HQ Trust

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Will Inflation Rise After Corona?

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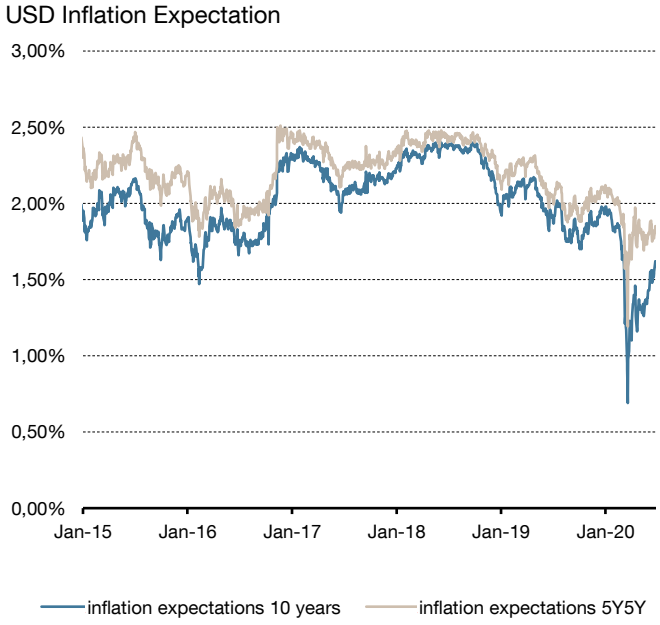
Since the great financial crisis of 2008/09, the global economy has recorded relatively weak low-inflation growth. From the perspective of the central banks, price level increases have been too low rather than too high in most years. However, even with extremely low, partly negative interest rates and large-scale bond purchase programs, it was not possible to bring inflation to the level of around 2 percent that is commonly targeted. With the onset of the Corona crisis, however, the monetary policy impulses have once again been significantly strengthened. This and very expansionary debt financed fiscal programs make it likely that inflation will increase in the future.

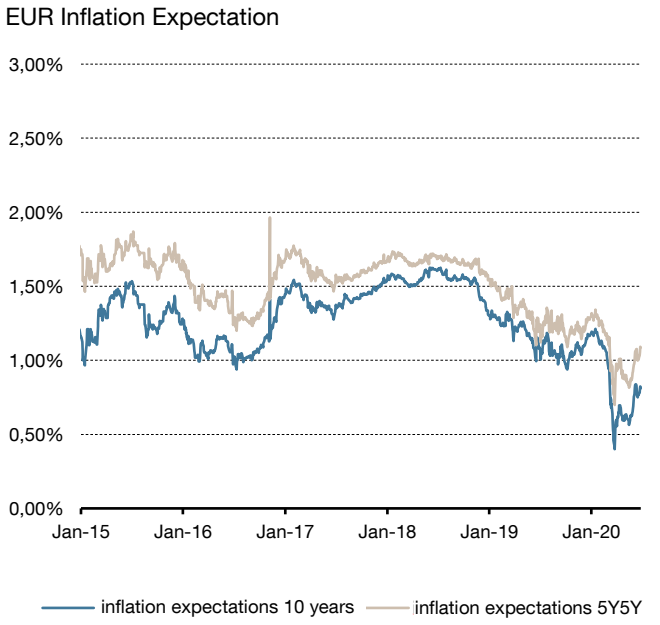
At first glance, the current figures on inflation do not appear to give cause for concern. The consumer price index in Germany rose by only 0.9 % above last year´s level in June 2020; without energy it is around 1.6 %. In the second half of 2020, the price trend will be determined primarily by the reduction in value-added tax. Assuming that around half to two-thirds of the VAT relief will be passed on to consumers, the price level in the second half of 2020 is unlikely to rise, in fact it may even fall slightly. This increases consumers' purchasing power and will lead to advanced purchases of durable consumer goods.

At the beginning of 2021, however, the inflation environment is likely to be significantly different. Several factors driving prices up are then likely to come together. The return to the higher VAT rates will probably be passed on in full by companies in higher sales prices. In view of additional costs resulting from the infection control requirements and the already rising unit labour costs, it seems unlikely that companies will cushion a significant part of the VAT increase through lower net prices and profit margins. Additional cost burdens and a loss of purchasing power are also likely to result from an increase in the price of oil and other commodities, which is to be expected when the widely anticipated economic upswing sets in. The year-on-year increase in consumer prices in Germany could then easily exceed 2 % on average for the year.

