CENTRAL BANKING

High US inflation should not be ruled out

A prolonged health crisis raises the risk that supply-side factors, monetary expansion and rising personal savings could stoke hidden inflationary pressures

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While the longer-term effects of the Covid-19 pandemic on US inflation are highly uncertain, the prospect of a sharp increase in prices during the latter end of an expected recovery should not be ruled out.

The longer the health crisis continues, the more three inflationary undercurrents could build in momentum: a longer-term supply-side shock, significant monetary expansion and the potential for a release of pent-up demand.

During the current containment phase of the pandemic, aggregate demand has fallen rapidly and the US has begun to see disinflation. It may even see deflation if the lockdown measures continue for long enough or a second wave of cases erupts.

Personal consumption expenditures (PCE) **fell** by a record 13.6% in April from March, surpassing the previous record of a 7.5% fall in March from February. Domestic investment **fell** by 6% in the first quarter from one year ago. As a result, the PCE price index dropped 0.5 percentage points to 1.3% in March and by a further 0.8 percentage points in April to 0.5%. Lower oil prices during recent months have also likely contributed to slowing inflation.

Former Fed chair Janet Yellen recently **told** *Central Banking* that she is concerned the current inflation targeting framework could lead to a deflationary spiral. But others, such as Michael Bordo, who has had an intercontinental career as visiting scholar at a number of major central banks, as well as former Bank of England monetary policy committee member Charles Goodhart, point to the potential for high inflation over the medium term.

Supply-side disruption

Periods of contracting growth can leave scarring on the supply side of the economy. Structural forces – such as supply chain disruption, exiting of skilled workers from the labour market and businesses turning insolvent – may take time to realign and there is no guarantee the economy will be as efficient when they return.

Fed chair Jerome Powell **warned** about this on May 12, saying a prolonged and severe recession could leave "lasting damage" to the productive capacity of the economy.

The impact on supply chains was one of the first economic consequences when lockdown measures began in China, in January. The supply shortages of raw materials, input components and retail goods from Asia meant many companies, particularly in high-tech and chemical manufacturing, **found** it more difficult to source vital goods.

This then became a domestic problem in the US towards the end of March as local production and services were also shut down – a disruption that had '**ripple effects**' down the supply chain. Some US manufactures with a global perspective say supply chain problems have now **shifted** from China to Mexico.

The longer the lockdown continues, the greater the chance firms will face difficulty in meeting fixed payments and face the threat of insolvency. Businesses filing for Chapter 11 bankruptcy – a form of bankruptcy that requires debt restructuring – **rose** 17% in March compared with the same period last year. A total of 44 defaults have occurred this year, which is already the same amount of defaults in all of 2018. Rating agencies are expecting the number of defaults to continue growing this year and in 2021, and likely surpass record levels seen in 2009.

The economy will take time to return to pre-crisis levels as firms are forced to re-establish supply chains, business relationships and their workforce. The Fed's recent 'Fed Listens' **event** showed that some businesses, particularly within the restaurant trade, are unsure whether they will even move back to normal operations straight after lockdown measures are eased, due to the risk of spreading the virus.

Offsetting demand

Ultimately, however, the extent that supply is the binding constraint on the economy during the recovery will depend on the degree of the damage to aggregate demand. There are lingering concerns the pandemic could lower demand in some industries on a more permanent basis, such as travel and leisure services, as consumers opt for 'safer' means to spend their incomes in the future.

On May 17, Powell **acknowledged** a full recovery relies on consumer sentiment returning to normal levels, which he said may take until the end of 2021 or until the arrival of a vaccine.

Aggregate demand will also inevitably feel some negative effects from the increase in unemployment. Over 38 million people have filed for unemployed benefits since the mid-March and unemployment has risen to a post-war record for 14.7%.

In contrast to the 2008 crisis, which took nearly a decade for unemployment to fall back to the pre-crisis levels of 4.4%, the Fed expects unemployment to fall more quickly following the lockdown phase. The unemployment results for May show that total non-farm payroll employment rose 2.5 million. This, in part, pushed the unemployment rate down to 13.3% in May, though some concerns over data reported glitches have clouded this figure.

