The world economy's strange new rules

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RICH-WORLD economies consist of a billion consumers and millions of firms taking their own decisions. But they also feature mighty public institutions that try to steer the economy, including central banks, which set monetary policy, and governments, which decide how much to spend and borrow. For the past 30 years or more these institutions have run under established rules. The government wants a booming jobs market that wins votes but, if the economy overheats, it will cause inflation. And so independent central banks are needed to take away the punch bowl just as the party warms up, to borrow the familiar quip of William McChesney Martin, once head of the Federal Reserve. Think of it as a division of labour: politicians focus on the long-term size of the state and myriad other priorities. Technocrats have the tricky job of taming the business cycle.

This neat arrangement is collapsing. As our special report explains, the link between lower unemployment and higher inflation has gone missing. Most of the rich world is enjoying a jobs boom even as central banks undershoot inflation targets. America's jobless rate, at 3.5%, is the lowest since 1969, but inflation is only 1.4%. Interest rates are so low that central banks have little room to cut should recession strike. Even now some are still trying to support demand with quantitative easing (QE), ie, buying bonds. This strange state of affairs once looked temporary, but it has become the new normal. As a result the rules of economic policy need redrafting—and, in particular, the division of labour between central banks and governments. That process is already fraught. It could yet become dangerous.

The new era of economic policy has its roots in the financial crisis of 2007-09. Central banks enacted temporary and extraordinary measures such as QE to avoid a depression. But it has since become clear that deep forces are at work. Inflation no longer rises reliably when unemployment is low, partly because the public has come to expect modest price rises, and also because global supply chains mean prices do not always reflect local labour-market conditions. At the same time an excess of savings and firms' reluctance to invest have pushed interest rates down. So insatiable is the global appetite to save that more than a quarter of all investment-grade bonds, worth $15trn, now have negative yields, meaning lenders must pay to hold them to maturity.

Economists and officials have struggled to adapt. In early 2012 most Fed officials thought that interest rates in America would settle at over 4%. Nearly eight years on they are just 1.75-2% and are the highest in the G7. A decade ago, almost all policymakers and investors thought that central banks would eventually unwind QE by selling bonds or letting their holdings mature. Now the policy seems permanent. The combined balance-sheets of central banks in America, the euro zone, Britain and Japan stand at over 35% of their total GDP. The European Central Bank (ECB), desperate to boost inflation, is restarting QE. For a while the Fed managed to shrink its balance-sheet, but since September its assets have started to grow again as it has injected liquidity into wobbly money-markets. On October 8th Jerome Powell, the Fed's chairman, confirmed that this growth would continue.

One implication of this new world is obvious. As central banks run out of ways to stimulate the economy when it flags, more of the heavy lifting will fall to tax cuts and public spending. Because interest rates are so low, or negative, high public debt is more sustainable, particularly if borrowing is used to finance long-term investments that boost growth, such as infrastructure. Yet recent fiscal policy has been confused and sometimes damaging. Germany has failed to improve its decaying roads and bridges. Britain cut budgets deeply in the early 2010s while its economy was weak—its lack of public investment is one reason for its chronically low productivity growth. America is running a bigger-than-average deficit, but to fund tax cuts for firms and the wealthy, rather than road repairs or green power-grids.

While incumbent politicians struggle to deploy fiscal policy appropriately, those who have yet to win office are eyeing central banks as a convenient source of cash. "Modern monetary theory", a wacky notion that is gaining popularity on America's left, says there are no costs to expanding government spending while inflation is low—so long as the central bank is supine. (President Donald Trump's attacks on the Fed make it more vulnerable.) Britain's opposition Labour Party wants to use the Bank of England to direct credit through an investment board, "bringing together" the roles of chancellor, business minister and Bank of England governor.

