Lost Inflation?*

Rod TYERS

Business School
University of Western Australia,
Research School of Economics,
Centre for Applied Macroeconomic Analysis (CAMA)
Australian National University

Not only has the rate of inflation in Europe, Japan and North America been seen as undesirably low (Blitz and MacKenzie 2017, *The Economist* 2017b) but the duo of low inflation and low interest rates is expected by many to continue, with unfortunate consequences (*Financial Times* 2017). Concerned about defending the economy during the "next recession", the US Fed is considering changes to its monetary targeting arrangements that would sustain monetary expansions in search of a higher inflation trend (Summers 2017, Brookings Institution 2018). Yet short interest rate declines of several percentage points have been required to restore economic performance in previous recessions and there is no longer room for such cuts without further unconventional monetary policy (UMP) in the US and its continuation in Europe and Japan. The downsides of further central bank asset expansions, however, include widening income and wealth disparities, low productivity growth, trade tensions and disruptive property booms, particularly outside the UMP-implementing economies.[1]

Central banks are perceived to be less equipped to offset deflation with monetary expansions because of the several-decade declining trend in the "natural" rate of interest at the global level and the looming proximity of the "zero lower bound" (ZLB). The ZLB arises because of the perception that no-one would choose to hold negative yielding bonds when zero-yielding cash is available as an alternative.[2] When the natural rate falls close to the ZLB the capacity for conventional monetary policy to generate inflation is limited. This begs two questions. Is

[1] The literature on UMP and its consequences is now large. There is no doubt that UMP helped restore liquidity and capitalization to the banks and other financial institutions (Chodorow-Reich 2015). Its downsides, however, not only include increased wealth disparity and the negative feedback loop that sees low yields motivate portfolio money holding, which demands monetary expansions via UMP that further reduce yields. See the comments from central bankers in Blitz and Mackenzie (2017), and particularly from the US Fed. There is enhanced risk of financial bubble behaviour, the perpetuation of inefficient "zombie" firms and the increased vulnerability of these firms and indebted households to yield reversals. See Burns et al. (2014), BIS (2017), Bloomberg (2017), Gugliano (2017) and Watling (2017).

[2] This perspective is not universal, however, with negative rates emerging not uncommonly in recent years and Rognlie (2016) suggesting the possibility of effective monetary policy with negative rates.

deflation so much worse than inflation, and what are the deflationary forces that central banks are fighting against that have become so potentially overwhelming?

For Keynes (1950: 10, and 2007: 16), actual deflation is always to be avoided, relative to inflation, because, in the presence of nominal wage rigidity it leads to unemployment, it discourages lending for investment and it encourages the "hoarding" of money, or a rise in the holding of portfolio money at the expense of productive assets.[3] The modern expression of this concern is as in Shiller (2017), who reminds us, accurately, that low inflation *expectations* are important because they suppress incentives to invest in productive capital expansion. Yet, while the prospect of deflation is always associated with a lack of perceived capacity of central banks to accommodate money demand, there are increasingly prominent deflationary forces in the global economy.

The advanced economies in Europe, North America and Australasia are experiencing rising rates of immigration. These flows suppress real wage growth and benefit higher-income households whose saving rates from disposable income are comparatively high and whose contributions to domestic demand in a globalised economy are comparatively low. At the same time, technology changes in these economies are displacing low-skill workers and favouring the skilled and capital-owners. This not only curtails demand generated by low-saving worker households but the greater returns to capital owners also stimulate financial inflows, which appreciate these countries' real exchange rates and reduce home consumer prices.

Finally, there is the emergence in these economies since the early 2000s of a tendency to outsource manufacturing and service activities to poorer countries that offer reduced wage costs, environmental controls or corporate tax rates. For the advanced economies this has seen an important rise in trade in intermediate inputs and components, a decline in domestic relative to foreign value added shares and therefore a period during which domestic expenditure has fuelled international, at the expense of domestic, factor incomes (Constantinescu et al. 2015, Duval et al. 2015). In effect, domestic supply has grown faster than domestic factor income, again applying deflationary pressure.

[3] For a detailed exposition on this topic see Bagus (2015). The behaviour of portfolio demand for money was formalized by Tobin. See Tobin and Hester (1967).