Thus, there is evidence demand may rebound relatively fast, while the supply side of the economy could be ‘scarred’ for some time. That would tend to be inflationary.

Unprecedented monetary shock

To accommodate the shock to the economy and replace lost incomes during the lockdown period, monetary and fiscal authorities have been implementing significant expansionary policies.

The Congressional Budget Office estimates the government’s deficit will increase by $3.7 trillion in 2020 and $2.1 trillion in 2021, up from roughly $1 trillion estimated for each year before the pandemic. In addition, since March 15, the Fed has purchased upwards of $1.6 trillion of government debt and $720 billion of mortgage-backed securities from the banking system. Through its lending programmes, the central bank has also **injected** roughly $180 billion into the economy and has committed over $3 trillion if demand for such facilities arises.

While these policies have likely been necessary to avoid a total collapse of the banking sector and longer-term economic damage, they have led to a significant increase in the supply of money. The ‘money zero maturity’ (MZM) – a measure for all money that is readily available or in a liquid state – rose by $3.7 trillion (21%) from March 2 to June 1 (see figure 1). This is over two and a half times the $1.4 trillion (9%) for the 12 months ending on March 2, which in itself represented a sharp acceleration from the $476 billion (2.9%) from March 2018 to March 2019.

March 2 to May 18.

It is difficult to judge when monetary expansion becomes inflationary, and economists have been proved wrong in the past when predicting money-driven inflation. There have been periods – such as the 1990s and late 2000s – where money supply growth has outpaced GDP growth by more 10% for the year without significant inflationary pressures, although there has been market asset price appreciation.

But the increase in money during the latest period – and also the acceleration seen in 2019 – will have to be absorbed by the economy at some point. While the initial deluge of money into the economy may be slowing, a certain amount of monetary expansion looks set to continue as long as the health crisis remains unresolved. If too much money is created relative to output the result will be inflation and the erosion of the real value of people's incomes.

Different to 2008?

During the 2008 financial crisis similar concerns were raised about the pace of monetary expansion relative to economic output. From 2006 to year-end 2012, the percentage change of MZM from one year prior averaged 7.5%, while the percentage change of GDP from the year before averaged 1.2% (see figure 3).

Many disciples of Milton Friedman argued high inflation would result, but they were proved wrong. The faster pace of money growth relative to output growth was accompanied by an average inflation of 2% during the same period. It also remained very subdued thereafter, averaging 1.3% since the year-end 2012.

reduces the counterbalancing effect. Furthermore, business investment is subdued, likely worsening supply constraints.

Challenging task ahead

Despite immediate figures showing a significant drop in inflation (with the exception of some asset prices), policy-makers should be prepared for the possibility of a sharp turn around as the economic recovery unfolds. If this comes to pass, central banks will face tough choices. Raising rates to conquer inflation would likely be a highly undesirable outcome due to the high levels of debt recently taken on by the government and businesses. Central banks might have little choice but to tolerate somewhat higher inflation in the future to avoid choking off the nascent recovery.