In a mirror image, central banks are starting to encroach on fiscal policy, the territory of governments. The Bank of Japan's massive bondholdings prop up a public debt of nearly 240% of GDP. In the euro area QE and low rates provide budgetary relief to indebted southern countries—which this month provoked a stinging attack on the central bank by some prominent northern economists and former officials (see Free exchange). Mario Draghi, the ECB's outgoing president, has made public appeals for fiscal stimulus in the euro zone. Some economists think central banks need fiscal levers they can pull themselves.

Here lies the danger in the fusion of monetary and fiscal policy. Just as politicians are tempted to meddle with central banks, so the technocrats will take decisions that are the rightful domain of politicians. If they control fiscal levers, how much money should they give to the poor? What investments should they make? What share of the economy should belong to the state?

A new frontier

In downturns either governments or central banks will need to administer a prompt, powerful but limited fiscal stimulus. One idea is to beef up the government's automatic fiscal stabilisers, such as unemployment insurance, that guarantee bigger deficits if the economy stalls. Another is to give central banks a fiscal tool that does not try to redistribute money, and hence does not invite a feeding frenzy at the printing presses—by, say, transferring an equal amount into the bank account of every adult citizen when the economy slumps. Each path brings risks. But the old arrangement no longer works. The institutions that steer the economy must be remade for today's strange new world. ■

The world economyInflation is losing its meaning as an economic indicator

economist.com/special-report/2019/10/10/inflation-is-losing-its-meaning-as-an-economic-indicator

INFLATION USED to be the scourge of the world economy and the bane of American presidents. In 1971 amid an overheating economy Richard Nixon took to television to announce a freeze on “all prices and wages throughout the United States”. A board of bureaucrats ruled on what this meant for everything from golf club memberships to commodity futures. Gerald Ford, Nixon’s successor, preferred a grassroots approach. He distributed buttons bearing his slogan: WIN, for “whip inflation now”. Ronald Reagan, running for office four years later amid another surge in prices, declared inflation to be “as violent as a mugger, as frightening as an armed robber and as deadly as a hit man”.

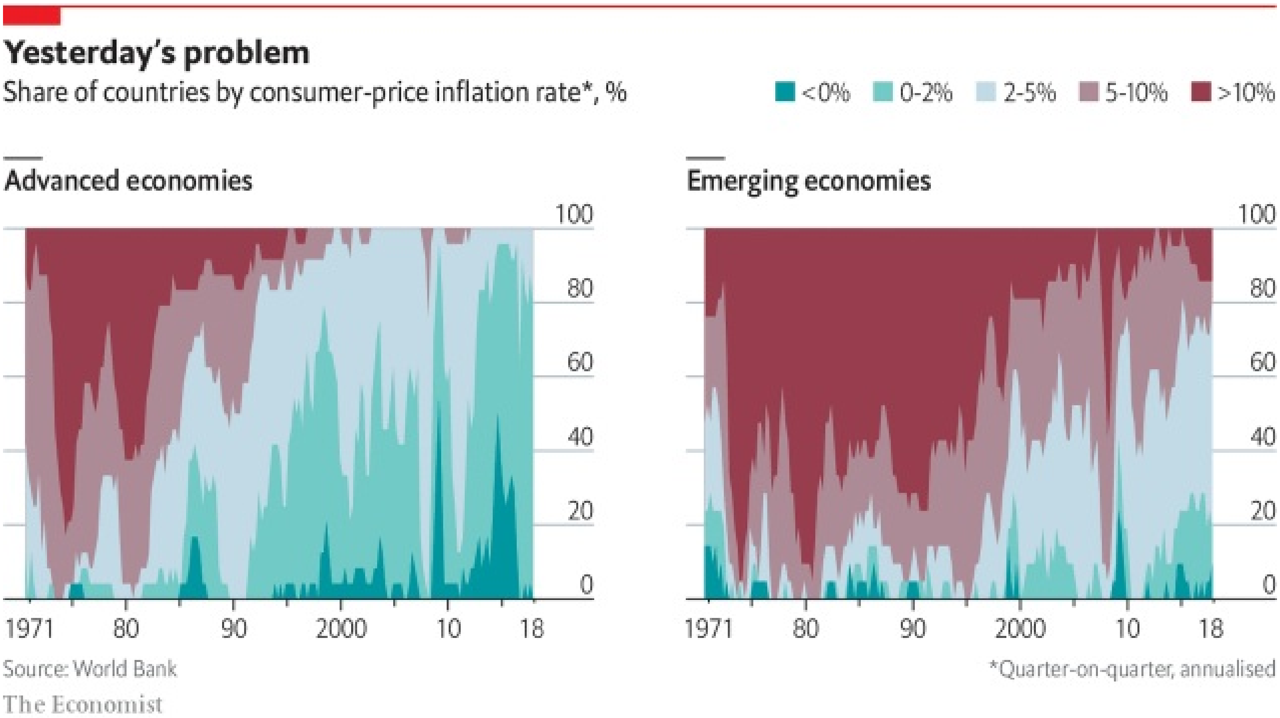
Today the lethal assassin has gone missing. Most economies no longer struggle with runaway prices. Instead they find inflation is too low, as judged by their inflation targets. A decade of interest rates at or near rock-bottom has not changed that. Nor has the printing of money by central banks in America, the euro zone, Britain and Japan that has expanded their balance-sheets beyond a combined $15trn (35% of their combined GDP). Nor have unemployment rates that are in many countries the lowest they have been for decades.

