A new economic era: is inflation coming back for good?

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1 juin 2021

In the first in a series, Chris Giles examines whether the extraordinary post-crisis stimulus will lead to rising prices

© FT montage; NCJ Archive/Mirrorpix/Mirrorpix/Getty | Pensioners protest in Newcastle in 1974, as inflation soared

Chris Giles in London

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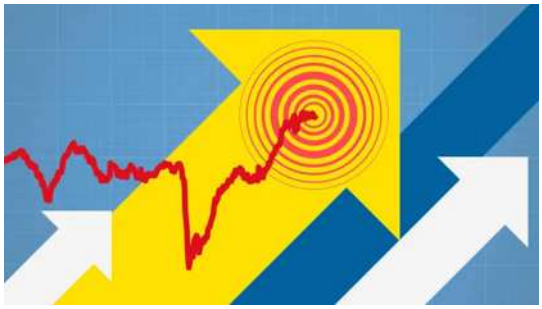
The December meeting of the Federal Reserve's most important economic committee was routine. Policymakers agreed that the economy could cope with rising levels of spending "without any strong general upward pressure on prices".

Although prices of a few raw materials were rising sharply, "finished goods have not been subject to pervasive upward cost pressures".

Generalised inflation, the committee concluded, was not a serious concern.

This meeting of the Federal Open Market Committee was held on December 15 1964, just two weeks before the start of a 17-year period the Fed now dubs The Great Inflation.

Inflation: A New Era?



Prices are rising in many major economies. The FT examines whether inflation is back for good.

DAY 1: Advanced economies have not faced rapidly rising inflation for decades. Is that about to change?

DAY 2: The global consensus among central bankers on how best to foster low and stable inflation has broken down.

DAY 3: The canary in the coal mine for US inflation: used cars.

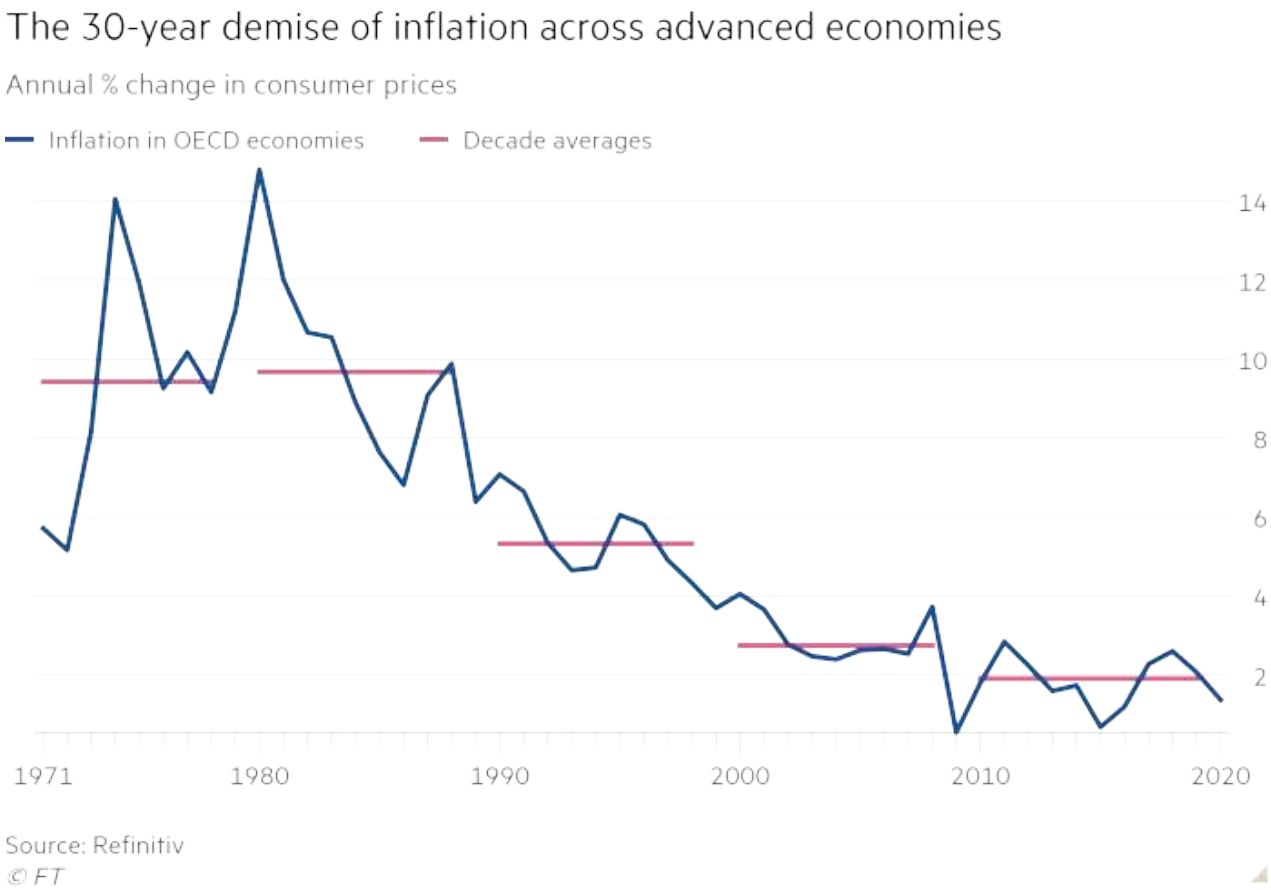
DAY 4: How a virus can disrupt official inflation statistics.

