Opinion **Global Economy**

Why inflation might follow the pandemic

Governments should finance their debt at today's ultra-cheap rates with the longest possible maturities

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Martin Wolf YESTERDAY

The pandemic has been likened to a war, though one against a disease, not other humans. Like a war, it is reshaping economies and demanding huge increases in public spending and monetary support. It will certainly bequeath far bigger public debt and central bank balance sheets.

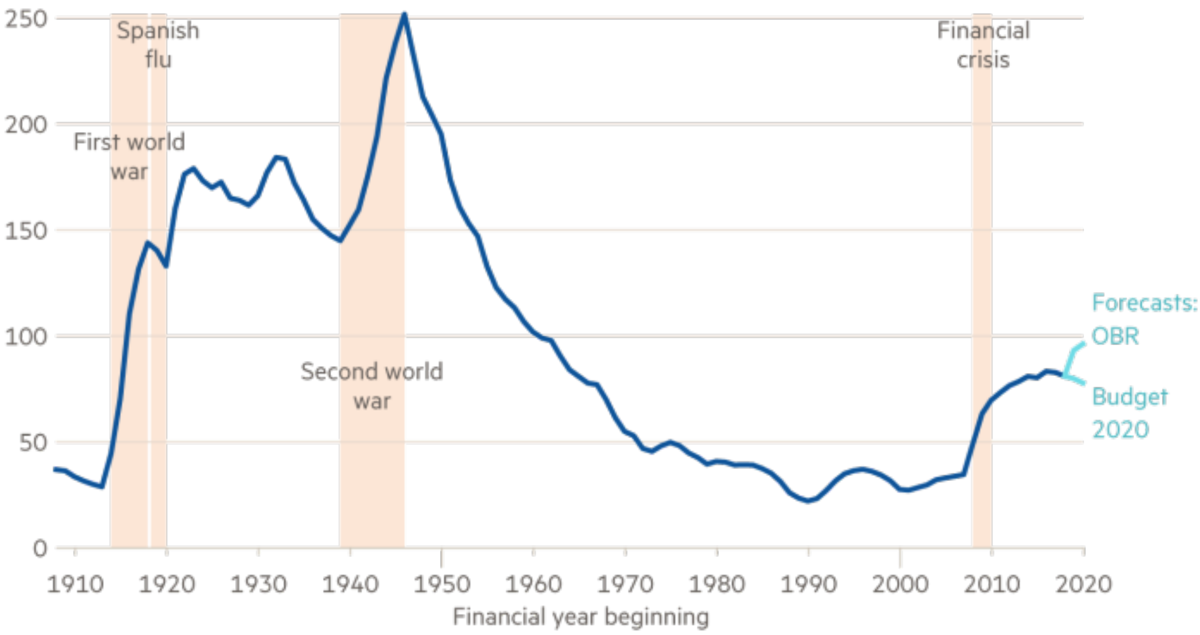
Does this mean the question of whether this long debt cycle must end in inflation has to be answered in the affirmative? No, but this is possible. After the first world war, Germany inflated away its domestic war debt in the hyperinflation of 1923. After the second world war, the UK emerged with fiscal debt of 250 per cent of gross domestic product. Modest inflation helped erode a part of it.

So what might happen now? We need to start from initial conditions. We entered this crisis with high levels of private debt, low interest rates and persistently low inflation. In the group of seven leading high-income countries, none has debt close to that of the UK in 1945. But Japan's net debt was 154 per cent of GDP and Italy's 121 per cent pre-crisis.

The economic impact of Covid-19 is different from that of a big war. Wars restructure economies and destroy physical capital. Coronavirus has shrunk economies, by suppressing both supply and demand that depend on close human contact. The immediate impact, as Olivier Blanchard of the Peterson Institute for International Economics argues, looks strongly deflationary: unemployment has soared, commodity prices have collapsed, much spending has vanished and precautionary savings have soared. Consumption patterns have changed so much that inflation indices are meaningless.

