ARTICLE FOR THE EDGE

WHAT IF GLOBAL INFLATION SURPRISES ON THE UPSIDE?

Inflation, or more precisely the lack of inflation, has become a major point of contention for monetary policy makers and also for those seeking to understand where asset markets are heading. In general, this year has seen lower than expected inflation in developed economies. As a result, central banks in the US and Europe face a conundrum: Their economies have recovered from the ravages of the global financial crisis and subsequent aftershocks such as the Eurozone sovereign debt crises. Particularly in the US where unemployment is low and average growth has been in line with the economy's potential, there is little reason for the ultra-low policy rates and quantitative easing that were appropriate for a time of extreme crisis. In other words, central banks really should be raising interest rates and reducing the size of their balance sheets. But, the absence of inflationary pressures has deterred them because some policy makers fear that the low inflation could reflect underlying weaknesses in the economy and financial system.

Consequently, it has become important to understand what is happening to inflation. Is low inflation really a danger and will it persist? Is this phenomenon shaped by forces which are benign or which are potentially damaging? Our view is a positive one – low inflation is by and large a good thing and it should not be a reason to delay the normalisation of monetary policy.

What's wrong with low inflation?

For someone who grew up during the 1970s and 1980s when inflation was A Bad Thing, this debate about inflation sounds strange. It is astounding that some people are worried that we do not have enough inflation, when inflation can decimate the real value of savings and pensions, hurt living standards and undermine the quality of price signals that are essential for the efficient working of free market economies.

For the greater part of history, we have had broadly stable prices. Periods of mild deflation were followed by periods of mild inflation so that prices were mostly stable over the long term. Far from being something bad, low inflation did not hurt anyone and seems to have been the natural order of things.

That is not to say that a period of low inflation does not cause some potential headaches. There are two scenarios under which low inflation or deflation could cause complications.

First, one way for countries to escape painfully high debt burdens is to inflate the risks away. In other words, pump up inflation which then reduces the real value of debt and the debtors then get relief. In fact, many countries today confront very high debt levels. According to the International Monetary Fund, gross debt held by governments, non-financial firms and households all over the world has more than doubled since 2000, and stood at USD152 trillion in 2015, or 225% of world GDP. It has probably risen since then.

But is it right that governments depend on a zero-sum game to work out a debt problem? After all, if the value of debt is deliberately eroded through higher inflation, the lender loses. And if the lender is the banking sector, then its depositors, who are ordinary folks who diligently saved to fund their future needs, will also lose out. The proper way to handle high debt is to confront the issue head on. Macro-prudential measures should be put in place to prevent a further increase in debt and debt restructuring efforts should be made to help work out the debts of those who have borrowed excessively. Why should savers and pensioners be penalised in order to help debtors?

A second scenario where low inflation could be problematical is when an economy has become uncompetitive because it allowed labour costs to rise excessively. Politically, it is difficult to cut wages in nominal terms, so higher inflation is a way to sneak in reduced real wages over time, thus restoring competitiveness. However, we do not have a general global problem of excessively high wages. If anything, median wage growth has been too slow. The last thing we should be doing is to make the problem that has produced Trump, Brexit and populism even worse. Where there are countries which have lost labour cost competitiveness, the right way forward was shown by Germany in 2000: trade unions and businesses agreed to hold down wages while governments deregulated the labour market, allowing for greater flexibility. It was painful at first, but now Germany has become super-competitive and businesses are beginning to reward workers with rising wages.

In short, the concerns about low inflation being a problem are not persuasive.

Are we under-estimating the risk of a pick-up in inflation?

Another issue is whether this phenomenon of low inflation is here to stay? In other words, could markets and policy makers be under-estimating the return of inflation? We suspect that this is the case.

