant, on this view, of the likely resurgence in inflation is the monetary (and fiscal) policies adopted to counter the pandemic.

So What Will Happen?

At this point in time, there are, therefore, two strongly held, but contrasting, views about the likely future path of inflation, following a proper recovery from the pandemic. The mainstream position is that the continuing dislocations in, and weakness of, the real economy will preclude any recovery in inflationary pressures for the foreseeable future, say the next three to five years, 'lower for longer'.

The contrary view is that, once the recovery has got underway, the expansionary monetary, and fiscal, measures already adopted will generate a resurgence in inflation, partly because an early reversal of such policies would just then be too painful for our economies to bear. In addition longer term trends, away from globalisation and with a slower growing workforce, will underpin inflation.

Apart from the important practical implications of finding out which of these positions is more nearly correct, it will affect macroeconomic theory and teaching, perhaps forever.

We shall see.