Global Letter Rising US inflation concerns

Markets are starting to fret: it is a close call, but we are slightly more sanguine.

The question

Inflation is now back on many minds. And this matters because, as go inflation expectations, so go bond yields, and thence asset prices, exposed leveraged entities, official interest rates, and more.

Inflation expectations however are difficult to forecast, not least because they are driven by a range of factors, none of which is certain. But there are two broad strands of thought:

1. **Budget deficits and money growth**. There is concern, especially in, though not limited to, the financial community that budget deficits and/or recent money growth presage faster inflation, if not immediately then in due course. We shall write about that shortly.
2. **The pressure of demand.** During the post-2008 and then the COVID-19 recessions this potential driver has been quiescent; but it has recently reared its head, in the US at least, with concern that President Biden's proposed $1.9 tr fiscal stimulus[1] is potentially riskily large in relation to the admittedly uncertain margin of extant spare capacity.

The pressure of demand argument

The issue here is whether pressure on capacity – by itself or in conjunction with a price spike[2] – would lead not just to a one-off increase in the aggregate price level, but to the sort of sustained price-wage-price spiral that defines 'true' inflation.

The notions of spare capacity, and hence productive potential, are useful pedagogic devices; and at the extreme they can be operationally useful: egregious excess demand will almost always be inflationary. But whether estimated measures of spare capacity, or productive potential, are good enough to support *ex ante* judgements, and to calibrate policy settings appropriately, is moot.[3]

In practice, much would be revealed by whether unit labour costs were to pick up; and in turn that would depend *inter alia* on wage developments;[4] the evolution of productivity; and to some extent the exchange rate of the dollar.

Wage developments. Many factors stand to be at work, but important could be that a falling US participation rate over the past 20 years suggests that there is considerable additional labour potentially available.[5] Furthermore, compared with earlier epochs, union membership in the US, at 11.9%, is at its lowest for more than 70 years:[6] the US labour market today is highly atomistic.

Productivity developments. US productivity growth (output per person employed basis) has been slowing for decades.[7] Typically however productivity is procyclical – Verdoorn's law – and would likely accelerate somewhat with stronger growth. Over the longer term, however, productivity is determined importantly by the pace of net investment, and the extent to which this brings the new technologies into the workplace. But the likely extent of any such pickup is inescapably uncertain.

The outlook

Investors are clearly on the lookout for an acceleration of inflation, and indeed are already changing their expectations[8] – even if the implied acceleration is mild by past standards.[9]

We doubt that the stage is being set for a material, sustained, increase in US inflation,[10] at least this year and quite probably next. Moreover, were excess demand to start to eventuate, we suspect that it would manifest itself primarily not as faster inflation but as a widening current account deficit.[11] Perhaps most importantly, while the Fed has reiterated its 'lower for longer' mantra,[12] if there were to be a need to cool the economy, that would probably require only a small rise in official interest rates, given that leverage in the economy is almost certainly high.

Watch fors

To assess the evolving risk, watch for:

- The extent to which the proposed US package gets whittled down in the political negotiations.
- The composition of the package – how much it merely supports aggregate demand or, alternatively, promotes investment spending.
- The rate of growth of nominal GDP, and its split between its real and price elements.[13] ■

Early thoughts *on an initial draft of this Global Letter were discussed with a range of people, and particularly useful comments were offered by Saul Eslake, Gerald Holtham, Han de Jong, Russell Jones, Philip Turner, and Dimitri Zenghelis. However, none has responsibility for this final version: that owes solely to the author.*

[1] See for example Stewart, E., 2021. *The risks of going too big on stimulus are real — but going too small could be riskier.* 8 February. Available at https://www.vox.com/policy-and-politics/22268787/larry-summers-op-ed-biden-stimulus. And see also Summers, L., 2021. The *Biden stimulus is admirably ambitious. But it brings some big risks, too.* The Washington Post, 4 February. Available at Opinion | Biden's covid stimulus plan is big and bold but has risks, too - The Washington Post February. [Accessed 10 February 2021]