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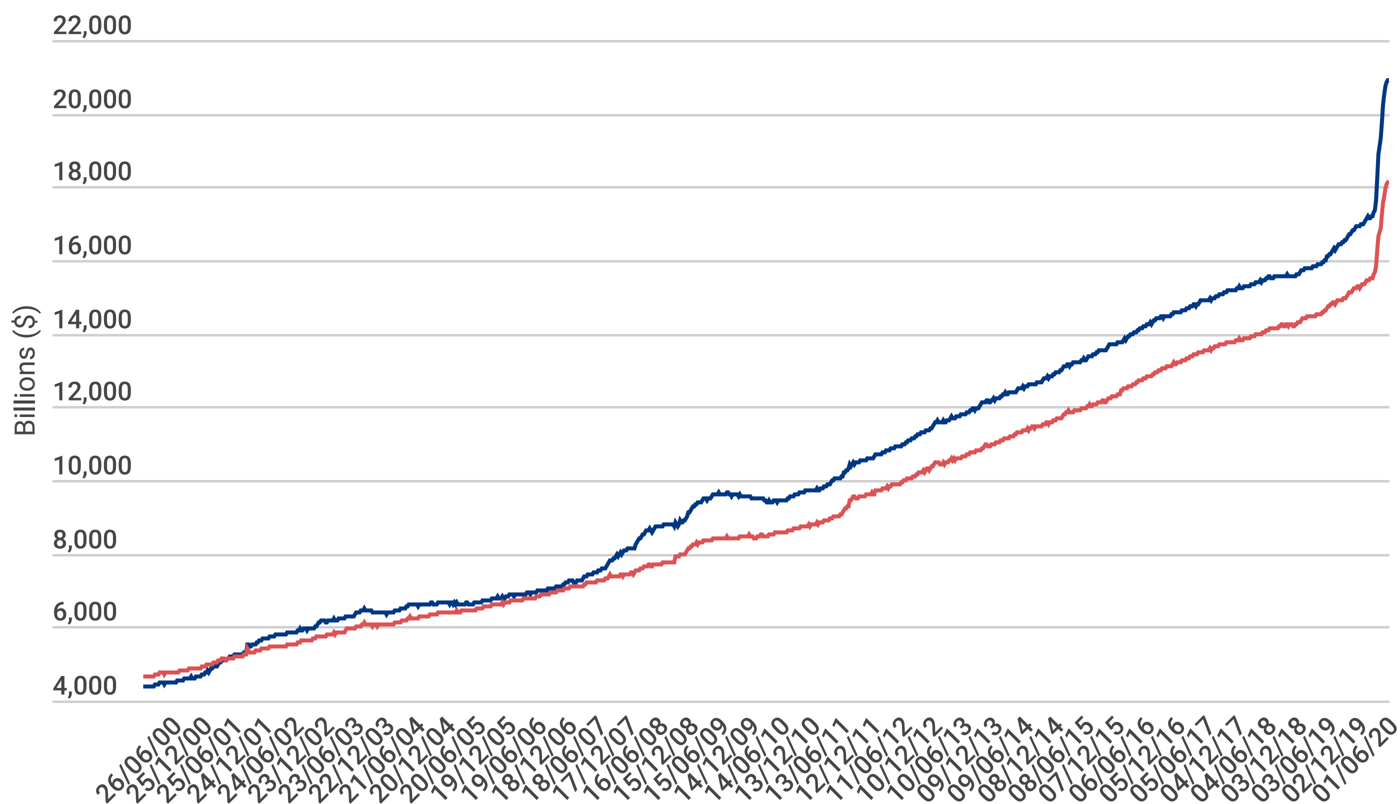