The IMF counts among its members 41 countries in which monetary-policy targets inflation. Add in the euro zone and America (where the Fed has multiple goals), and you get 43. Of those 28 will either undershoot their inflation targets in 2019 or have inflation in the bottom half of their target range, according to the fund’s most recent round of forecasts. (When those forecasts are updated on October 15th, after this special report goes to press, that number will probably rise.) By GDP 91% of the inflation-targeting world is an inflation laggard on this measure. That includes nearly all the advanced economies under examination—Iceland is the sole exception—and more than half of the emerging markets.

This shift in the inflation landscape reflects both the successes and the failures of economic policy. The advent of inflation-targeting central banks since the 1990s has gradually immunised economies against runaway prices. But policymakers seem either unwilling or unable to stop inflation falling short of their targets. This special report will argue that anchored inflation expectations, technological change and the flow of goods and capital across borders have conspired to make inflation a less meaningful—and less malleable—economic indicator. Central banks are therefore finding their targets harder to hit. At the same time, constraints on monetary policy mean that the risk of inflation shortfalls looms larger than that of excessive price rises. Central bankers and politicians must find ways to adapt economic policy to this new world.

Disinflation nations

Low inflation is striking over both the long term and the short term. In the long term it is the culmination of a decades-long trend. The rich world conquered runaway prices by the late 1990s as governments made central banks independent and gave them inflation targets. In the 2000s and the early 2010s commodity-price booms kept prices rising at a decent clip. But since the oil price crashed in 2014, inflation above 2% has been rare. In emerging markets it is higher, but the direction of change is the same (see chart). For nearly two decades economists have talked of an era of "global disinflation".



In the short term low inflation is especially striking because it seems to defy the "Phillips curve", the supposed inverse relationship between inflation and unemployment. In two-thirds of countries in the OECD, a club of mostly rich countries, a record proportion of 15- to 64-year-olds have jobs. According to the models taught in economics courses and used by central banks, a jobs boom on this scale should have brought accelerating prices and wages. For the most part, it has not.

Central bankers have been caught out. For years they have promised that jobs growth would soon be over and inflation would rise. They have repeatedly been proved wrong and are conscious of their mistakes. In February 2016 Mario Draghi, the outgoing head of the European Central Bank (ECB), described whether inflation targets can be met as "the most fundamental question facing all major central banks". Mark Carney, governor of the Bank of England, recently warned of an "increasingly untenable" economic-policy consensus. In March this year Jerome Powell, the Fed's chairman, said low global inflation was "one of the major challenges of our time". The Fed's failure to hit its inflation target has encouraged an assault by President Donald Trump, who is incensed that in 2018 Mr Powell slowed growth by raising interest rates to see off an inflationary threat that has not yet materialised.

