Diverging outlooks

From deflation to hyperinflation, nothing can be ruled out in post-lockdown economies

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Economic crises are typically due to either a contraction in aggregate demand (AD) or a reduction in aggregate supply (AS). Clearly, **the crisis caused by the coronavirus epidemic is all but "traditional"**.

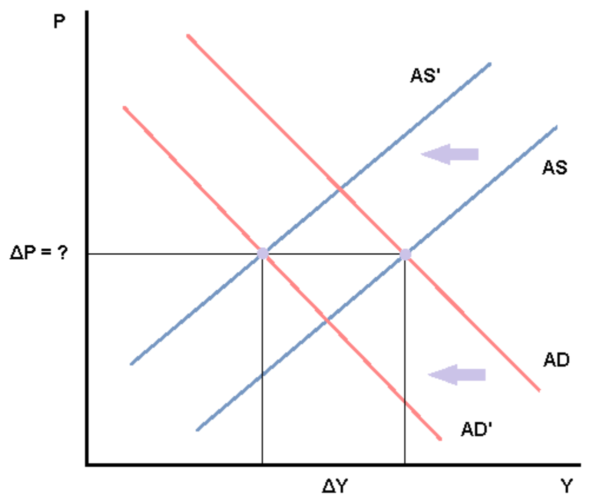
Unlike standard demand-only or supply-only shocks -- which are associated with a decrease and an increase in the price level, respectively -- the only certainty with AD-AS twin shocks, such as the one caused by Covid-19, is the severe contraction in output suffered by affected economies.

Most economists agree that, in the short term, the pandemic will cause a reduction in the growth rate of consumer price indices (i.e. disinflation) and therefore **low or even negative inflation** (i.e. deflation). **But extending**, even slightly, **the forecast horizon, the range of opinions** on future price paths **widens considerably**.

Much depends on the letter of the alphabet that each forecaster has in mind to describe the recovery of the global economy -- an optimistic V, a more prudent U, a less desirable L or W. **Those who tried to look for answers in the bond market have emerged with even more confused ideas**, as signals sent by this key corner of the financial system are blurred by central banks' massive monetary injections.

So here we are, with a long series of question marks. Will demand recover faster than supply (and therefore inflation will accelerate) or the other way round? Will firms decide to raise prices -- to balance out lockdown-weakened earnings and take advantage of decreased competition resulting from the default of some of their peers -- or will they prefer to lower prices -- in an attempt to attract customers who are not keen on spending in a context of abiding uncertainty?

Econ 101: Covid-19's impact on aggregate demand and supply



A simultaneous shift in aggregate demand and aggregate supply causes a decline in output but generates an uncertain effect on the price level.

If supply is hit more severely, prices rise.

If the shock on demand is stronger, deflation is the consequence.

Forecasts for annual HICP inflation (euro area)

	2Q20	1Q20	Δ pp
2020	0.4%	1.2%	-0.8
2021	1.2%	1.4%	-0.2
2022	1.4%	1.5%	-0.1
2024	1.7%	1.7%	=

Source: ECB Survey of Professional Forecasters (May 4, 2020)

Reading list

(*Financial Times*) The world has more to fear from deflation than hyperinflation.

(*Financial Times*) Investors struggle to hear signals from bond markets.

(*Financial Times*) Why prudent investors should start paying up for inflation protection.

(*Financial Times*) Investors warn Covid-19 crisis is paving the way for inflation.

(*Bloomberg*) World faces rare 'inflationary depression,' says Keynes scholar.

(*Bloomberg*) Fears mount about inflation returning with a vengeance.

(*Bloomberg*) Deflation is the Voldemort of the coronavirus era.

(*Bloomberg*) Dangerous disinflationary shock slams reeling world economy.

(*Bloomberg*) Inflation worriers will be wrong for a second time.

(*Bloomberg*) Why deflation is poison for virus-plagued economies.

(*Bloomberg*) V, L or 'Nike swoosh'? Economists debate shape of global recovery.

(*Bloomberg*) Fed study says pandemic likely to have muted impact on deflation.

(*Vox*) Is there deflation or inflation in our future?

(*Vox*) Future imperfect after coronavirus.

(*Vox*) Will inflation make a comeback after the crisis ends?

Inflation

The comparison with war is undoubtedly **the one used the most by those who argue that the** post-pandemic **economy is headed towards a future of inflation or hyperinflation**. Therefore, it is not surprising that the current situation is sometimes compared to that of a ticking time bomb: the fact that inflation will not explode immediately doesn't mean that it will never blow up.

The starting point is that the unprecedented **fiscal and monetary interventions** put in place by governments and central banks -- combined with often irreversible damage suffered by global production chains -- **will** sooner or later **turn into a powerful engine of price growth**. Even worse, some observers fear that a sharp rise in inflation will not be synonymous with economic recovery, but with stagflation.