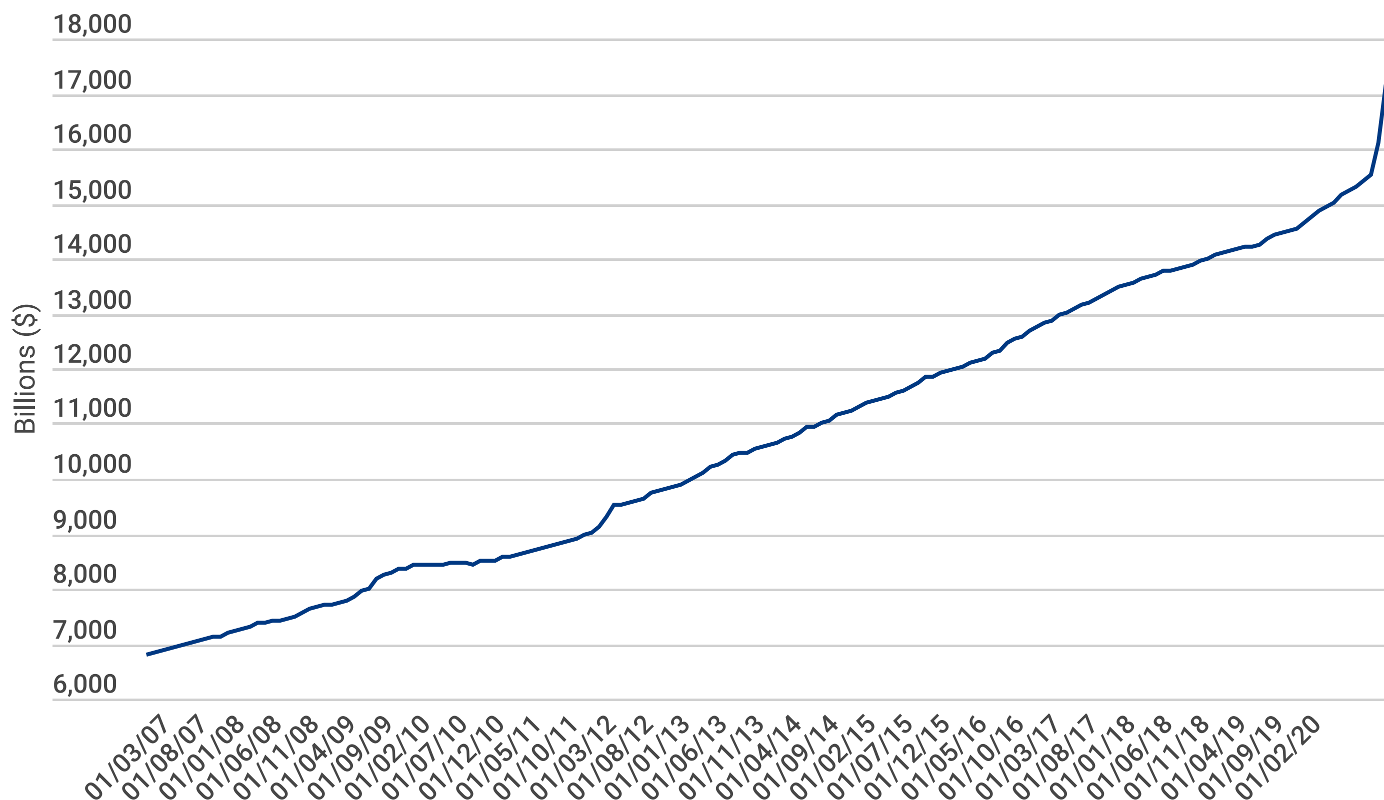
1. Zero money maturity and M2 growth in the US