The disease of the 1970s and 1980s was simultaneous high inflation and high unemployment. That both are now low might seem like cause for celebration. Certainly inflation below target is a better problem to have than runaway prices. But it poses problems for three reasons. First, it represents a missed opportunity. Monetary policy could have been looser, and hence growth faster, without price pressures taking off. Second, central banks missing their inflation targets undermines their credibility. In Europe markets' long-term inflation expectations have sunk to little over 1%, lower than when the ECB started its quantitative-easing programme in early 2015, despite an inflation target of below but close to 2%. When inflation targets are not credible, the future is more likely to spring a costly surprise. Unexpectedly low inflation causes lenders to profit and borrowers to suffer, because debts do not shrink as fast in real terms as they were expected to when loans were agreed.

Central bankers have repeatedly been proved wrong

Most important, low inflation can be self-reinforcing. More significant than the nominal interest rate set by central banks is the real interest rate, which adjusts for inflation. As the public comes to expect lower inflation, the real rate rises, weakening demand and pushing inflation down even more. That would not be a problem if central banks could cut the nominal rate further to fight the disinflationary slump, but they have little room to do so. In Europe and Japan nominal interest rates are already below zero. They are near zero in Britain, and only a little higher in America. Though the exact location of the lower bound on interest rates is uncertain, it exists somewhere because the public always has the option of holding cash at a zero nominal return.

Why has inflation reached this curious—and precarious—point? Some would argue that inflation is falling short because governments have lost the ability to boost prices. This cannot be true. If it were, they could cut taxes to zero, boost spending, print money to finance the resulting deficits and never see an inflationary downside. Inflation will always respond, eventually, to a determined policymaker who has access to interest rates and the printing presses. Governments can always debase their currencies, as high inflation in Argentina and Turkey shows.

This might suggest that below-target inflation reflects only a failure of ambition. But that is not right either. Inflation has become harder to fine-tune because economies have changed in ways that are not yet fully understood. Monetary policy must not just become more ambitious but also adapt to rely less on failing models and to take a longer-term view. And while central banks are hamstrung by low rates, fighting low inflation will increasingly fall to fiscal policy. The case for reform rests first on an understanding of where economic models have gone wrong. ■

See next article: Economists' models of inflation are letting them down

The rich worldEconomists' models of inflation are letting them down

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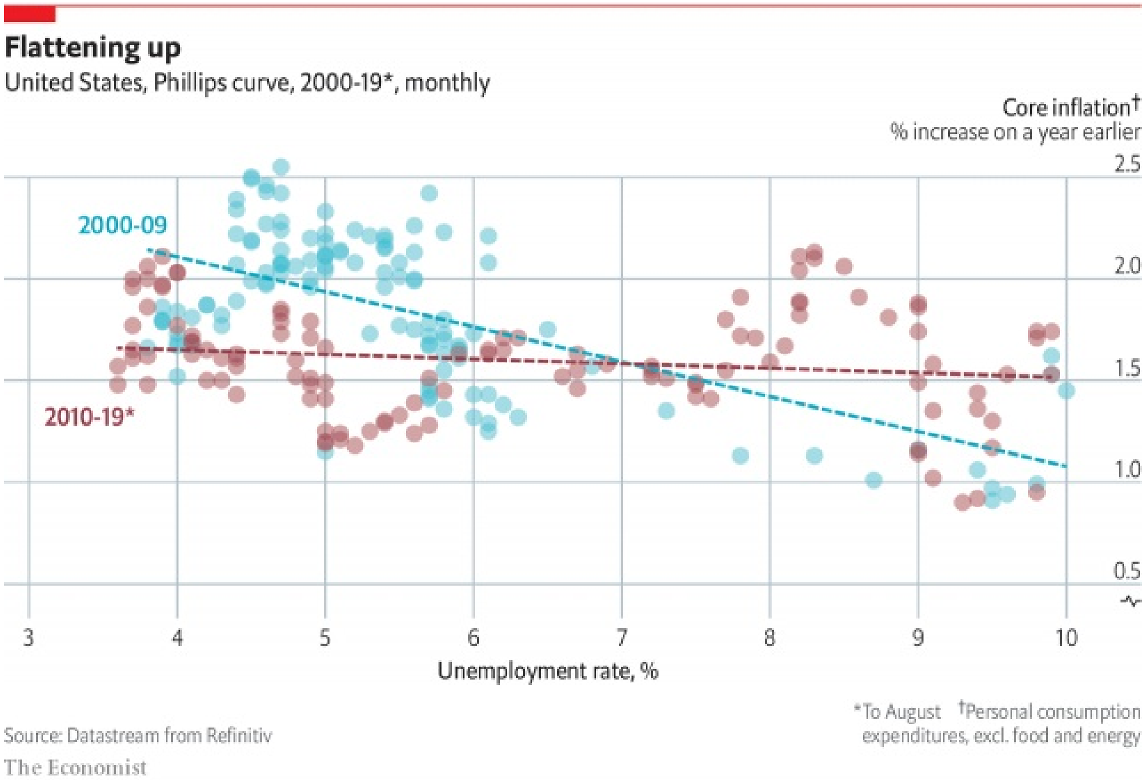