UK net public debt is going to remain far lower than after the two world wars

UK public sector net debt as a % of GDP



Source: HM Treasury, Office for Budget Responsibility
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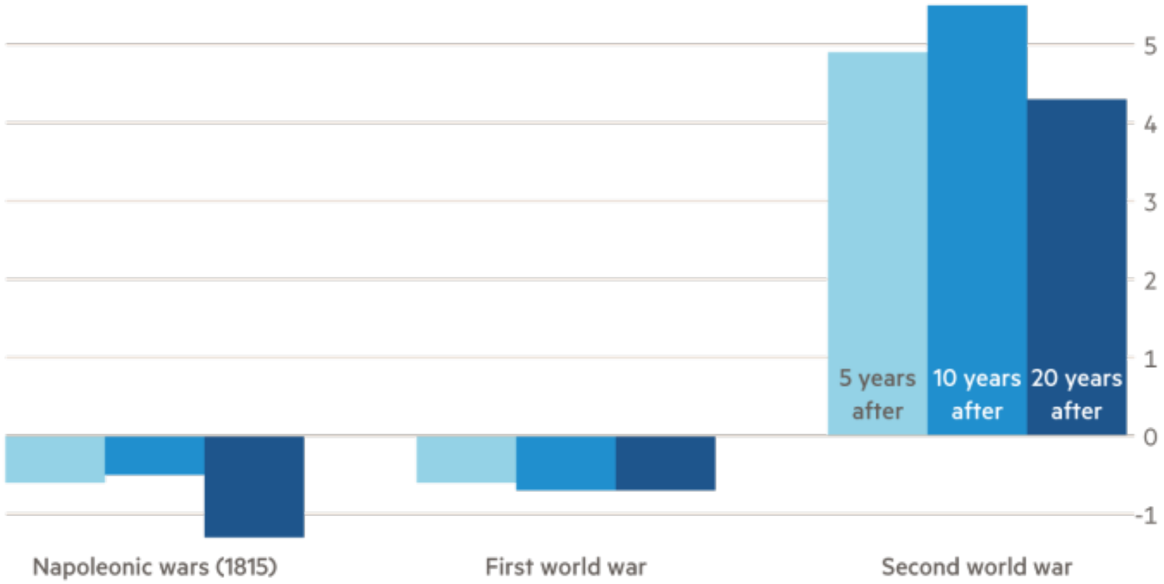
For more than a decade, hysterics have argued that expanded central bank balance sheets are harbingers of hyperinflation. Followers of Milton Friedman knew this was wrong: the expansion of central bank money offset the contraction of credit-backed money. Broad measures of money supply had grown slowly since the 2008 crisis.

But this time it really is different. In the past two months, US M2, a measure that includes demand, savings and deposits for fixed amounts of time, and Divisia M4, a broader index that weights components by their role in transactions, both show large jumps in growth. If one is a monetarist, like Tim Congdon, the combination of constrained output with rapid monetary growth forecasts a jump in inflation. But it is possible that the pandemic has lowered the velocity of circulation: people may hold this money, not spend it. But one cannot be certain. I will not forget the almost universally unexpected surge in inflation in the 1970s. This could happen again.

Inflation does not have to follow huge increases in public debt, but it did after the second world war

Average UK inflation after three major conflicts (%)