DAY 5: Why rising prices in advanced economies are a problem for indebted developing countries.

Turning points in price trends tend to occur just at the moment when the authorities and expert opinion dismiss the risks. The current consensus is that price rises in commodities and goods markets have clear pandemic-related explanations and that the risks of a resurgence in global inflation remains remote.

Three decades after the authorities in advanced economies managed to suppress the beast, they remain confident they are in control. The mantra of the moment is summed up by Andrew Bailey, Bank of England governor, who likes to say he is watching inflation "extremely carefully" but not worrying.

This view is still the mainstream but it is losing supporters. One notable recent defector is Roger Bootle, author of the book *The Death of Inflation*, who spotted the coming decline in price rises in the mid 1990s. He is now worried. "Financial markets are going to have to get used to the return of troublesome issues that had, until recently, seemed long dead," Bootle wrote in May.



Central bankers have not had to deal with an inflation problem during their careers. Having averaged around 10 per cent a year in the 1970s and 1980s, global inflation rates fell to an average close to 5 per cent in the 1990s in the rich world countries of the OECD, 3 per cent in the 2000s and 2 per cent in the 2010s. The question today is whether their view is complacent. Is the world entering another inflationary era?

While many households think the definition of price stability would be an absence of inflation, economists and policymakers favour a gentle annual increase in prices of around 2 per cent. This reduces the risk that an economic crisis could spark a deflationary spiral with spending, prices and wages all falling, raising the real burden of debts and further hitting spending. Holger Schmieding, chief economist of Berenberg Bank, explains that a little inflation also greases the wheels of the economy, allowing declining sectors to fall behind gracefully.

“Higher inflation eases economic adjustments as it creates more scope for changes in relative wages without a need for an outright fall in wages in sectors under pressure,” he says.

In most advanced economies — the US, the eurozone and Japan — central banks have fallen short of meeting their targets of inflation of around 2 per cent despite having slashed interest rates to zero and having created trillions of dollars, euros and yen, which has been pumped it into their economies by purchasing government debt. A modest rise in inflation therefore would be welcomed by central banks, which have generally been delegated the task of achieving price stability.

