An Ominous Inflation Outlook
October 7, 2021

For the ten or so years between the Global Financial Crisis and the pandemic recession of 2020, the Federal Reserve and other central banks struggled to raise inflation to their targets (usually 2 percent.) Not surprisingly, therefore, they have seen the pick-up in inflation in 2021 as due to transitory factors. However, there are good reasons to believe that a fundamental shift has occurred and that we have entered a period of increased inflationary pressures. Recent price surges arising from fiscally stimulated, pent-up demand running up against supply constraints caused by the pandemic and trade frictions, certainly have a transitory element. But I would argue that the long-term outlook for inflation has worsened and that even these transitory increases, by raising – and destabilizing - inflationary expectations, contribute to upward pressures.

Among the reasons for building inflationary pressures are

a) Global labor supply constraints
b) Increased government spending and intervention in the economy
c) Reduced central bank commitment to low inflation

Global Labor Supply Constraints

In their book, *The Great Demographic Reversal* (Palgrave Macmillan, 2020), Charles Goodhart and Manoj Pradham argue that the modest inflation rates experienced in most of the world since the early 1990s owe much to the entry of China into the global marketplace. China's participation in world trade greatly expanded the world's effective labor supply. Hundreds of millions of low-wage workers were suddenly available to meet the needs of the world's consumers. Moreover, the productivity of these workers increased rapidly, so that China became competitive in an increasing array of increasingly sophisticated products. This expansion in global labor supply put downward pressure on prices, particularly for traded goods.

Today, however, China is largely integrated into the world economy and its population is aging and soon to decline. No longer will the rising productive capacity of China exert downward pressure on global prices. Furthermore, other countries are seeing similar demographic changes – slowly growing, aging populations. India and Africa are important exceptions. But in general, global labor supplies are likely to tighten compared to the experience of the past thirty years.

Goodhart and Pradham argue that this tightening in global labor supply will tend to raise inflation. They also suggest that the bargaining power of labor will increase, perhaps with salutary effects on income inequality.

What about arguments that technology is eliminating many jobs and making workers redundant? Goodhart and Pradham counter that aging populations require more caregivers. As those jobs cannot easily be outsourced or automated, demand for labor will remain relatively strong.

But their main point is that the low inflation rates of the past thirty years were not simply due to good monetary policy. China's joining world markets substantially increased supply capacity. But looking ahead, China will no longer be a deflationary force.

## Government Intervention in the Economy

In response to the Covid outbreak, governments around the world intervened aggressively in their economies. More intense intervention has become the new norm and risks raising costs.

a) Fiscal Stimulus
   Unprecedented fiscal stimulus eased the pain of the pandemic-caused shutdowns and supported an unexpectedly robust recovery. Generous transfer payments boosted incomes and when vaccines and reduced restrictions on activity allowed more normal behavior patterns, people spent freely. Although strong demand ran into supply constraints and inflation picked up, the overall response to fiscal stimulus will likely be judged favorably, and governments will return to these policies when growth falters again. And they will continue to do so until the costs are obvious.

b) Expanded Government Role
   Governments have become more willing to intervene in the economy. Responding to Covid, with mask mandates and shutdowns, energized those desirous of remaking the economy. The interventions do not stop with Covid. In the United States, the Biden administration plans major spending on infrastructure, community services, housing, education, and R&D. This is on top of the fiscal stimulus to counter the recession. These longer-term programs significantly increase the government's role in the economy and risk competing with private demand and pushing up prices. Tradeoffs receive little attention.

   Rules and regulations also increase costs. An example is increases in the minimum wage, which are *intended* to raise labor costs (although some might argue that higher wages will come at the expense of capital rather than through higher prices.) But even seemingly minor requirements to monitor emissions or track certain financial activities impose record-keeping, compliance and oversight costs. This is nothing new, but government directives seem more prevalent and sweeping, with little thought to costs. Moreover, the effects of multiple regulations will be so diffused over time and across the economy that they will be indistinguishable from underlying inflationary pressures.

c) Response to climate change
   The response to climate change will be costly. Reducing greenhouse gases, however it is done - through carbon taxes, rules and regulations, investments in new technologies - will add to inflationary pressures. The vision is to replace an economic infrastructure built to take advantage of fossil fuels with one built on

electricity powered by renewable sources. This is slightly reminiscent of trying to replace imported oil in the 1970s, in that functioning power plants and industrial equipment were pre-maturely retired in favor of coal or, later, natural gas facilities. But climate change is a much more enormous task as it involves all sectors of the economy and fundamental changes in how we live and work. Electricity costs will rise and supplies will become more volatile, with the effects percolating throughout the economy.

One may view these costs as well worth it. One may believe that the costs of inaction and the resultant increase in temperatures are higher than the costs of acting now. If so, the world still faces long-term supply constraints and inflationary pressures – but in a different form and over a different time frame.

<u>Central Bank Hesitancy</u>

One reason for confidence that inflation will remain low is confidence that central banks have the will and the tools to keep it down. But do they?

As noted at the outset, before the pandemic, central banks had been contending with inflation rates below desired levels. With inflation low, some central banks focused more on their role in achieving high employment levels. Notably, in 2019, the Federal Reserve announced an approach to monetary policy that called for inflation above its 2 percent target to compensate for episodes of below target inflation and increased its emphasis on achieving maximum employment. These shifts followed numerous conferences and much internal debate and soul-searching. Having just shifted their focus, central banks will be hesitant to accept that the world has changed, and they are fighting the last war.

Central banks are also being asked to take on additional roles, notably, curbing climate change and, in the United States, reducing racial disparities in income and wealth. More goals will blur the focus on maintaining low inflation and potentially create conflicts with its achievement. For example, curbing inflation may call for higher interest rates while supporting investments in green energy may require low and stable rates. Different goals will also attract different people with different priorities to central banks.

However, the biggest impediment to central banks addressing rising inflation is that government debt has increased dramatically – first in response to the Global Financial Crisis and again in the pandemic, as governments undertook aggressive fiscal stimulus. This expansion in government debt has not raised government interest payments because interest rates have fallen, in large part because of central banks' stimulus efforts. But this will change if rates rise. Payments will not increase all at once, as longer term securities must mature and be refinanced. But even a return to what were once considered normal rates will substantially increase the government's interest obligations. In 2020, net interest payments amounted to 5 percent of federal outlays, but the average interest rate on Treasury securities of all maturities was less than 2 percent. Before the Global Financial Crisis, the average Treasury rate was 5 percent. Thus, central banks' efforts to curb inflation by raising interest rates will increase the governments' interest payments. This, in turn, will require the government to cut spending, raise taxes – or issue more debt, with the last potentially putting more upward pressure on interest rates.

Central banks will also be concerned about the effect of higher rates on the private sector. This is always an issue when central banks tighten policy. Reducing inflation generally requires a weaker economy; but after such a long period of very low interest rates, the effects of rate hikes may be unusually unpleasant and unpredictable. Private sector borrowing has increased in recent years, although substantially less than government borrowing. A greater vulnerability may lie in stock valuations, which soared in response to low interest rates. In any event, central banks may approach the prospect of tightening with more caution than in the past.

## Summary

The outlook for inflation has shifted. Inflationary pressures have increased. The long-term global environment has changed: China is no longer a deflationary force. Governments in many countries adopted aggressive fiscal stimulus policies in response to the pandemic and are exerting more control over economic activity. Efforts to address climate change will be costly; higher energy costs will percolate through the economy. Central banks may be slow to recognize shifting inflationary trends, and when they do, they will be constrained by conflicting goals and the effect of higher interest rates on government deficits.