Source: David Miles, Andrew Scott (VoxEU/CEPR, 2020)
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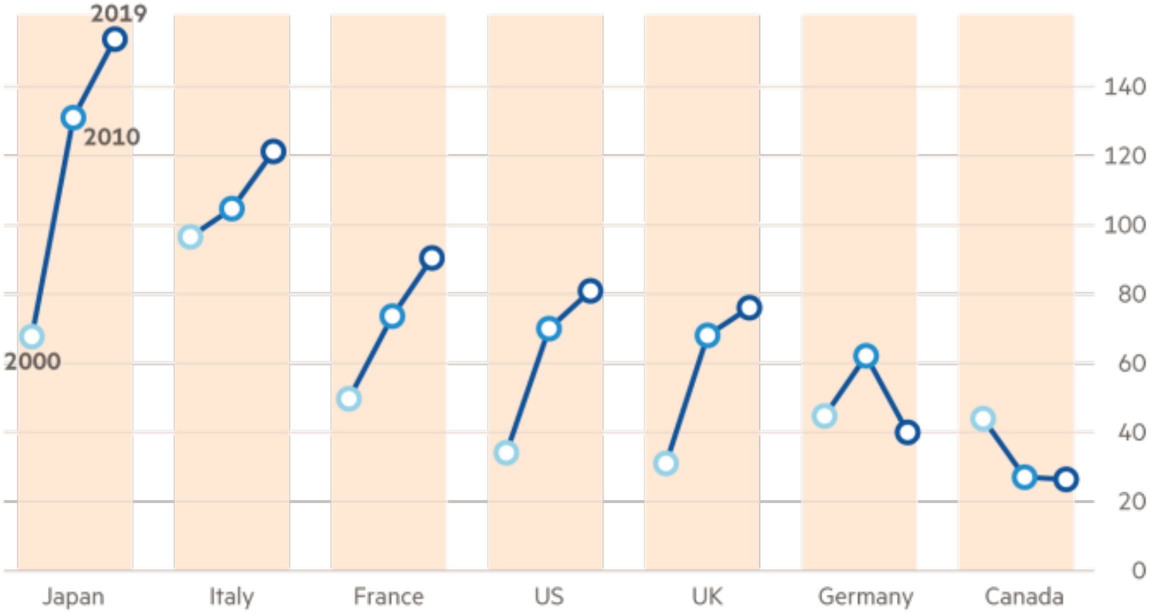
What about the longer term? Mr Blanchard suggests we are likely to see more of the same: structurally weak demand, low inflation and ultra-low interest rates — Japan's situation for a generation. China's shift to slower growth and weaker investment adds still more grey to this picture. Mr Blanchard suggests three reasons why inflation might surprise on the upside: increases in public debt ratios much greater than the 20-30 percentage points now expected; a big jump in the interest rates needed to keep economies operating close to potential output; and "fiscal dominance", or the subordination of the central bank to government demands for cheap finance.

Indebtedness has mostly been rising, but it also varies greatly

General government net debt as a % of GDP



Source: IMF
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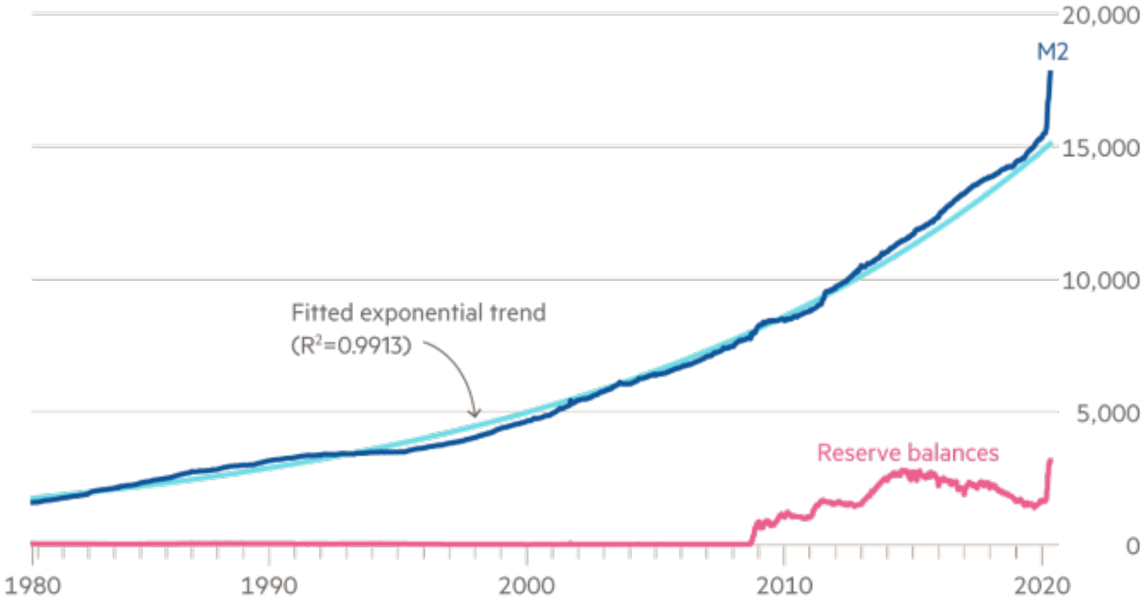
The rise in debt ratios cannot be ruled out. But, as things stand, the countries that look most fiscally exposed are Japan and Italy. The former has been unable to get inflation up for years. The latter is, for now, contained in the eurozone. On interest rates, Charles Goodhart of the London School of Economics and Manoj Pradhan a business economist, argue that huge structural changes are coming. The deflationary environment created by rising Chinese exports and globalisation is over. Wage pressure will increase. When the surge in spending fuelled by fiscal and monetary largesse spills over into inflation, it will be viewed as temporary, or just welcome, as the real burden of debt is eroded.