For financial markets, the medium-term inflation expectations are particularly relevant. Higher inflation expectations would undermine the belief in permanently low interest rates and continuously loose monetary policies. The result would be considerable distortions on the financial markets. At present, however, the trend is more in the opposite direction. In the United States, inflation expectations for the ten-year horizon are now only around 1%, with expectations for the period in five years' time being higher than for the next five years. Also in the euro zone, markets expect low inflation in the coming years. (Chart 1)

Chart 1. Inflation Expectations Dampened By The Covid 19 Crisis[1] | Market-based Indicators Of Longer-term Inflation Expectations | Period: 01.01.2015 – 25.06.2020*





[1] Source: Datastream, HQ Trust calculations. *Expected inflation on the capital market implied by inflation swaps. This is available for various maturities. The inflation expectation 5Y5Y describes the current expectation of inflation that will exist in 5 years over the following 5 years. It is calculated from the inflation swap over 10 years by correction with the expected inflation from the inflation swap over 5 years.

So can the all-clear be given with regard to the longer-term inflationary dangers of expansionary monetary policies? It is not that obvious. The reaction of monetary and fiscal policy to the Covid 19 crisis points rather in the opposite direction. In contrast to the years after the financial crisis, monetary policy is not alone, not the only game in town´, rather it is strongly supported by fiscal policy trying to boost economic growth. The massive increase in government debt does not play a major role in the public debate. With zero or even negative interest rates, it seems sensible to many to incur additional debt. Of course, central banks, which are monetizing public debt through huge government bond purchases, are a major cause for these low yields (Chart 2). This is often advocated as a beneficial integration of monetary and fiscal policy. And yes, it is certainly justified in the midst of a deep economic crisis in order to stabilize expectations and provide economic stimulus. As a long-term concept, however, it harbours risks for the level of price stability.

