'Inflation and Interest Rates; not so much lower for longer as higher and sooner?'

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Inflation Break Even Point (5 Years)
**Trap Risk: “Inflation whipsaw”**

Brunnermeier, Merkel, Parker, Sannikov (2020)
2 Traps

1. Deflation trap (Liquidity trap) Japan
   - Precautionary savings, flight to safety
   - Policy rate close to Reversal Rate (ELB) ⇒ low inflation for long

2. Inflation trap (inflation like a bank-run)
   a. Run in other safe asset/foreign currency (digital) [Portfolio choice]
      ⇒ import cost push shock (for small countries)
   b. Run into consumption, global supply shock [Consumption-savings]
   c. Wage pressure demographics [Labor-leisure]

- High debt inhibit necessary monetary policy steps
  - Fiscal sector Fiscal dominance ⇒ threatens independence
  - Financial sector Financial dominance
What are the inflation/deflation pressures?

- Risk
- Forced savings
+ Pent-up demand
+ capital misallocation
+ (re)-distribution
+ government commitment
-/+ Lending policy
+ Margin for large firms
- Weak financial sector
+ slow-/deglocalization
+ demographics

Brunnermeier, Merkel, Parker, Sannikov (2020)
Inflation (professional forecasters)

Source: Philadelphia Fed
Inflation uncertainty and dispersion (household surveys)

Source: New York Fed
1. Lowflation + falling interest rates: Is the role of globalization and demography
   ▪ (i) huge; (ii) large; (iii) somewhat; (iv) small; and (v) unimportant?

2. CBO indicates slowing economic growth slowing down and debt/deficits rising. What is your confidence that USA political system achieve deficit reduction over the next few years:
   ▪ (i) very; (ii) perhaps; (iii) only with luck; (iv) not at all?

3. Monetary expansion in 2020 and 2021, but dramatic fall in velocity. Do you expect velocity to:
   ▪ (i) return to normal; (ii) return a significant part of the way towards normal; (iii) move back a little bit; (iv) stay constant; (v) fall further, as monetary growth continues?

4. If full employment has not been re-attained by end-2023, would you expect the FOMC to raise interest rates when inflation is:
   ▪ (i) averaging above 2%; (ii) averaging above 3%; (iii) averaging above 4%; (iv) averaging above 5%; (v) averaging higher; (vi) never?
The Great Demographic Reversal: Ageing Societies, Waning Inequality, and an Inflation Revival

By
C.A.E. Goodhart
Financial Markets Group, London School of Economics

and

Manoj Pradhan
Talking Heads Macroeconomics
Figure 1: Interest rates have been falling for decades
Figure 2: Working age populations falling globally – Africa is the key exception, and India to a lesser extent
Table 1: Dependency ratios rising because of the elderly, not the young

<table>
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<th></th>
<th>USA</th>
<th>UK</th>
<th>Germany</th>
<th>Japan</th>
<th>China</th>
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<td>Change 1970–2010:</td>
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<td>20</td>
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<td><strong>Retiree</strong></td>
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<td>8</td>
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<td>6</td>
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*Source* UN Population Statistics
Figure 3: Consumption Increases Over Time in the AEs
Table 2: Inequality has narrowed across countries, particularly the EMEs

Ratio of the wages of the workers

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<th>Year</th>
<th>USA/China</th>
<th>France/Poland</th>
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<td>34.6</td>
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<td>20.4</td>
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<td>2006</td>
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<td>2007</td>
<td>15.2</td>
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<td>2008</td>
<td>12.2</td>
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<td>2009</td>
<td>10.8</td>
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<td>2010</td>
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<td>2011</td>
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<td>3.2</td>
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<tr>
<td>2018</td>
<td>5.1</td>
<td>2.9</td>
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</tbody>
</table>

*Source* National Sources
Figure 4: Those with lower educational attainment have been most exposed to the global shock to labour

Cumulative change in real weekly earnings at working age adults aged 18-64, 1963-2017

Source: American Economic Association
Figure 5: Ageing will lead to a massive rise in deficits and borrowing

Baseline projections of the primary balance and PSND

Source: OBR
Figure 6: Debt Falls After Wars, But That Will Not Apply to Ageing

**Debt and Deficits**

Federal debt held by the public is projected to equal 195 percent of gross domestic product (GDP) in 2050, and the deficit is projected to equal 13 percent of GDP.

Percentage of Gross Domestic Product

In CBO’s projections, federal debt held by the public surpasses its historical high of 106 percent of GDP in 2023 and continues to climb in most years thereafter. In 2050, debt as a percentage of GDP is nearly 2.5 times what it was at the end of last year.
The Endgame? Inflation

Dealing with Debt

• Growth – unlikely

• Productivity – yes, but modest

• Inflation – unattractive, but necessary

The Pandemic:

• Monetary Aggregates

• Markups
Mitigants

- Africa/India
- Limit benefits to old
- More participation of elderly
- Technology
- “Why didn’t it happen in Japan?”
Table 3: The oldest-old form the dominant cohort among ‘medical dependents’

UK, 2017

<table>
<thead>
<tr>
<th>Cohort</th>
<th>Total population</th>
<th>Dependents</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Young–Old</td>
<td>65–75</td>
<td>5276</td>
<td>1621</td>
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<tr>
<td>Old</td>
<td>75–85</td>
<td>3130</td>
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<tr>
<td>Old–Old</td>
<td>85+</td>
<td>1318</td>
<td>1023</td>
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</tbody>
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Figure 7: Participation Rates are Already High Thanks to Pension Degradation
Figure 8: “Why Didn’t It Happen in Japan?”

GDP per worker

Sources: OECD; Eurostat.

Japan Inc. Invested Heavily Abroad

Labour Adjustment via Hours, Not Wages
Conclusions

• Inflation is coming – unlike the post-GFC recovery, stimulus has gone to the real economy, and demand will outstrip supply in the presence of policy that will become increasingly procyclical

• The yield curve will steepen – if ‘Yield Curve Control’ is imposed, it will act in a procyclical manner to push inflation even higher

• Asset returns will be harder to extract

• Lower within-country inequality

• Central bank independence will come under increasing threat