Source: Federal Reserve Bank of St Louis

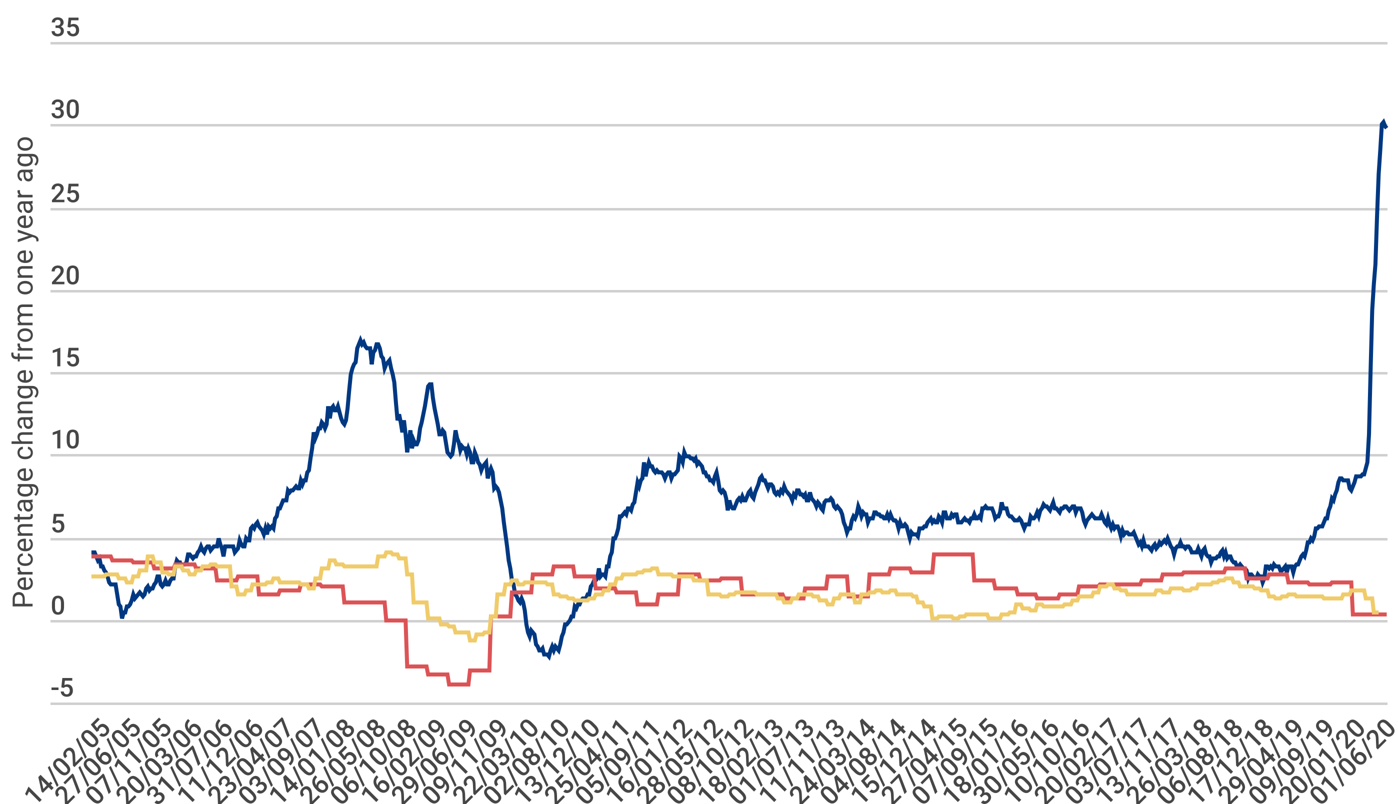
2. M3 growth in the United States (2007- 2020 Q1)