Future macroeconomic stabilisation around growth trends in the advanced economies will depend on how governments address the accelerating technical changes that are fostering inequality and their deflationary consequences. Competing ideas include the universal basic income, the popularity of which is rising in Europe, and the earned income tax credit, which originates from the US. While the earned income tax credit appears to offer better outcomes, mainly because it maintains higher levels of employment and output[4], both will require more "fiscal space" than is currently available in the advanced economies, requiring changes to taxation regimes that will, at least temporarily, be inflationary.[5] Ironically, today's low rates stem from conventional monetary policy failure, expanded central bank balance sheets and the resulting global "bond bubble".[6] Future monetary policy effectiveness as deflationary forces continue will depend on financial market "normalisation" in the advanced economies and this requires the phasing out of UMP in Europe and Japan.

* This is a summary of the forthcoming paper by Rod Tyers and Yixiao Zhou: "Missing inflation: causes and consequences".

References

Bagus, P. (2015), *In Defense of Deflation*, Financial and Monetary Policy Studies 41, Switzerland: Springer, 215pp.

Bank for International Settlements (BIS, 2017), "International banking and financial market developments", *BIS Quarterly Review*, September.

Blitz, R. and M. Mackenzie (2017), "Moments when central banks set pulses racing", *Financial Times*, 27 December, p 18.

Brookings Institution (2018), "Should the Fed stick with the 2 percent inflation target or rethink it?" Conference, 8 January, Washington DC.

Burns, A., M. Kida, J. Lim, S. Mohapatra and M. Stocker (2014) "Unconventional monetary policy normalisation and emerging-market capital flows", *VOX*: 21 January.

Chodorow-Reich, G. (2015), "Effects of unconventional monetary policy on financial institutions", NBER Working Paper No. w20230, Cambridge, MA, June

[4] See the analysis by Tyers and Zhou (2017).

[5] The race to the bottom under way on capital income taxation will advantage first movers only but it will reduce fiscal space thereafter. A redistribution of the taxation burden to ward indirect taxes seems to be an essential development on the horizon, particularly in North America and Japan.

[6] " See Krishnamurthy and Vissing-Jorgensen (2012), Maley (2016) and Price (2016).

Constantinescu, C., A. Mattoo and M. Ruta (2015), "The global trade slowdown: cyclical or structural?" IMF Working Paper 15/6, Washington DC, January.

Duval, R., K. Cheng, K.H. Oh, R. Saraf and D. Seneviratne (2014), "Trade integration and business cycle synchronization: a reappraisal with focus on Asia," IMF Working Paper, 14/52, Washington DC.

Economist (2017a), "Money mountains: is there any rational justification for tech firms' huge cash piles?" Schumpeter, 3 June, p 58.

Economist (2017b), "Global inflation: gone missing", Finance and Economics, 4 November, p 71.

Financial Times (2017), "Hard times for humble savers in the years ahead", Editorial, 27 December, p 8.

Glugliano, A. (2017), "The financial system's weak link: zombie firms", *Bloomberg*, 19 September.

Keynes, J.M. (1950), *A Treatise on Money*, Vols I and II, London: Macmillan, volumes first published in 1914 (363pp) and 1930 (409pp).

_____ (2007), *The General Theory of Employment, Interest and Money*, London: Palgrave Macmillan, 472pp, first published in 1936.

Krishnamurthy, A. and A. Vissing-Jorgensen (2016), "The aggregate demand for Treasury debt", *Journal of Political Economy*, 120(2): 223-267, April.

Maley, K (2016), "The global bond bubble looms ever larger", *Australian Financial Review*, 11 August.

Price, B. (2016), "Bond market is in an 'epic bubble of colossal proportions,' says Boockvar", *CNBC*, 7 July.

Rognlie, M. (2016), "What lower bound? Monetary policy with negative interest rates", Brookings Institution, Washington DC.

Shiller, R. (2017), "The economy is stagnant because people fear for the future", *The Guardian*, Business, 23 May.

Summers, L.H. (2017), "Five reasons why the Fed might be making a mistake", *Washington Post*, Analysis: 14 June.

Tyers, R. and Y. Zhou (2017), "Automation and inequality with taxes and transfers", CAMA Working Paper 70/2017, Australian National University, November.

Watling, C. (2017), Zombie companies stalk a broken monetary system", *Financial Times*, 27 December, p 18.