US money supply has suddenly jumped upwards since the Covid-19 crisis

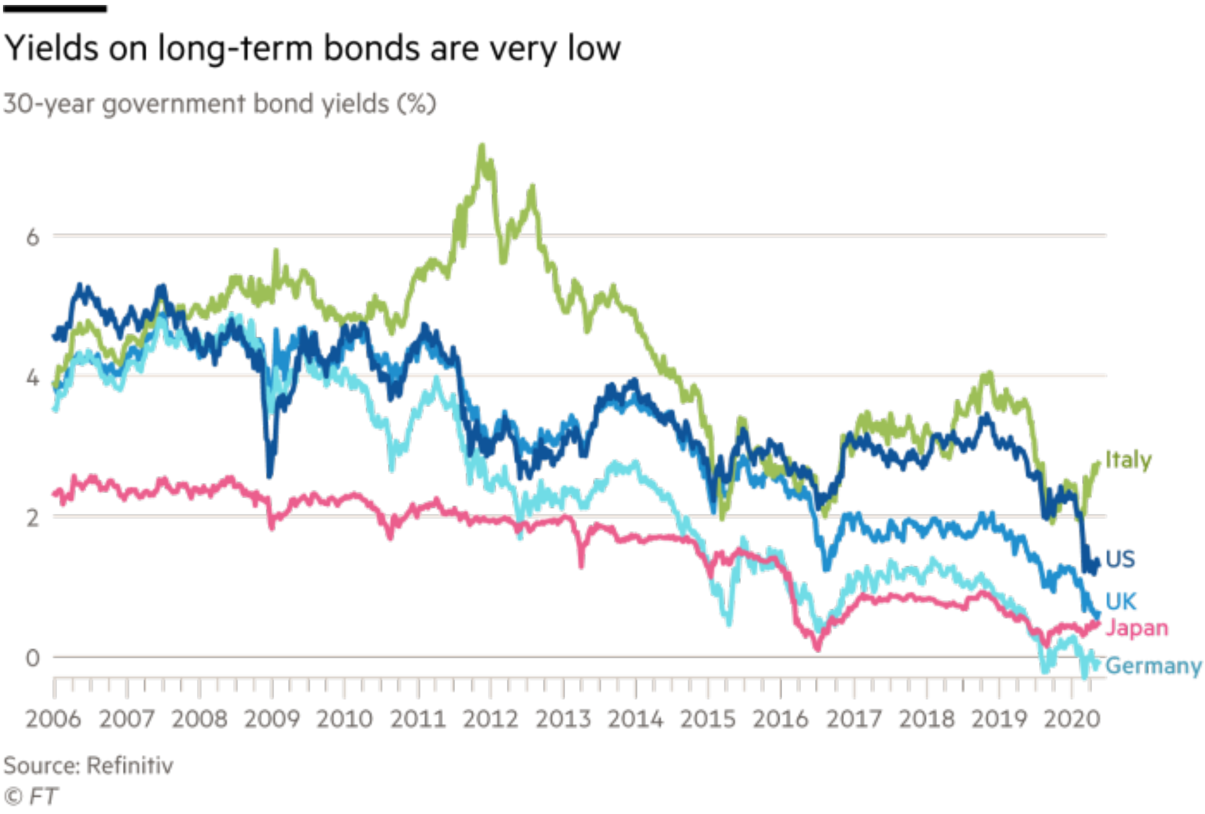
Broad money measure M2 and reserves of the banking system ($bn)