1950s and 1960s: Variable inflation

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Although inflation did not surge in the US until the mid-1960s, the UK saw persistent prices rises from the 1950s, partly as a result of currency devaluations

And until this year, the main economic concern regarding prices was the risk that countries were turning Japanese and might soon emulate the nation’s 30-year struggle with mild deflation. Such was the difficulty of keeping inflation high enough that some economists even began to question the doctrine of Ben Bernanke, former Fed chair, who argued in 2002 that “under a paper-money system, a determined government can always generate higher spending and hence positive inflation”.

But this view of the world has turned on its head in 2021. A new whatever-it-takes borrowing and spending programme by the Biden administration, enforced savings during the coronavirus crisis giving households additional firepower, bottlenecks in the supply of goods and a reversal of longstanding downward pressures on global wages and prices have rekindled fears of excessive inflation.

No one is talking about hyperinflation of the sort seen in Weimar Germany in 1923 or Latin America in the 1980s or even the 10 per cent global rate of the 1970s, but a creeping rise to persistent levels of generalised price increases not seen in a generation. When the April rate of US inflation jumped to 4.2 per cent, financial markets swooned.

The new concern about a return to inflation is not just the result of immediate economic forces but also reflects longer-term, underlying changes in the structure of the global economy. The aggressive economic stimulus is being adopted at the very moment when the global economy is feeling the impact of ageing populations and the maturing of China's 40-year transition.

1970s: The era of oil shocks

A sign outside a service station in the UK in February 1978 © Pete Primarello/Evening Standard/Getty Images

Inflation really started to take off after the 1973 oil shock when Opec imposed an oil embargo amid tensions in the Middle East

Moreover, history also tells us that neither politicians, economists nor policymakers can guarantee the world will maintain low and stable inflation. As the Fed's experience from the 1960s demonstrates, turning points in inflation arrive with little warning. Unlike in the US, where there was no fear of inflation after the second world war, concern about inflation was "always rumbling on" following devaluations of sterling and higher import prices in the UK during the full employment years of the 1950s and 1960s, according to Nick Crafts, professor of economic history at Sussex university.

But it only really took off in the 1970s after the first Opec oil shock and a switch in government policy from austerity to "a massively excessive stimulus, pushing the economy beyond any reasonable estimate of the sustainable level of unemployment", Crafts adds.

Research from Luca Benati, professor at Bern university, suggests that the world's faith in central bankers being able to tame any similar episodes is probably overblown. The UK's inflationary pressure in the 1970s was so strong, he found, that when he ran history again in multiple simulations assuming an independent central bank is in charge of controlling prices, inflationary forces would have been more powerful than any likely action by a Bank of England with an independent Monetary Policy Committee. In the 1970s, it would have had only a "limited impact" on quelling price rises which reached an annual rate of 26.9 per cent in 1975.

1980s: The central bankers take charge

Paul Volcker, then Federal Reserve chair, (R) meets then president Ronald Reagan in the Oval Office in July 1981 © Bettmann Archive