The following also promises to be a useful discussion: [Forthcoming] Krugman, P., and Summers, L., 2021. *Will the Biden Stimulus lead to Inflation? A Conversation with Paul R. Krugman and Lawrence H. Summers.* 12 February 2021 (forthcoming). Available at Will the Biden Stimulus lead to Inflation? A Conversation with Paul R. Krugman and Lawrence H. Summers | Princeton University - Department of Economics

[2] The aggregate price level may well spike near-term, the result of bottlenecks, or structural adjustment to both post-COVID-19 and climate change, and the like. It would seem likely that still-strong global product market competition would keep a lid on that; but that can never be certain.

[3] Measures of productive potential are often useful *ex post*, not least as a way of explaining how inflationary pressures have evolved. But the usefulness of such measures *ex ante* is more debatable; and this poses real problems for policymakers who wish to assess the relative risk of alternative policy settings.

[4] It has been well documented that the observed relationship between unemployment and wage inflation has diminished, i.e. that the Phillips curve has flattened, but there can be various reasons for this. See for example Occhino, F., 2019. *The Flattening of the Phillips Curve: Policy Implications Depend on the Cause.* Federal Reserve Bank of Cleveland, 10 July. Available at The Flattening of the Phillips Curve: Policy Implications Depend on the Cause (clevelandfed.org) [Accessed 11 February 2021]

[5] The civilian labour force participation rate has fallen by over 5 percentage points since its peak around 2000, and the employment to population ratio has fallen similarly.

[6] Union membership has declined steadily since 1983. In that year, the earliest for which strictly comparable data are available, union membership rate was 20.1 percent of total wage and salary workers. In 2020, the union membership rate was 10.8 percent, See U.S. Bureau of Labor Statistics, 2021. *Union Members Summary*. 22 January. Available at https://www.bls.gov/news.release/union2.nr0.htm [Accessed 10 February 2021] For a discussion of the evolution, see Dunn, M., and Walker, J., 2016. *Union Membership In The United States.* US Bureau of Labor Statictics. Available at union-membership-in-the-united-states.pdf (bls.gov) [Accessed 10 February 2021]

[7] Most recently, after a negative reading in 2008, it bounced back and averaged some 1.2% annual rate over the next five years, but was running at a below 1% annual rate in 2019, and is likely to have turned negative in 2020.

[8] On 8 February, for example, the 30-year Treasury briefly traded above 2%.

[9] At the time of writing, the US 10-year bond yield is close to where it was in February 2020 – and there was little apparent concern about inflation then. And the Cleveland Fed's composite measure of 10-year inflation expectations, which is running at around 1.5%, has barely risen over recent months. That said, however – and this is potentially the troubling element – around 0.4 ppts of this is accounted for by the inflation risk premium, as measured. See Federal Reserve Bank of Cleveland, 2021. *Inflation Expectations.* [online] Available at https://www.clevelandfed.org/our-research/indicators-and-data/inflation-expectations.aspx, [Accessed 11 February 2021]

[10] As conventionally defined and measured, 'inflation' typically excludes asset prices – but perhaps, for some purposes at least, there should be a special-purpose measure that includes asset prices.

[11] A widening current account deficit could be expected to push the dollar down somewhat; but to the extent that the prices of many US imports are determined in large part in the US market, this would contain the overall rise in the price level.

[12] See Politi, J. (2021). *Powell stresses patience in pledge to keep monetary policy loose.* Financial Times [online], 10 February. Available at: Powell stresses patience in pledge to keep monetary policy loose | Financial Times (ft.com) [Accessed 11 February 2021]

[13] For more on this, see Llewellyn, J., and Sepping, S., 2021. *Nominal GDP.* Llewellyn Consulting, available on request.

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