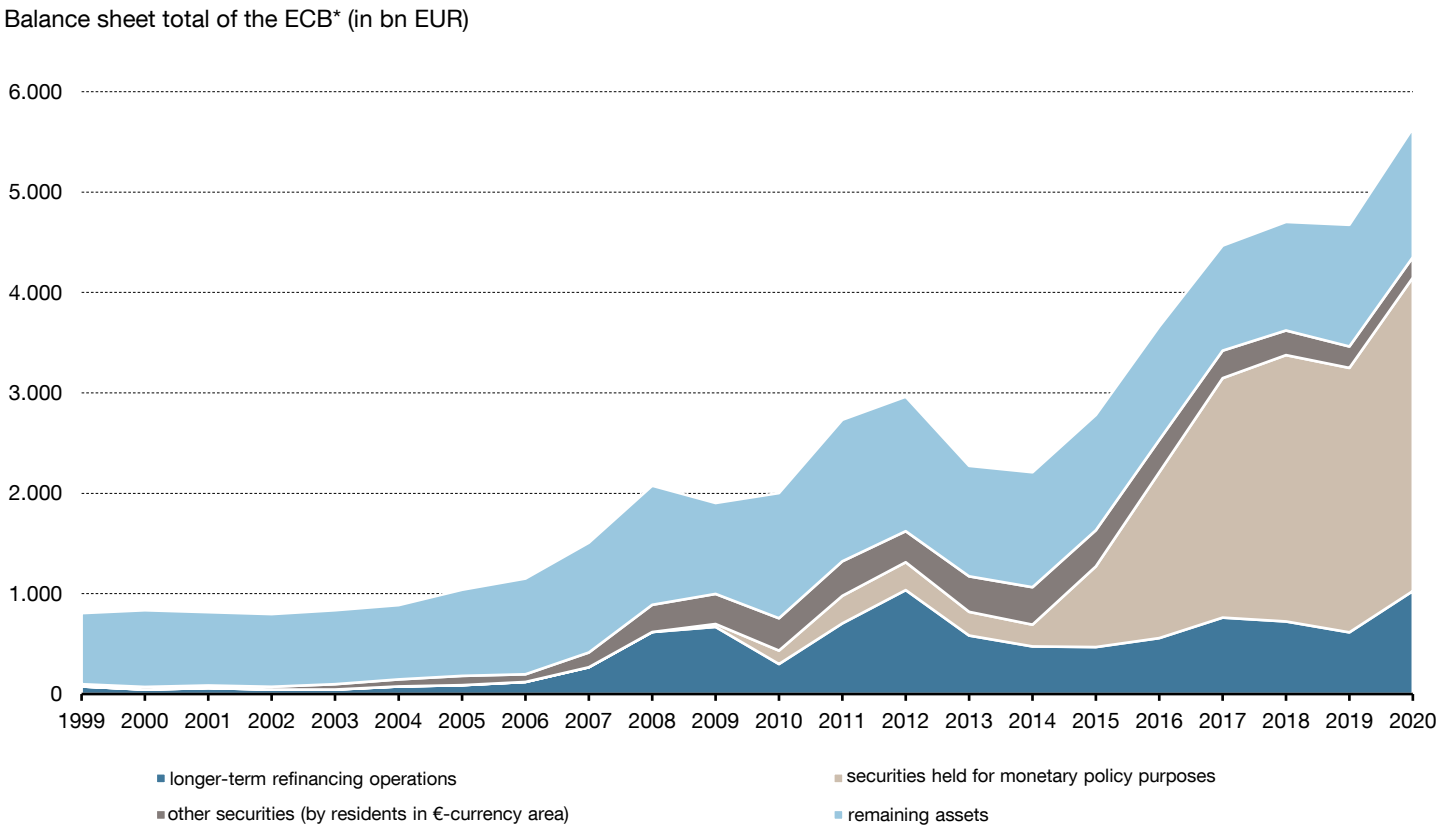
Given the high level of government debt already existing, it is difficult to see how monetary policy can put an end to the monetization of government debt. Particularly if inflation accelerates - and a market-driven rise in interest rates sets in as a result - it will be difficult for central banks to fight inflation by further raising interest rates. Such a turnaround in monetary policy would not only raise doubts about the sustainability of government debt, but it would also profoundly change the interest rate expectations of financial markets, thereby eroding the basis and the logic of extremely high valuations of risky assets. For this reason, interest rate hikes or also a reduction in central bank balance sheets through the sale of securities appear very unlikely in the near future. Rather, it looks as if we are dealing with a paradigm shift in which fiscal and monetary policy are viewed as a single entity and new government debt is purchased on the market by central banks on a considerable scale to stimulate the economy.

Current policy thus seems somewhat receptive to the recommendations of the so-called Modern Monetary Theory, which was much discussed a year ago and dismissed by most economists as an obscure marginal phenomenon. Advocates of this policy direction point out that monetary financing of governments need not necessarily lead to inflation, as the example of Japan has long shown. There must simply be sufficient production capacity available to meet the demand for goods. That is probably the case at present, but in the long term it is questionable. Moreover, it is by no means certain that inflation will remain low if a large part of the world begins monetary financing of governments and this does not happen in Japan alone, where special conditions prevail anyway due to the sharp decline in the population and the pronounced domestic orientation of investors.

In order for the money creation resulting from central bank purchases of government debt to have an inflationary effect, the additional central bank money supply must find its way into the economy and contribute to a significant expansion of the money holdings and credit volumes there. This has not been observed in recent years The additional central bank money supply remained largely in the banking sector. To put it simply, monetary policy has not been particularly effective in terms of stimulating demand.

It does not have to stay that way. At present, there is not only a strong increase in money holdings by non-banks, but also a marked increase in lending to companies (Charts 3 and 4).

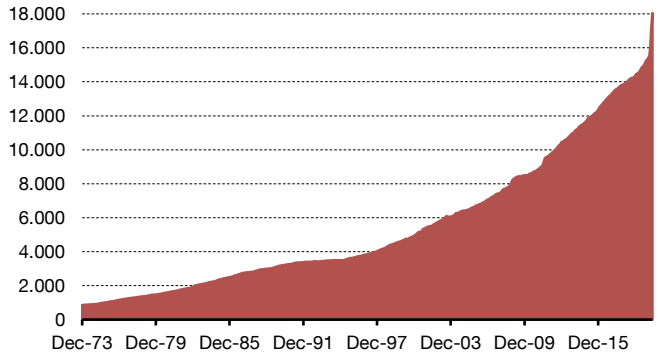
Chart 2. ECB Balance Sheet Expansion Through Bond Purchases[2] | Period: 1999 – 2020*