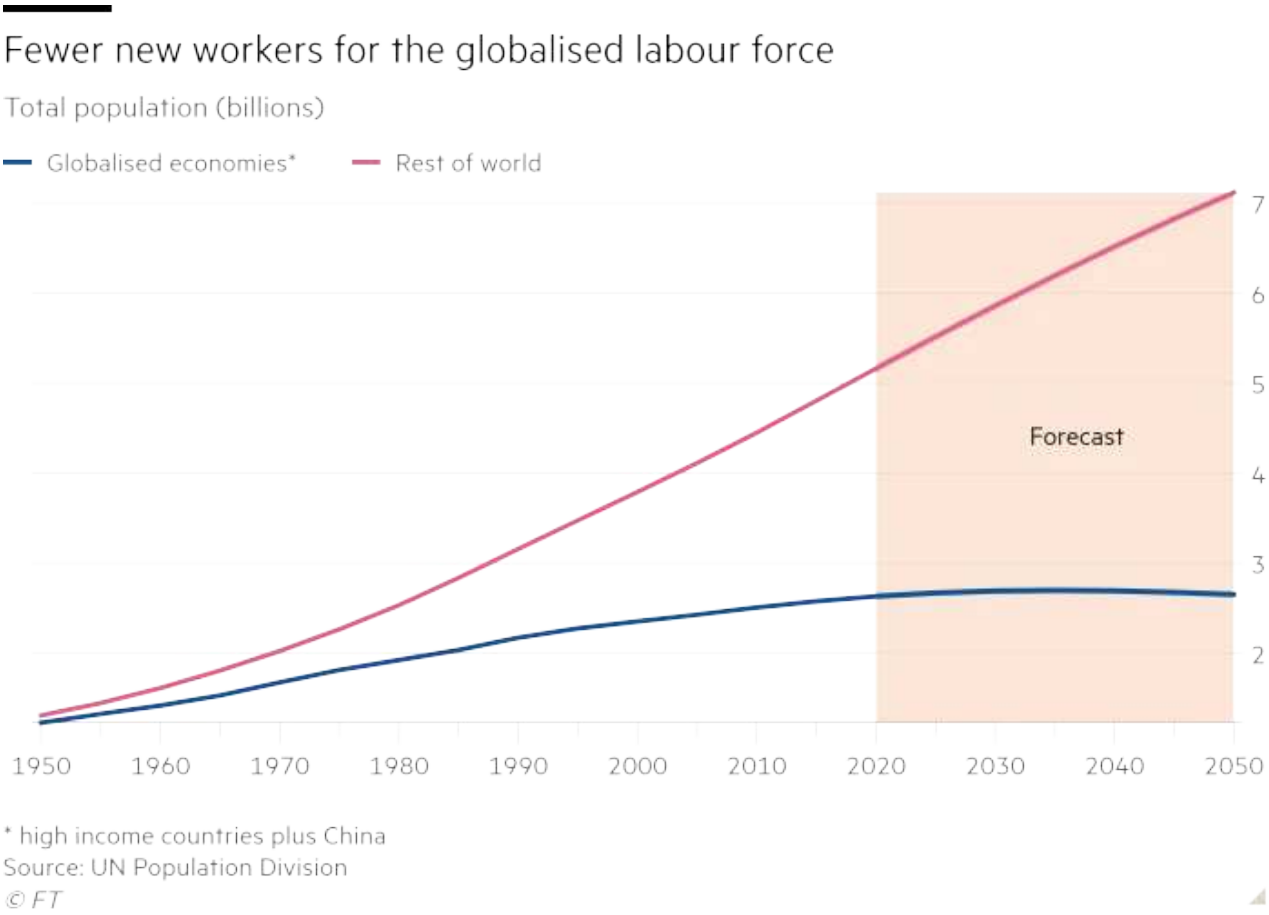
As Fed chair, Paul Volcker raised interest rates in a bid to tame inflation and launched an era of all-powerful central banks

According to Karen Ward, chief European market strategist at JPMorgan Asset Management, this means the Bernanke doctrine still stands and should not be forgotten. “We’ve always assumed that the structural supply side enhancements such as technology and globalisation are so great that we could never overwhelm them with demand, but it still must be the case that you can overwhelm supply with demand and ultimately generate inflation,” she says.

It is exactly this fear which is raising inflation rate expectations in the US and Europe at the moment. Alongside a recovery of energy prices to pre-Covid levels, there has been a shortage of microchips, wood products, many metals and even cheese. These have been the proximate causes of higher inflation, but financial markets worry that the ultimate cause has been the pandemic-related fiscal and monetary stimulus which has led to a much faster economic recovery in advanced economies than was thought possible at the end of 2020.

With economic policy pressing harder on the accelerator than at any time in recent history, spending could exceed the capacity of economies to provide goods and services, especially if the coronavirus crisis and government support have left people less willing to work, creating labour shortages and significant pressure on companies to raise wages.

