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# Where is inflation going?

## Chief economist's comment

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- Economic growth is expected to be very strong in the third quarter. This may change some relative prices, but it is unlikely to cause general inflation.
- In the near term, excess capacity in the global economy should be disinflationary.
- Today's fiscal policy is mainly about transfer payments (not especially inflationary). As this turns to stimulus, inflation may increase.
- Central bank policy should not be especially inflationary, unless central bank independence is lost.
- Reversing globalization is inflationary if it is politically motivated. If it is a consequence of the fourth industrial revolution, it should be neutral or disinflationary.
- The most likely outcome is near term low inflation, longer term higher but not high inflation.

## What are we talking about?

Inflation is a *general* rise in prices. Over the next few months, we will certainly see some things rise in price. These will be *relative* price increases. Some prices will go up, others will go down. The net effect is likely to be lower rather than higher inflation. Thus, in the US, the price increase of food (at home) accelerated sharply in April, but most prices either fell or rose more slowly. Higher US food prices do not mean there is an inflation issue. It means there is more demand for food at home.

It is dangerous to judge average inflation on the basis of personal experience of a few prices. We are genetically programmed to remember price rises more than price declines (loss aversion). We also tend to remember the prices of things we buy more often (frequency bias). This means our instincts are not to be trusted when it comes to inflation.

Asset prices should not be part of consumer price inflation. Rising consumer prices reduce spending power. Rising asset prices increase spending power. The two things have completely opposite effects. Statisticians go to a lot of trouble to exclude asset prices from measures of consumer price inflation.

## What happens in the short term?

Economic *growth* rates will bounce back in the third and fourth quarters. It is perfectly possible that, in Europe and the US, the third quarter will have the strongest quarterly growth rate on record. No doubt politicians will scramble to take credit for that, but this is just economically obvious. GDP will be compared to the very weak activity of the second quarter. In addition, there should be a surge in consumer spending, as people spend the savings they were forced to accumulate during lockdown.

The money people have been forced to save during lockdown will probably be treated like a tax rebate. Tax rebates are generally spent within six months, on consumer durable goods. This could mean that consumer electronics prices rise, but there is no reason why (for example) clothes prices will rise. Indeed, the experience of US President Donald Trump's trade taxes in 2019 suggests that businesses do not rush to exploit short-term opportunities to raise prices. Durable goods prices may not react to a short-term demand surge.

More important for inflation, advanced economies will have a lower *level* of economic activity at the end of the year than they did at the start. The level of GDP will not return to 2019 levels before the end of 2021. That means that there will be spare capacity in economies for the near term. This spare capacity will be obvious in higher unemployment rates. It will have a *disinflationary* effect on prices.

## What happens in the long term?

There are two broad concerns about longer-term inflation trends. First, will fiscal and monetary policy raise inflation? Second, will structural changes like the reversal of globalization raise inflation?

*Fiscal policy*

Most of the fiscal policy response to the virus has been what economists call transfer payments. Unemployment benefit or furlough schemes are not inflationary. This sort of fiscal policy is trying to prevent a collapse in demand, not boost demand as such. Fiscal policy today is therefore fighting disinflation, not promoting inflation.

As the economic bounce-back continues, we will see governments shift to stimulate economies. This spending will increase demand in an economy; investing in infrastructure, for example, increases demand for labor and goods. This can be inflationary, depending on how much spare capacity there is in the economy. In 2021, most economies will still have significant amounts of spare capacity. That will limit the ability of fiscal policy to increase prices, though it will have some effect.

It is worth noting that inflation does not generally help reduce government debt burdens. This was covered in the 7 May 2020 Chief Economist's Comment.

*Central bank policy*

Central banks are increasing money supply significantly. This is not inflationary. Inflation is only a risk if *too much* money is produced. Money supply has to be considered against money demand to understand the inflation risks.

Normally, money demand increases roughly in line with the growth of the economy. If more economic transactions are taking place, more cash is needed to do those transactions. It is a little more complicated for the US dollar (as the global reserve currency), as an increase in global trade will increase demand for US dollars independently of the US economy.

At the moment, money demand is growing faster than the global economy. This is because, in the face of the crisis, people and companies are hoarding cash. Savings rates have been rising during lockdown. This means that demand for cash increases. Today, much of the money printed by the Federal Reserve ends up in the Federal Reserve. Banks in the US have increased their cash reserves at the Fed this year by the equivalent of 70% of the Fed's increase in asset holdings. The cash is not out chasing goods or assets—it is sitting at the Federal Reserve doing nothing.

The inflation risk from central bank policy is most likely to emerge as demand for cash starts to fall. At that point, a central bank will need to manage the balance of liquidity demand and supply. They could do this by telling banks to hold more reserves, forcing demand for cash to rise again. Alternatively, they could reduce the cash supply. If a central bank does not react to the decline in demand, then there will be inflation. (This is why cryptocurrencies are so prone to inflation. The supply cannot fall when demand collapses.)

*The end of globalization*

It is often claimed that globalization led to lower inflation. In fact, it lowered some prices and raised others, and was probably a small net positive for inflation. Nonetheless, as local production starts to replace complex global supply chains, there is a fear that inflation will increase.

Why supply chains are shifting will matter. If the introduction of robotics, digitalization, and localization is driving local production, this will be disinflationary or neutral. Companies that onshore are replacing people with robots. They are doing this because it is more costeffective overall. This may lead to increased profits, or it may lead to reduced prices (or some combination). It is unlikely to lead to higher inflation.

The localization of music production is a good example of this. Compact disks involve long, complex global supply chains. Streaming digitally allows music to be "made" extremely locally (in the home). The rise of streaming has coincided with a very negative inflation rate for music in the United States.

If supply chains are shifting under political pressure, then inflation is more likely. Trade taxes or political restrictions force companies to relocate supply chains when it is not efficient for them to do so. This creates a cost pressure that may (in time) be passed on as higher inflation.

Both of these changes are present in the global economy today. However, it is likely to be the disinflationary forces that are more significant over time.

## Where does this leave us?

Over the next year, the world economy will probably experience some relative price changes. Global demand patterns are changing, and that will have some relative price effect. Consumers will also often think that inflation is higher than it actually is—but consumers are normally useless at assessing inflation, so this is not unusual.
The spare capacity of the global economy means that overall inflation is likely to remain very low for the next 12 months.

Over the medium to longer term, there should be some increase in inflation from current levels. Spare capacity will eventually be reduced by economic stimulus. This should allow a normalization of inflation. Central banks may accept inflation slightly above target. Having spent around a quarter of a century bringing inflation under control, it seems unlikely that an independent central bank would allow inflation to rise significantly above target. Central bank independence is important to this view. If that is maintained, it seems sensible to expect higher, but not high, inflation in the medium term.

# Appendix

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