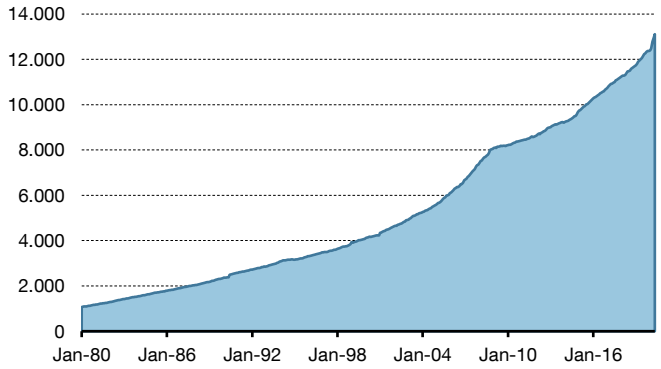
[2] Source: ECB, HQ Trust calculations. *end of year; in 2020: 26th of June

Chart 3. Strong Monetary Growth In The USA And The Euro Area | M2 Money Supply In The USA And The Euro Area[3]

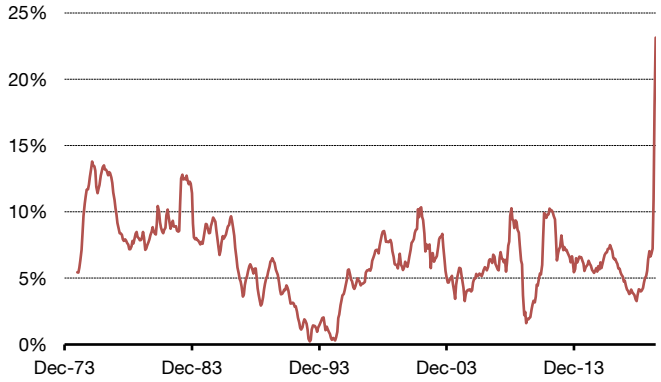
USA | Period: Dec 1973 – May 2020



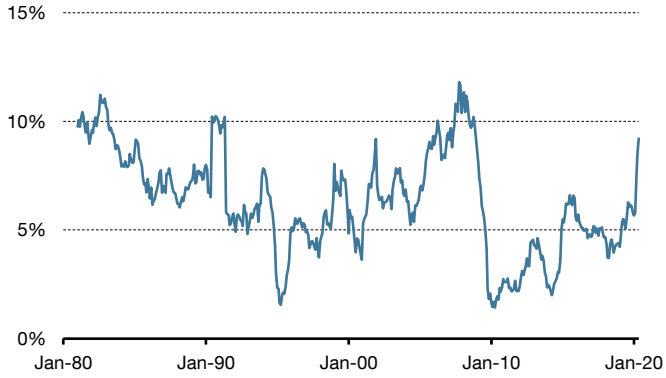
Euro Area | Period: Jan 1980 – May 2020



Year-On-Year Change | Period: Dec 1973 – May 2020



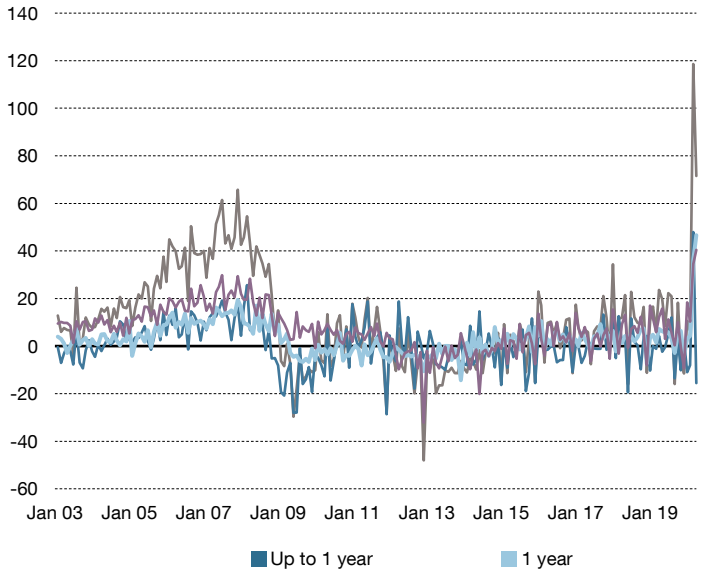
Year-On-Year Change | Period: Jan 1980 – May 2020



