Global Economic Research

AUGUST 6, 2021

Inflation: What's the Worst That Could Happen?

Studying past examples of runaway inflation can help policymakers avoid mistakes.

By Vaibhav Tandon

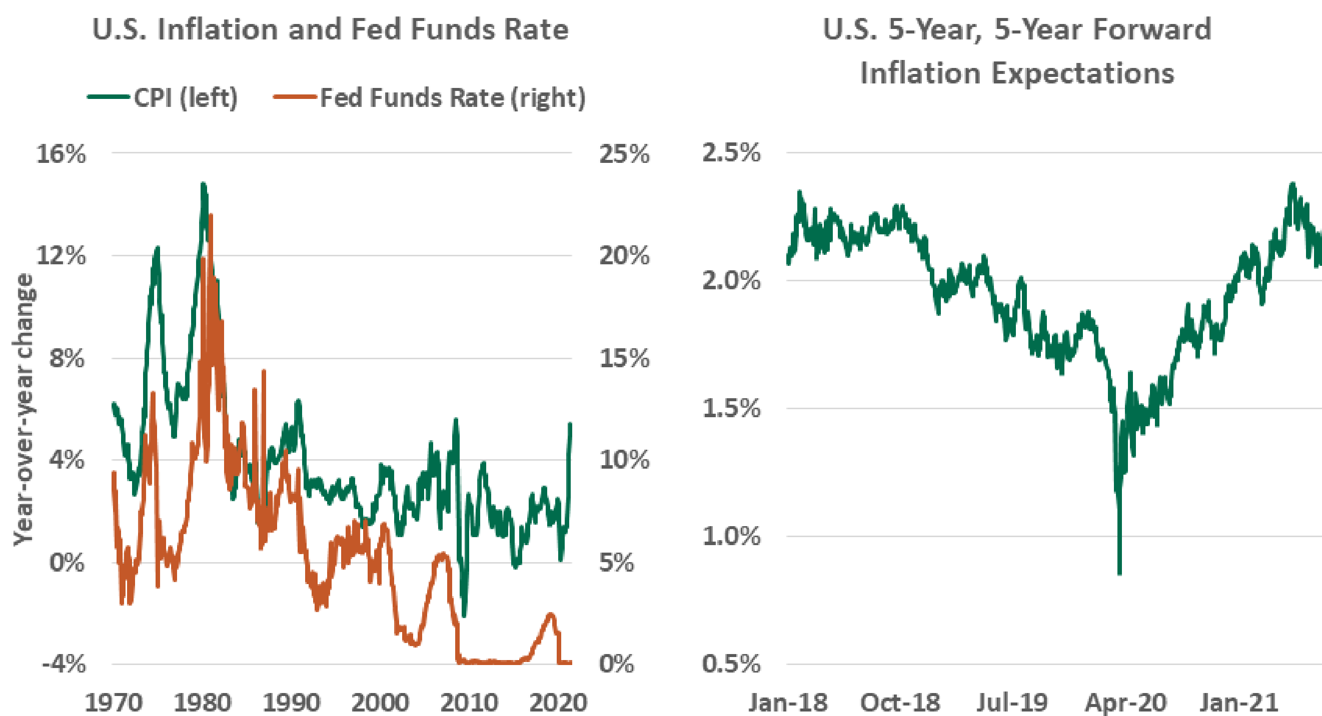
Ronald Reagan did not mince words about economic forecasting in a 1984 speech, as he led an economy overcoming stagflation: "I hope you'll keep in mind that economic forecasting is far from a perfect science. If recent history's any guide, the experts have some explaining to do about what they told us had to happen but never did."

Few among us would hold a grudge against those comments. He was right that economic forecasters often missed the mark at that time. To this day, despite deep research and advancements in modeling, economic forecasting remains imprecise.

Prices of goods and services like groceries, travel, restaurants and vehicles have all pushed inflation to its highest growth rates in over a decade. Workers are in short supply as businesses reopen, and higher wages are being offered to incentivize people to get back to work. Trillions of dollars' worth of fiscal and monetary policy measures were deployed to fight the pandemic's effects. All these factors combined have led to concerns as to whether the nation is going to face 1970s-style stagflation (the combination of high inflation, sluggish economic growth and high unemployment) or even a full-blown debt crisis.

Most economists (including us) believe that the recent bout of inflation is temporary and will fade. The general view among economic forecasters is that this is not the beginning of a persistent, upward spiral like the one witnessed in the 1970s. But in light of Mr. Reagan's concern about forecasters, it's worth asking the question: What if we're wrong? What if we see prolonged or runaway inflation, and long-term inflation expectations start to surge?

Dealing with high inflation won't be easy if it proves persistent.



Source: Haver Analytics, St. Louis Fed

The Federal Reserve has adequate policy room to tame inflation. As the above chart indicates, raising interest rates can be an effective tool to bring inflation down. But the Fed would face a major predicament.

Maintaining their extremely accommodative policies will let inflation run hot and risk a return to stagflation as supply side shocks and the lingering pandemic weigh on growth. Persistently high inflationary pressures (when prices rise faster than wages) erode the value of money. Consumers would be the first to feel the squeeze, reducing their spending and finding more

sympathy for populist messages. It would also diminish the present value of investors' holdings.