There is one critically important point that many analysts tend to miss: The period 2002-2016 was one of unusual shocks and stresses. In the early 2000s, liquidity growth was excessive as the US central bank responded to the bursting of the tech bubble by aggressively cutting interest rates – and then taking its time to raise them again. That period also saw China's economy soar, partly as a result of high credit growth. All this caused global growth to accelerate but that acceleration was accompanied by financial imbalances that finally ended in the mother of all crises in 2007. Simply by virtue of the immense damage that crisis caused, it took a long time for the world economy to recover. Worse still, that recovery itself was delayed and distorted by multiple other crises - the Eurozone had several rounds of its sovereign debt crisis; the collapse in oil and commodity prices that followed added to difficulties; And, just as we were getting over those challenges, China managed to create several shocks for financial markets. If all that were not enough, we now have a range of geo-political stresses as well.

In this unusual period of extreme stresses, the global economy was not able to settle down into any kind of "new norm". However, the good news is that the global economy is now,

finally, finding its feet. Will that mean that, gradually, the global economy will return to its familiar patterns, with inflation returning to the rates we used to see? As economic growth returns, unemployment rates decline and risks fall, businesses are likely to become more willing to raise wages and step up capital spending while banks will probably recover their appetite to lend. That should help reduce the slack in the economy which keeps inflation low. Some of this is beginning to emerge in the US where measures of underlying wage growth such as "median usual weekly earnings" show a strong rebound, which would be enough over time to put upward pressure on labour intensive services prices.

In other words, as the global economy normalises, inflation could well return. We believe that this is the most likely scenario.

What could go wrong for inflation?

Is there anything that could derail this return of inflation? We need to look at two arguments that those who are concerned about deflation offer.

First, new technologies are taking off rapidly such as advanced manufacturing processes, solar and wind energy, digital technologies and advances in bio-medical sciences. Some analysts fear that the disintermediation, job dislocation and other disruption caused by these multiple new technologies would add deflationary pressures that will keep headline inflation at bay. This would be especially the case if these new technologies displaced much labour and put severe downward pressure on wages, or if energy prices collapsed because solar and wind power became so cheap. However, it is important to distinguish between deflation – a **general** fall in all prices – and a change in **relative** prices. New technologies reduce prices in some industries relative to others but do not trigger a general fall in all prices. For example, taxi fares or hotel room rates have fallen relative to the prices of other goods and services we consume but prices overall continue to edge up as seen in the positive rates of inflation. For full-fledged deflation to happen, one normally needs a breakdown in the monetary and credit mechanisms, which are not evident today.

A second risk is, however, more plausible. The ultra-low interest rates in recent years probably meant that the cost of capital and the price of risk were mispriced. Companies, investors, ordinary consumers and speculators may well have over-borrowed and increased their exposure to more risk as a result. We saw this happen in 2002-2007 and it is entirely possible that it is happening again. After all, valuations of financial assets and real estate have certainly appreciated hugely in recent years. And the Bank for International Settlements (the bank for central banks) has been warning in its recent reports of growing debt burdens. What happens as the US Federal Reserve Bank raises rates and cuts back on its quantitative easing? Could we see an abrupt recalibration of asset prices or an exodus of capital from risky assets? If such asset price corrections were severe enough, that would certainly generate strong deflationary pressures. Unfortunately, it is really difficult to estimate how serious a risk this factor is. Our best guess is that such a scenario is not imminent as we do not see evidence of imbalances that are large enough – yet.

Conclusion: what does this mean for Asian economies?

In short, we believe that inflation is not a good thing and that the current low inflation should not be an excuse for central banks to keep postponing monetary normalisation. In fact, we see inflation likely to pick up in time and that central bankers will eventually react to that higher inflation risk with stepped up monetary normalisation, starting with the US Federal Reserve Bank.

That carries big implications for Asia:

First, it means that the recent depreciation of the US Dollar against Asian currencies will reverse.
Second, there will come a time when capital will be sharply re-allocated out of risky assets to less risky ones. Another round of outflows from Asian emerging bond and equity markets is therefore quite likely, although difficult to time.
Third, a rise in global inflation together with weaker currencies in Asia would raise inflation within Asia as well. That implies that there is less scope for easy monetary policies in our region and that central banks should err on the conservative side as far as changing policy rates is concerned.

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