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Inflation tug of war



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Today's environment is unusual for many reasons. We are probably at the tail-end of the Great Recession, which followed the Global Financial Crisis, but the environment is far from 'normal'.

The outlook remains highly uncertain and prospects for inflation have turned out to be the topic on which opinion is perhaps most divided. There is an atypical polarisation of views—on the one hand many worry about an inflationary outcome to the public policy response in the wake of the crisis. On the other hand, many worry about deflation as a consequence of de-leveraging and prolonged sub-par economic growth. Unusually, inflation expectations are not as congregated around an assumption of a benign inflationary outcome as they have been for many years now—the distribution of inflation forecasts is more than usually skewed towards two extremes—prolonged deflation or uncomfortably higher inflation.

This is not just an academic argument—the medium to longer-term inflation outcomes will have profound impacts on economic policy, the world economy, and asset prices.

Typically modern economies operate in a benign inflationary environment. Low and stable inflation keeps growth, employment and the incentive structure of the economy operating effectively. It is when inflation diverges from these expectations that implications for markets can be dramatic. Higher levels of inflation tend to be associated with greater inflation volatility, and hence less certainty in valuing future cash flow streams, resulting in higher risk premiums for risky assets. Conversely, deflation involves declining prices and has a risk of leading to debt-deflation cycles and liquidity traps.

What the textbooks say

Inflation is defined as an increasing general level of prices in an economy that is sustained over time. It is measured as the change in the weighted average price of a basket of goods and services in an economy. Note that a key part of this is that price increases have to be sustained over time. A one-off increase in the price level resulting from, for example, the introduction of a GST or a one-off increase in key commodity prices doesn't really qualify.

Inflation tug of war

In the economics textbooks, inflation is generated primarily from two sources:

- Demand pull inflation occurs where an increased desire for goods and services is greater than the supply of those goods and services, pushing prices upwards.
- Cost push inflation occurs where increased costs in the production process flow into higher prices of goods and services.

In practice, the two types of inflation tend to be interrelated. Higher demand for goods and services that outstrips available supply (demand-pull) also increases the demand for, and price of, a range of production inputs including, most notably, labour (cost-push).

While a simplification, the views of economists can be characterised as falling into two broad schools on the causes of inflation. The Monetarist view is that inflation is always and everywhere a monetary phenomenon relating to the supply of money in the economy. A Monetarist would argue that all inflation is essentially demand-pull, caused by too much money chasing too few goods and services. Conversely, Monetarists view deflation as the result of an inadequate supply of money. In traditional monetary theory a government can control the money supply, thereby influencing interest rates and the level of investment. More recently, this has morphed into a view that it is through variation in interest rates that aggregate demand and inflation outcomes are affected,

with the stock of money being a residual variable which is only indirectly under the control of the monetary authorities. Importantly, the impact of changes in money supply on the economy and inflation depends on the interaction between changes in the money supply and changes in credit availability. The two do not necessarily operate in tandem, particularly in times of crisis. Thus an increase in money supply may not be inflationary if the supply of credit has not also increased.

Monetarists are likely to express concern over the massive liquidity injections into the financial system and monetisation of debt, particularly in the US and UK, that are being used by governments to stimulate their economies. Moreover, Monetarists tend to view fiscal policy as a less powerful macroeconomic policy tool than monetary policy. Consequently they tend to advocate a balanced budget approach where automatic budget stabilisers are allowed to operate freely.

In contrast, while Keynesians would not dispute the notion that excessive money supply growth can cause inflation, they would emphasise that inflation is fundamentally caused by excessive demand for goods and services relative to the economy's ability to supply those goods and services. Excessive money supply can cause inflation if that money finds its way, through the financial system, into the real economy. For a Monetarist, excessive money always causes inflation. In addition, a Keynesian might argue that a range of

factors could cause demand to accelerate relative to supply, and hence cause inflation. Right now, worrying about inflation would be well down a Keynesian's list of priorities. Our Keynesian would stress that demand remains extremely weak relative to supply, and that the massive injections of liquidity have not found their way into the real economy. A Keynesian would also argue that big budget deficits are merely a symptom of Government efforts to replace private demand.

Reality

The massive injections of liquidity by central banks have not yet resulted in significant increases in credit growth, as the liquidity generated by central banks has been used to repair bank balance sheets. Banks have not been as willing to lend as much as prior to the crisis, and consumers, faced with declining asset values and the need to de-leverage, have not been as willing to borrow. The effectiveness of increasing the money supply has been limited by the breakdown of credit availability, making conventional monetary policy as effective as 'pushing on a string'.

As a consequence, we have yet to see meaningful improvements in private sector spending, nor any acceleration in inflation. That is not to say neither will occur—the lags involved are famously long and variable. For the time being, excess aggregate demand is all but absent. The global economy continues to experience sub-par economic growth. Furthermore, cost-push

inflation has not yet emerged as a source of concern. Wage costs have not risen as unemployment continues to rise. However, labour share of GDP has been at or near all time lows, and if this was to rise it could imply cost-push inflation from labour at some point. Commodity prices have normalised after their dramatic falls, but have not gone back to pre-crisis highs.

The role of expectations

In practice, inflation is generated not only from too much demand chasing too few goods and services, but by the market's expectation of future inflation. Market psychology is an important driver of inflation behaviour. Bond yields soared in the 1970s as a result of rising inflation expectations. An entrenchment of high inflation expectations then led to wage-price inflationary cycles. This was one of the main drivers of the sustained inflation of the 1970s.

Studies have shown that confidence in the central banks' ability to manage inflation over the medium-term is a significant contributor to inflation outcomes. The success of central banks at managing inflation with inflation targeting regimes over the last 15 years has installed this confidence into investors. Furthermore, the independence of central banks and transparency in their approach to managing inflation has helped to keep inflation expectations contained.

While deflation remains a threat, particularly in the near term, stimulatory policies remain in place for much of the global economy. The depth of the recession means the threat of inflation is likely to be some way off. However, the current emergency measures will have to be reigned in by policymakers at some point in order to prevent an inflationary outcome. Policymakers may have to walk a fine line between inflation and deflation. It could easily be argued that Governments, now laden with so much debt, have an incentive to inflate their way out of debt, either by monetisation or by allowing their currency to depreciate. To the extent that the debt issued has been short-term and will need to be rolled over, governments will have limited ability to inflate their way out without facing higher interest rates. Countries such as the US and UK are seeing their currencies depreciate as a consequence of massive liquidity stimulus and rising debt/GDP levels.

Despite the best efforts of forecasters, future inflation outcomes are essentially unknowable. Credible arguments for inflation and deflation over the medium to longer term can be made, and indeed within MLC views on the inflation outlook remain mixed. Investors would be well-advised to diversify their investment strategy to protect against both a deflationary and/or an inflationary outcome.

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