Source: Federal Reserve Bank of St Louis

Broader measures often used for monetary aggregate analysis, M3 and M2, have also increased. M3 rose by nearly $600 billion in March (see figure 2) and M2 by $2.6 trillion from

3. Annualised change in MZM, M3 and inflation in the US (2005–present)



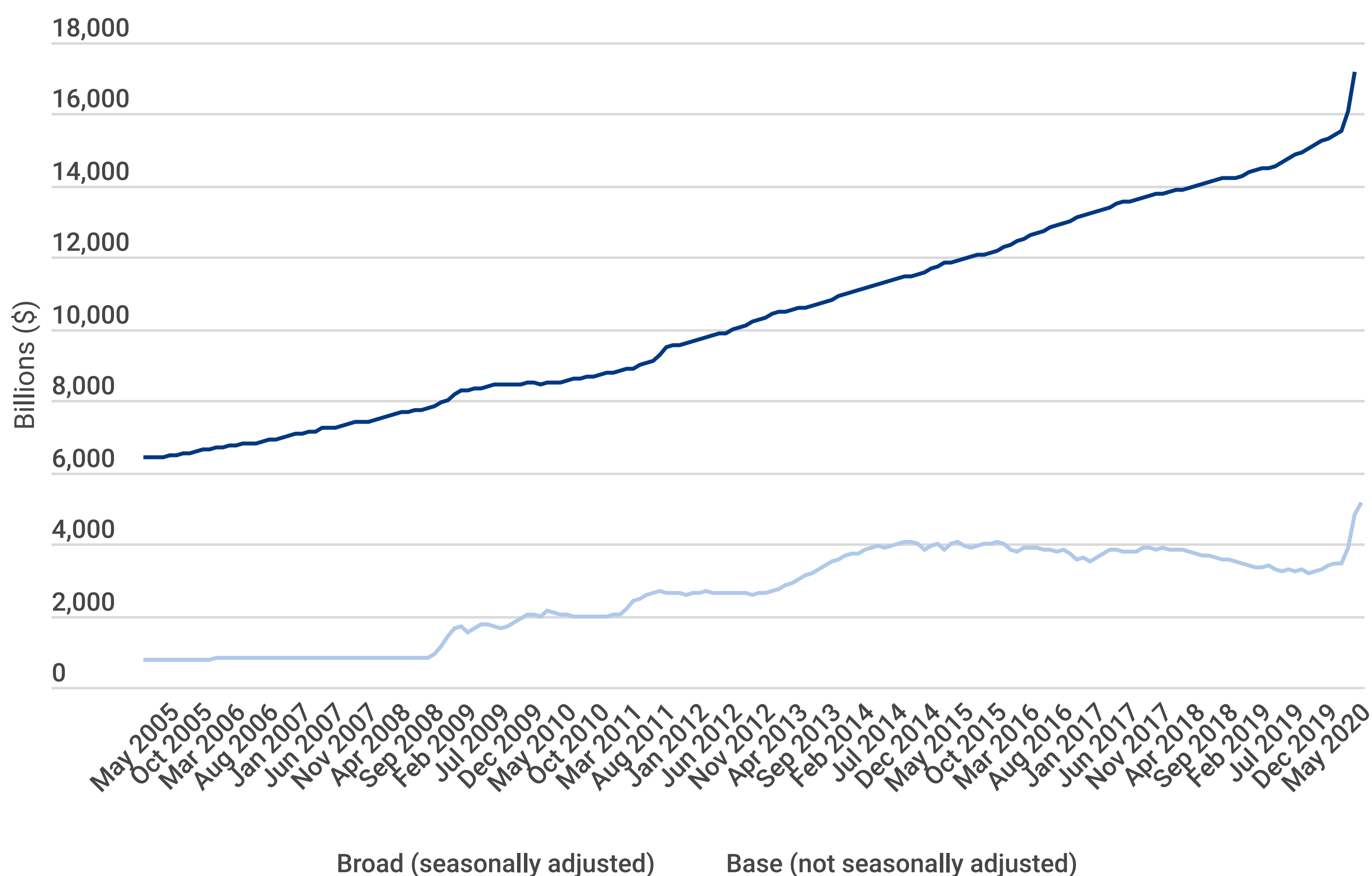
Source: Federal Reserve Bank of St Louis