ONE OF THE economic models named after William Phillips is physical. The Phillips hydraulic computer uses flows of water to simulate flows of money in the economy; its success helped earn Phillips a job at the London School of Economics in 1950. Today economists can bring the full power of modern computing to their calculations. But they still depend utterly on another Phillips eponym: the curve tracing the relationship between inflation and unemployment (see chart). It comes in various flavours, but the basics underpin central banking. If unemployment falls too low, inflation will rise; too high, and it will fall.

Over the past decade the "Phillips curve" has failed at both ends. First came the so-called "missing deflation". The financial crisis sent rich-world unemployment soaring to 8.5% by the start of 2010. Both theory and experience suggested that this should have caused a prolonged slump in inflation. But it did not. The IMF wrote of "the dog that didn't bark"; some economists argued that unemployment had become structurally higher (meaning it would not affect prices). It was only once oil prices collapsed in late 2014 that the rich world faced serious disinflationary pressure, with the euro zone falling temporarily into deflation in 2015 and 2016.

By then, however, labour markets were recovering. Unemployment fell and then fell some more. Today the proportion of 15- to 64-year-olds with a job is at a record high in two-thirds of OECD countries. Pockets of continued high joblessness remain in places such as Spain and Italy but, for the most part, missing deflation has become missing inflation. The Phillips curve you can still find in the data is extraordinarily flat. Economists at Goldman Sachs estimate that a one-percentage-point fall in American unemployment, for example, is associated with a 0.1-0.2-percentage-point rise in inflation—so small as to be difficult to perceive. Some economists argue that it is increasingly viable to forecast inflation without any regard to unemployment at all.

There are three potential explanations for a flat Phillips curve, none of them entirely satisfactory. The first is that it is a statistical artefact. In a recent working paper, Michael McLeay and Silvana Tenreyro of the Bank of England argue that the relationship between inflation and unemployment is subject to "Goodhart's law": that observed statistical relationships collapse once they are exploited by policymakers (not to be confused with the "Lucas critique", which says that some relationships cannot be exploited at all). Suppose a central bank cares about both unemployment and inflation. In a downturn it will ignore higher inflation if it needs to get unemployment back down. Yet when unemployment is low, central banks will react hawkishly to any sign of fast price rises. Over time those preferences will create an artificial positive correlation between inflation and unemployment, offsetting the underlying causal relationship running in the other direction.

This argument has some traction. In 2011, for example, a spike in commodities prices pushed inflation up but most central banks ignored it to focus on healing their scarred economies. Later in the decade, amid low unemployment rates, monetary policymakers became more attuned to the risk of overheating. It would be odd, however, to explain low inflation by appealing solely to deliberate choices on the part of central banks, when they themselves profess to be confused by inflation's quiescence. Moreover, the argument does not suppose that unemployment can fall for ever without inflation surging. Even if a flat Phillips curve over time is no surprise statistically, today's particular combination of low inflation and ultra-low unemployment still can be.