Such is the potential imbalance between rampant demand and more constrained supply, especially in the US, some supporters of centre-left policy ideas say that warning lights are flashing. Larry Summers, Treasury secretary in the Clinton administration, thinks policy has become far too lax, repeatedly criticising the “dangerous complacency” over inflation of today’s policymakers in recent weeks.



While the White House has hit back, saying "a strong economy depends on a solid foundation of public investment, and that investments in workers, families and communities can pay off for decades to come", even Janet Yellen, current Treasury secretary, has acknowledged the possible need for interest rates to rise "to make sure that our economy doesn't overheat".

The policy shift has come at a point when economists generally accept that some of the big global forces holding prices down are much weaker than they were. In the 1990s and 2000s, globalisation led to a huge transfer of the production of goods from high wage economies to China and eastern Europe, accelerating a decline in the power of workers in advanced economies to force their employers to pay them more, keeping prices low.

But these forces are at a turning point, according to Charles Goodhart, former chief economist of the Bank of England, and an author of the book *The Great Demographic Reversal.* The long boom in the size of its workforce has ended and its population is on the verge of falling for the first time in decades. Goodhart says that fewer new workers becoming integrated into the global labour force at a time of shrinking workforces in advanced economies as populations age will raise the pressures on companies to push up wages, increasing underlying inflationary pressures.

The change in demographic pressures have already been around for a decade and are intensifying, Goodhart says. He had been wary of putting a date on the coming inflation, saying that the world is likely so see rising inflationary pressure within five years and "we are fairly sure it would have happened by 2030".

2021: Biden promises action

© Reuters

The Biden administration has taken a do-whatever-it-takes approach to reviving the economy and reducing inequality, even if that risks some inflation

That was before Covid struck. Now, he says the underlying pressures, alongside more stimulative policies and Covid-related restrictions in supply, have brought forward the moment. “We tend to think that because of supply constraints in particular, it’s going to be more inflationary in 2021 than central bankers originally thought and it will last longer in 2022 and 2023 because there will be a confluence of the build-up of large monetary balances . . . combined with large continued fiscal expansion.”

Turning to specific examples of prices he expected to see rise, Goodhart notes how the added demand for holidays in the UK would push up the prices of holiday rentals, hotels and even ice cream this summer. “You’d have to be a saint not to raise your prices,” he says.

Demographic pressures are not something that can be reversed quickly, nor he argues can the forces of globalisation, which have gone into retreat having become politically unpopular in many advanced economies. Again, this is most acute in the US where economists such as Adam Posen, president of the Peterson Institute for International Economics, urges Americans to “embrace economic change rather than nostalgia” in domestic production, especially in manufacturing, as a means to improving living standards and promoting non-inflationary growth.

So far, however, although financial market expectations of inflation have risen sharply in 2021, mainstream policymakers are remaining calm.

There is increasing chatter in the Fed that at some point the current members of the interest-rate setting committee need to think about scaling back the pace of money creation and purchases of government bonds. But the view is that inflation is recovering to more normal levels and the US central bank has pledged to keep policy ultra accommodative until it achieves a more inclusive recovery.

This is the right approach, says Laurence Boone, chief economist of the OECD in Paris, a view which chimes with similar attitudes in central banks around the world. “It’s too early to ring the alarm bells about inflation,” she says. “That doesn’t mean one doesn’t have to watch what’s happening and we’re seeing frictions with the reopening of demand and supply after the crisis . . . but the right policy is to ease tensions on the supply side more than central bank action [to quell inflationary pressures].”

In most economies, there remains significant slack in the labour market, she adds, and the big demographic pressures could be eased significantly with later retirement, while other parts of Asia and Africa would be delighted to integrate into the global economy as China did.

Boone’s view still represents the consensus opinion among economists and there is considerable confidence in central banks that any rise in inflation this year will be temporary and easily tamed without having to tighten policy significantly.

But, for the first time in many decades, there is the possibility that a significant turning point has arrived, that price rises will be more than a flash in the pan and something more difficult to control.

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