Why might things be different this time around?

Firstly, as figure 1 and figure 2 demonstrate, the pace and size of monetary expansion is far greater than that during the financial crisis. The percentage change in growth of MZM from one year prior to May 18 was more than 30% – for M3 it was over 10% in March. The speed and scale of the expansion may be an important factor, but on its own it does it does not suggest any difference in how the supply of money will be transmitted into the real economy.

Economist George Selgin argued in his 2018 book, *Floored,* that the Fed's post-crisis monetary policy framework, which pays interest on excess reserves, gave banks little incentive to do much with the increase in excess reserve balances from the Fed's asset purchases. The result was a decoupling of reserve balances, or base money, and money supply in the economy (see figure 4). Selgin argued this deepened and prolonged the recession.

4. Decoupling and recoupling of broad and base money



Source: Federal Reserve Bank of St Louis

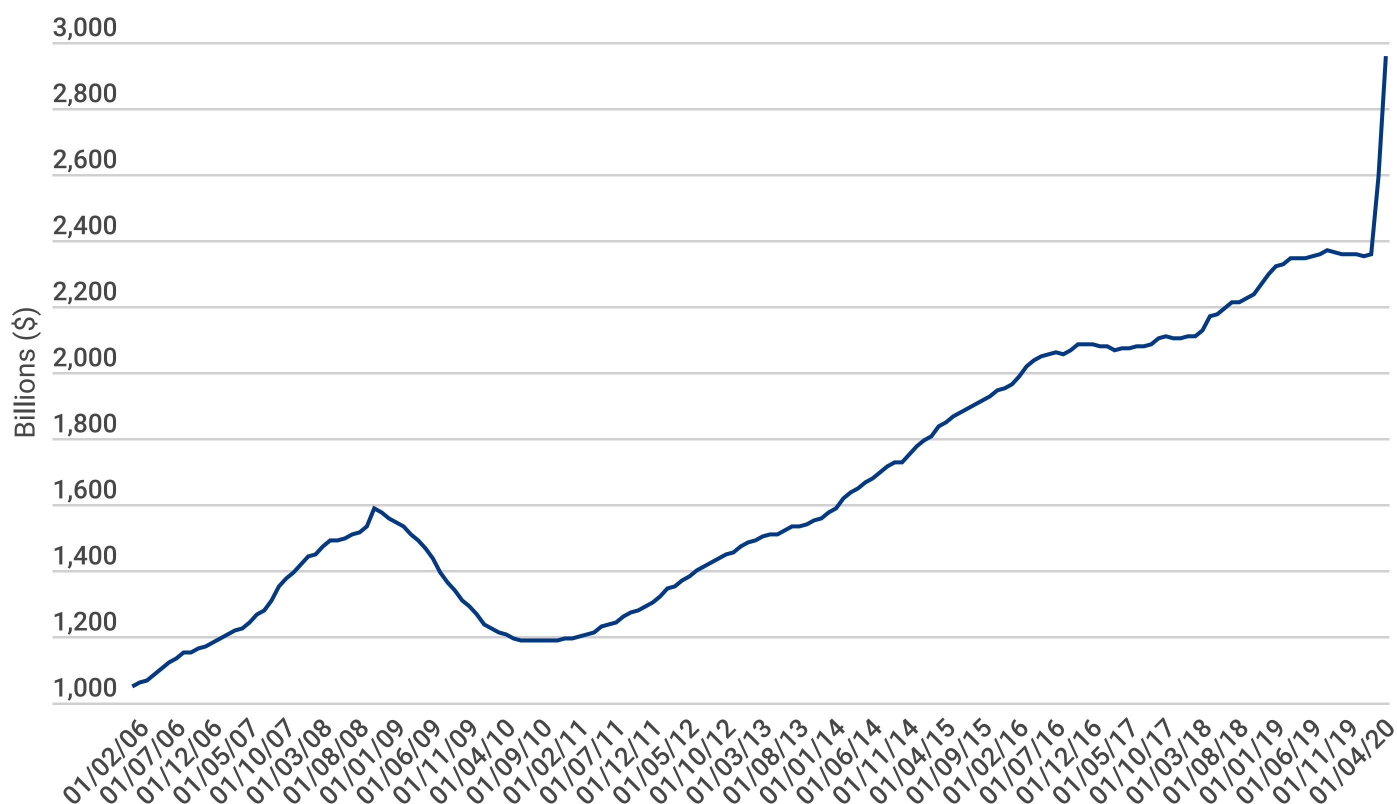
Note: The base money data is derived from the St Louis Fed's "Monetary Base; Total Balances Maintained". The broad money data is derived from M3 figures.

More recently, however, the growth in base money has been reflected in the growth in broad money. The difference is that banks are lending a greater amount during this crisis (see figure 5).

Several factors may be at play. Through a number of different **supervisory and regulatory actions** the Fed has encouraged banks to draw down on the capital levels they have build up during recent years. In addition, the Fed has launched several liquidity facilities, such as the Commercial Paper Funding Facility, the Paycheck Protection Liquidity Facility and the soon-to-be-implemented Main Street Business Lending Program, to ensure funds are making their way into the real economy.

A greater portion of the increase in money supply is thus being utilised to lend to the real economy. Higher lending implies a higher multiplier of base money, and bigger growth in broader monetary aggregates, which could be inflationary.

5. Commercial bank lending in the US (2006–present)



Source: Federal Reserve Bank of St Louis

In addition to the Fed's measures to let banks run down their capital buffers, it is worth noting the 'tailoring' of banking regulations in recent years under the current administration may add to the impetus for banks to boost lending.

Saving and borrowing

A final inflationary force that may be building momentum the longer the heath crisis continues, concerns recent personal savings and business borrowing behaviour. In April, households cut spending by a record 13.6% on a month on month basis, up from the previous record of 7.5% in March. In April incomes rose by 10.5%. As a result, personal saving as a percentage of disposable personal income **increased sharply** by 33% or by $6.15 billion, up from $2.2 trillion in March. Both March and April personal savings increases were the largest since 1981.

An increase in personal savings typically reduces the velocity of cash, as the money is being stored and thus not being exchanged as often. This tends to be disinflationary. But as the recovery starts, consumers may feel buoyed by their reserves of purchasing power and increase their spending. One might expect spending to be particularly strong in areas that were most impacted by the fall in spending, such as healthcare and dental services or in the car sector.

Business borrowing would appear to be a countervailing force, shifting spending from the future to the present. But during the current crisis, businesses are using a large chunk of the borrowing to pay wages, which in turn is being absorbed by higher savings rates. This