What to expect when you're expecting

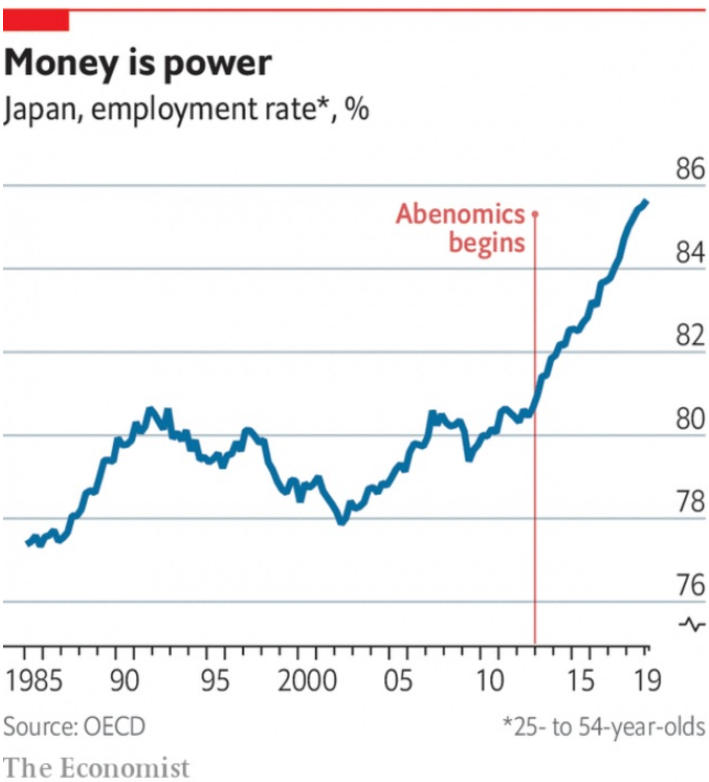
The second potential explanation concerns inflation expectations. The public's ability to anticipate an overheating economy, or at least to notice prices rising faster and adjust their expectations accordingly, is supposed to be a driving force behind the Phillips curve. Firms should raise prices and workers should demand higher wages as soon as they see a boom coming.

Such expectations seem to be getting stickier. Canada, New Zealand and Britain have barely reacted to short-term changes in inflation since 2000, according to the World Bank. Benoît Cœuré, a rate-setter at the ECB, has studied the sensitivity of households' fears that inflation might spiral out of control to perceptions of current price rises. Before the euro the two were closely linked; in the era of the single currency the link has been severed. In America, too, inflation expectations react more slowly to economic data than in the past, according to research by Damjan Pfajfar and John Roberts of the Federal Reserve. It might be that prices now rise so slowly that it is no longer worth paying attention to economic news.

There is little doubt that without the amplifying effect of inflation expectations the Phillips curve should be flatter. But although expectations are supposed to be important, they are not supposed to be everything. Eventually, economies must find that rising demand runs up against supply constraints. Hence the third, and most credible, explanation: that the Phillips curve still exists, but is “non-linear”. Prices and wages could suddenly and quickly accelerate should unemployment fall beneath some threshold at which everything becomes unanchored.

Where might such a threshold lie? Answering that question requires breaking the inflation puzzle into its constituent parts. First, to what extent are firms’ costs—most importantly, wages—rising? Second, are firms passing on those costs by raising prices?

The link between unemployment and wages has loosened but remains intact. In America and the euro zone wage growth has risen gradually in recent years as labour markets have tightened. America is further ahead, but in both cases the figures remain underwhelming by historical standards: 2.7% and 3.2% respectively, as this report went to press. Only in Britain has wage growth really taken off, reaching 4%, its highest since 2008, in July. Still, in most places the link between employment and wages remains discernible. The only real exception is Japan, where wage growth is flat despite monetary policy under the “Abenomics” programme driving a remarkable jobs boom (see chart). Japan’s culture of lifelong employment, in which some workers find it hard to move companies for higher wages without losing social status, is probably part of the explanation.