The Fed's recourse would be to wind down unconventional policies and raise policy rates sooner and more aggressively to fight inflation, but this would derail an incomplete recovery. The economic consequences would be severe, not just for the U.S. but for the rest of the world as well. Between 1980 and 1982, the Federal Reserve raised the overnight interest rate to a peak of 22% to contain double-digit inflation. Though high rates arrested price growth, the result was a severe double-dip recession in the U.S. and a global debt crisis. History could repeat itself.

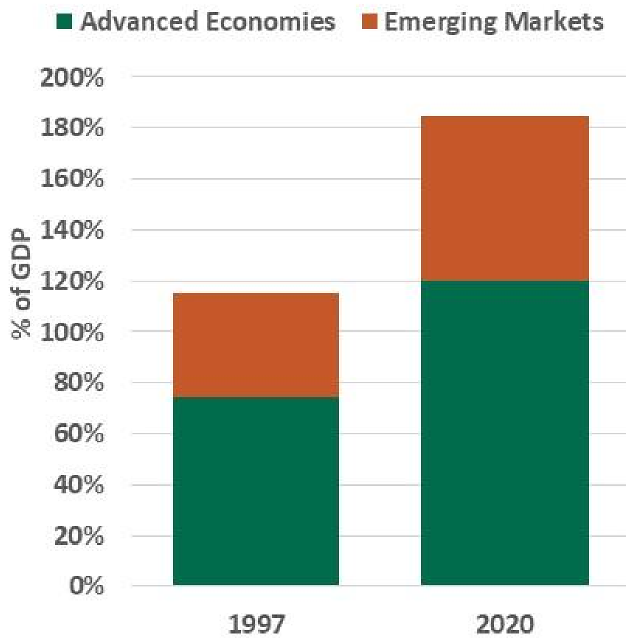
Such a move today would tighten financial conditions around the world. Businesses would likely put their long-term investments on hold. This would weigh on investor sentiment, upsetting equities, credit markets and interest rate-driven sectors like housing.

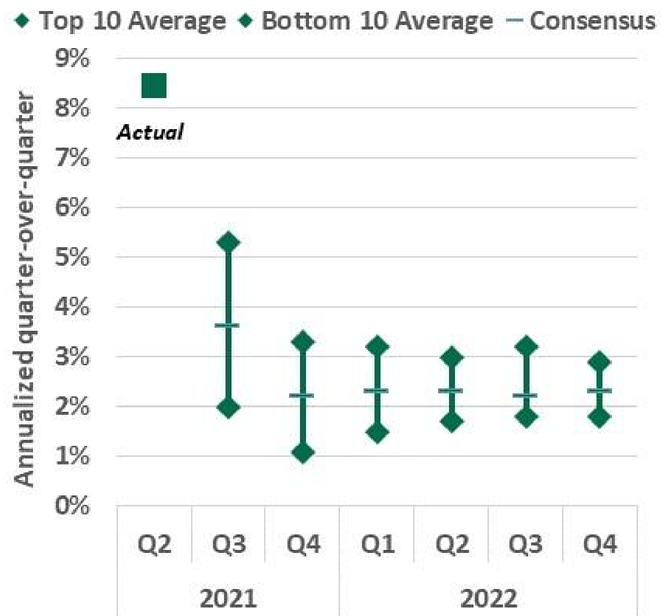
The world is more indebted now than it was a few decades ago. Debt ratios were already climbing in advanced economies and most emerging markets (EMs), and the pandemic has added to the burden. The taper tantrum of 2013 caused notable turbulence in developing economies in the form of capital outflows. It is not difficult to predict what aggressive tightening by the Fed and other advanced economy central banks would do to highly leveraged EMs.

Most EMs have already exhausted their financial resources and taken on more debt in dealing with the pandemic. Heavily indebted EMs, particularly those with large amounts of dollar-denominated debt, will be the worst hit. Higher interest rates will increase governments' debt service obligations. As a result, many would end up defaulting and restructuring their debts. The situation could quickly spiral with defaults spreading to highly indebted firms, households and financial institutions.

High inflation starting in the 1970s had many causes: easy monetary policy, government spending, the oil crisis, the end of the gold standard and removal of wage and price controls, among other factors.

High debt levels will complicate the fight against runaway inflation.





Sources: IMF, Blue Chip Economic Indicators Survey July 2021

Circumstances today are different. Of all the problems our predecessors faced, they did not have to reckon with a pandemic. The spike in inflation readings, as elaborated here, stems from pandemic-related supply shocks and pent-up demand on the back of the economic reopening. Falling bond yields do not suggest widespread concern about prolonged inflation. Oil prices remain well below their historical peaks, and the sector is a much smaller part of the economy. Unions have lost traction, limiting workers' wage bargaining power. Global value chains have lowered the cost of production. All the forces that were keeping inflation at bay before the pandemic will still be in place after it ends.

The worst-case scenario might be improbable but is worth considering. Policymakers must tread with caution to avoid repeating past mistakes. Central banks have the tools to respond to runaway inflation, but it would be best to avoid this course entirely. We will continue to monitor all actual data closely, as well as keep our ears out for the president criticizing our profession.

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