Source: Federal Reserve

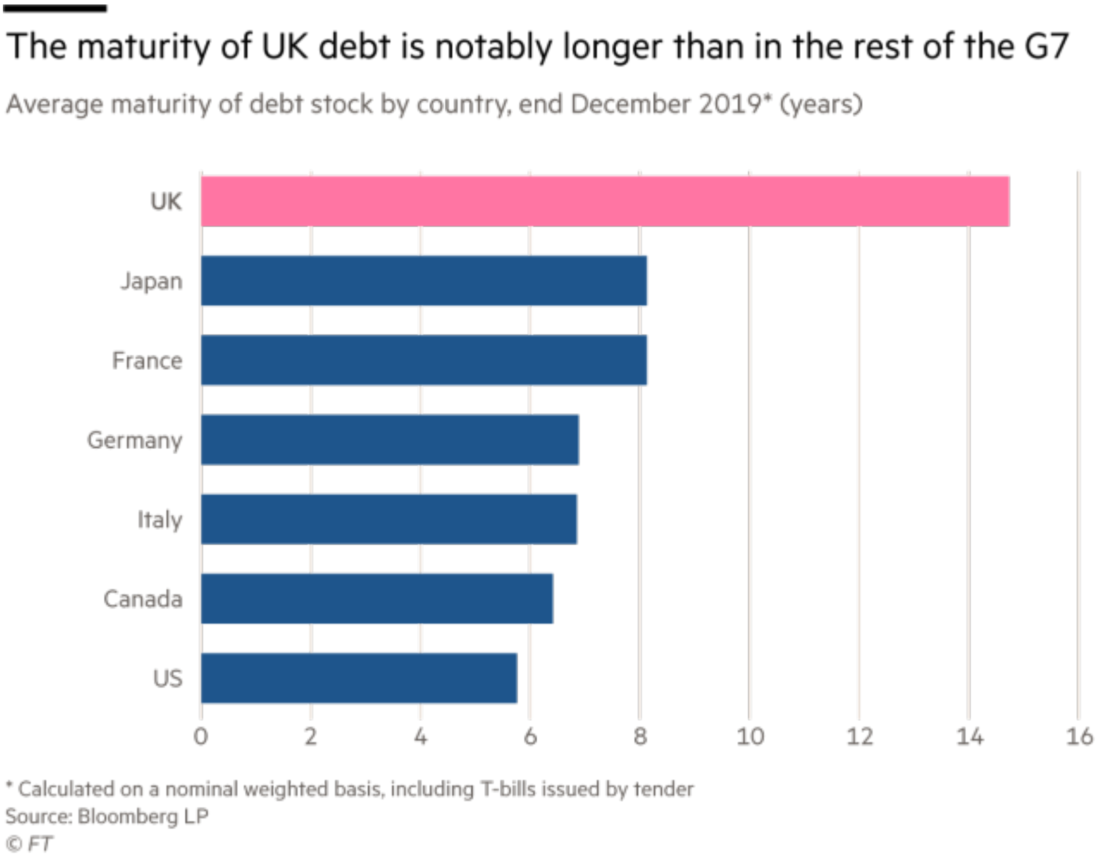
Among the beneficiaries of this erosion of the real burden of debt will, the authors add, be governments. Politicians will be furious if central banks raise interest rates above the growth of nominal GDP, and force fiscal retrenchment beyond that needed to curb the huge fiscal deficits created (rightly) by the crisis programmes. Popular resistance to a repetition of the public spending cuts that came after the financial crisis will be intense. Yet so, too, will be resistance to the higher taxes needed to shrink the fiscal deficits as full employment is restored.

Governments will then probably demand cheap central bank finance, probably reinforced by other forms of financial repression, including capital controls. They will be justified as a desirable expression of national sovereignty.



Is any of this inevitable? Certainly not. Sensible governments should finance all their debt at today's ultra-cheap rates with the longest possible maturities. As and when the economy recovers, they should also raise taxes on those who can afford them. The adverse structural shifts envisaged by messrs Goodhart and Pradhan are possible. But further erosion of the position of labour, as automation accelerates, and a continued savings glut, as crisis-hit investment remains weak, seem even more probable. Central bank independence may well survive. Many still back it.

Many countries that cannot borrow in their own currencies will certainly default, with members of the eurozone in a halfway house. Beyond that, the future is uncertain. Yes, the pandemic has created some features of a war economy. The chances of inflation may have risen. But they are still modest. Hedge against it. Do not bet your shirts on it.



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