Elsewhere it is the second link, between wages and prices, that seems to have vanished. On neither side of the Atlantic has core inflation displayed the same gradual upward trend as wages. Britain is an exception, but it has also had an inflationary devaluation of its currency since its vote to leave the European Union in 2016.

There are two ways to have wage inflation without price inflation. The first is a productivity boom, hitherto absent. The second is if firms' profit margins fall. There is clear scope for lower margins in America, where since the mid-2000s firms have enjoyed profits, as a share of GDP, that have been historically high. Profits have begun to come down in recent years as wage growth has risen. The question is how much further they might yet fall, given that America's high profit margins also reflect a lower level of competition in the economy. Outside America margins are lower and so profits provide less of a buffer between costs and prices.

In summary, if you wanted to tell a story about when inflation might take off in the rich world, it would go something like this. Wage growth is strongest in America, but so are profits. Once margins fall, firms will have no choice but to raise prices. In Europe profits are lower, but so is wage growth, because Europe's labour market has not boomed as much as America's. If it ever does, inflation will budge. The Phillips curve is non-linear, meaning that prices will suddenly rise sharply only once economies cross the inflationary Rubicon. Central banks will have to fight the subsequent overheating or risk losing control of inflation expectations, as they did in the 1970s. Japan, with its entrenched deflationary mindset and unique labour-market institutions, is a special case.

The problem with this story is that financial markets do not expect it to happen. As this report went to press, the price of swaps implied that America's consumer-price index between 2024 and 2029 will rise by an average of just 1.9% per year. Because the Fed targets an index that tends to undershoot the CPI by about a third of a percentage point, this implies missing the central bank's 2% target by a long way. In Europe the same measure of inflation expectations languished around 1.2%. Sometimes policymakers try to explain away markets' low inflation expectations by saying that they are driven by a lower risk of very high inflation, rather than a change to traders' central expectations. But this does not sit well with the idea of an inflection point in the Phillips curve lurking, ready to catch central banks off-guard.

Perhaps markets expect that recession, or at least an end to the jobs boom, will render the argument moot. But the puzzle has been enough to prompt a search for disinflationary forces beyond monetary policy and labour markets. One is technological progress. ■

See previous article: Inflation is losing its meaning as an economic indicator
See next article: Technology is making inflation statistics an unreliable guide to the economy

Technology is making inflation statistics an unreliable guide to the economy

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Some people blame Amazon for low inflation

AMAZON IS USED to fielding accusations: that it has killed off physical retail business, that it mistreats warehouse workers, that it abuses its dominant platform in online sales. So perhaps it is not a surprise that some people also blame it for low inflation. In 2017 Janet Yellen, then chair of the Federal Reserve, wondered aloud if cut-throat online competition might be stopping goods-producers raising prices even in a world of rising demand. Alberto Cavallo of Harvard Business School has found that Amazon's prices are 6% lower than those of eight large retailers, and 5% lower than on those retailers' websites. The internet in general is no place to go in search of inflation: in America online prices have been falling fairly steadily since about 2012 and are lower than they were at the turn of the millennium.

Yet the so-called "Amazon effect" should not seem so novel. The winds of disinflation have been blowing through American retail for decades. In the 1990s and 2000s big-box retailers like Walmart and Target ruthlessly cut goods prices as they optimised their supply chains. Cheap imports from China and other emerging-market economies squeezed domestic producers. One study in 2008 found that low-wage countries capturing 1% of market share in America was associated with a 3.1% fall in producer prices. There has been barely any cumulative rise in American consumer-goods prices, excluding food and energy, for two decades. Before the financial crisis, inflation as a whole behaved normally because services inflation held up. Today, both goods and services inflation are low (see chart). The rise of online retail does not easily explain that broader shift.

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