Expansion

According to some economists, one of the main differences between the policymakers' response to the coronavirus crisis and their reaction to the 2008-09 global financial crisis is the more coordinated nature of the international monetary and fiscal actions that have been deployed today.

If in the last decade central banks were left almost alone on the front line to help their troubled economies, in the past weeks governments have been equally audacious in adopting substantial budget measures. Moreover, this time **both monetary and fiscal measures have been much more targeted than before**, allowing earmarked resources to directly reach the hardest-hit sectors and economic agents.

The generosity of aid received, combined with the desire to rapidly return to normality (perhaps thanks to the discovery of a vaccine against the virus), **could lead households and businesses to swiftly reactivate consumption and investment**, releasing the huge demand they have accumulated and repressed during long months of lockdown.

A further consideration is that the fiscal initiatives deployed by governments might prove difficult to withdraw quickly, due to the likely opposition by public opinions to a repeat of the austerity policies that have characterized the last economic slump. On the contrary, **some commentators hypothesize initiatives aimed at shifting the burden of the repayment of "pandemic" debt toward the richest brackets of the population**, with consequent inflationary effects (due to the higher marginal propensity to consume of those who will benefit from a more progressive and redistributive tax system).

Fabio Panetta
Member of the Executive Board of the ECB

We think that inflation will stay very low for the next two or three years, well below our definition of price stability. I can't say what will happen in ten years, but I note that market-based indicators of longer-term inflation expectations have remained at depressed levels.

May 14, 2020

Deglobalization

One of the most classic causes of price increases is a rise in companies' production costs. According to some observers, the novel **coronavirus** has caused permanent (and not temporary) damage to global supply chains and **could lead to the repatriation** back to advanced economies **of many production activities that were previously outsourced in emerging economies** (where labor costs are typically lower).

Reshoring, aimed at bringing manufacturing closer to end markets and at increasing resilience to future epidemic shocks, would also be associated with lower efficiency and elasticity in the management of production processes, for example due to larger precautionary inventories.

The increasingly local nature of future Western labor markets -- as many low-income workers return to their home countries -- **could encourage upward pressures on wages and therefore on prices**.

Deflation

On the other hand, those who imagine a future of low or negative inflation in post-shutdown economies argue that using war as a benchmark is fundamentally inappropriate. The experience of the last few weeks is proving that **the end of lockdowns is a gradual process and not an event** -- unlike, for instance, the signing of an unconditional surrender or a peace treaty -- and, even if this transition will be implemented in a direct and sharp way, **the economy is not a machine that can be turned off and then switched on**, restoring its operations as if nothing had occurred.

The supporters of this school of thought look at what has happened over the past decade to conclude that, **however massive, even today's monetary injections will not lead to any surge in inflation**. In fact, if actions adopted by central banks and governments will help businesses survive the crisis, their effect could even be that of avoiding price growth arising from corporate defaults and resulting lower competition in the markets of goods and services.

Tobias Adrian
Financial Counsellor and Director of the IMF's Monetary and Capital Markets Department

For some countries around the world, it is dangerous to keep expanding public sector debt, because it may be unsustainable, but in the major advanced economies like the US and many European economies, the problem is more one of deflationary pressures.

April 15, 2020

For there to be inflation -- it is argued -- **the key factor is not an increase in the monetary base** (the liability side of central banks' balance sheets) **but a rise in money supply** (currency and sight deposits), and for it to grow, a sustained demand for credit is needed.

The peak of the pandemic was certainly characterized by an impetuous dash for cash by firms and individuals. However, **once the emergency will be over, it is far from clear whether and to what extent economic agents will be keen on piling up additional debt to fund consumption and investments** (or they will rather prefer deleveraging), in a scenario of lingering uncertainty.

As for state guarantees on bank loans, they can encourage lending and prevent a credit crunch, but they are not very effective in fostering borrowers' confidence and risk appetite.

Fiscal-wise -- the thinking goes -- **the measures announced by governments have been rather aimed at cushioning the blow of lockdowns than at providing an actual stimulus** to ailing economies. In other words, although large in scale, the budgetary efforts would not, even remotely, be able to compensate for Covid-19's recessive impact. As a result, **aid disbursed by governments is unlikely to translate into "pent-up demand", ready to be released in the form of spending**. High levels of precautionary saving and high unemployment rates will act as an anchor for consumption, wages, and prices.

Symmetry

In conclusion, what would happen if the inflationary burst feared by many actually materializes within the next 18 to 24 months? Some argue that, **after years of low inflation, a temporary overshoot of the 2% target** monitored by many central banks **could only be welcome**, a way to rediscover and reaffirm the symmetrical nature of this goal.

Those who fear rising prices, underweight fixed income securities in their portfolios -- with the notable exception of inflation-protected bonds -- overweight equities and accumulate safe haven assets such as gold or even cryptocurrencies.

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