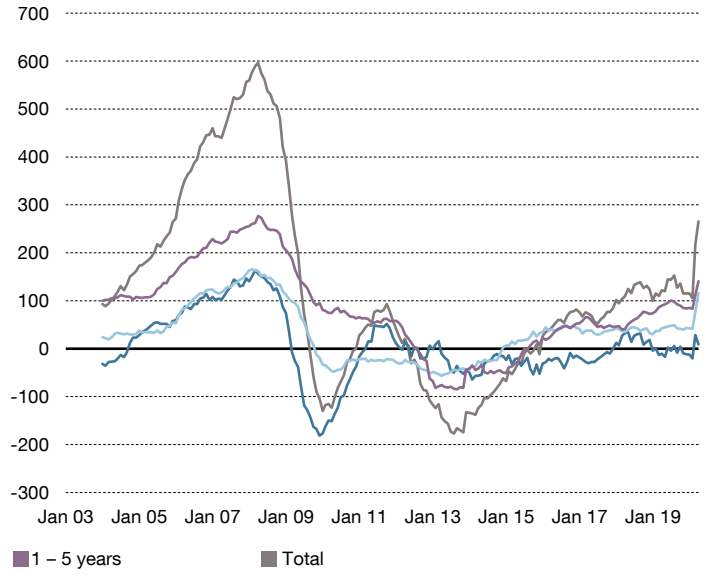
It is still too early to conclude from this that money supply-credit dynamics are imminent, as temporary effects of the corona crisis are at work. On the part of private households, the main factor is that many shops were closed during the corona lockdown and involuntary savings accumulated in their accounts. The rising demand for credit from companies is also to a large extent attributable to the corona crisis, which led many companies into liquidity problems and prompted them to take advantage of government credit programs. Thus, there may be a tendency for the stronger monetary expansion to recede as the crisis is overcome. Nonetheless, the banking system is so well supplied with liquidity that price-related higher transaction volumes in the economy could easily be financed.

Chart 4. Loans To Companies Skyrocket Through Corona[4]

Lending by monetary financial institutions to non-financial corporations (tn €, transactions last month)



Lending by monetary financial institutions to non-financial corporations (in tn €, transactions over the last 12 months)



[3] Definition of M2: The money stock M2 comprises currency in circulation at non-banks plus demand deposits of non-banks, deposits with a maturity of up to two years and deposits redeemable at notice of up to three months.
[3,4] Source: Datastream, HQ Trust calculations.

Conclusion

All in all, the risk of higher inflation in the coming years is far greater than the risk of deflation. The main driver is an expansionary economic policy approach that will aim for higher inflation rates in view of very high debt levels. After years of very low inflation, the central banks are likely to tolerate price level increases above the 2 % target for a limited period. Not without reason have they emphasized in recent years that their targets are symmetrical and allow both short-term overshooting and undershooting of inflation targets. For investors, therefore, there is a reason to be prepared for the scenario of somewhat higher inflation rather than deflation. Equities and real assets should continue to attract high demand. As with all forecasts, there are of course risks and alternative scenarios. A rather disinflationary development could occur if the fiscal policy of the large countries decides to turn around after the high deficits of 2020 in the direction of thriftiness and consolidation and to reduce the high debt ratios again. Whether such a policy shift will occur, however, seems highly questionable from today's perspective. Demands on the state have risen as a result of the Corona crisis and reducing unemployment will be a priority. There will probably be partial austerity measures and individual tax and contribution increases, but they will not change the fundamentally expansionary orientation of fiscal policy that was heralded by the crisis. The interaction of monetary and fiscal policy via the monetization of government debt will continue for quite some time. As a result, monetary aggregates will continue to rise. This will tend to reduce the purchasing power of money.

Author

Dr. Michael Heise is Chief Economist of HQ Trust. He is one of the best known economists in the German-speaking world. Prior to joining HQ Trust, he was Head of the Group Center Economic Research of Allianz SE and Secretary General of

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