Perspectives on Inflation and Real Rates

AFGAP - Zoom Event - May 20, 2021

François Geerolf
Assistant Professor of Economics, UCLA

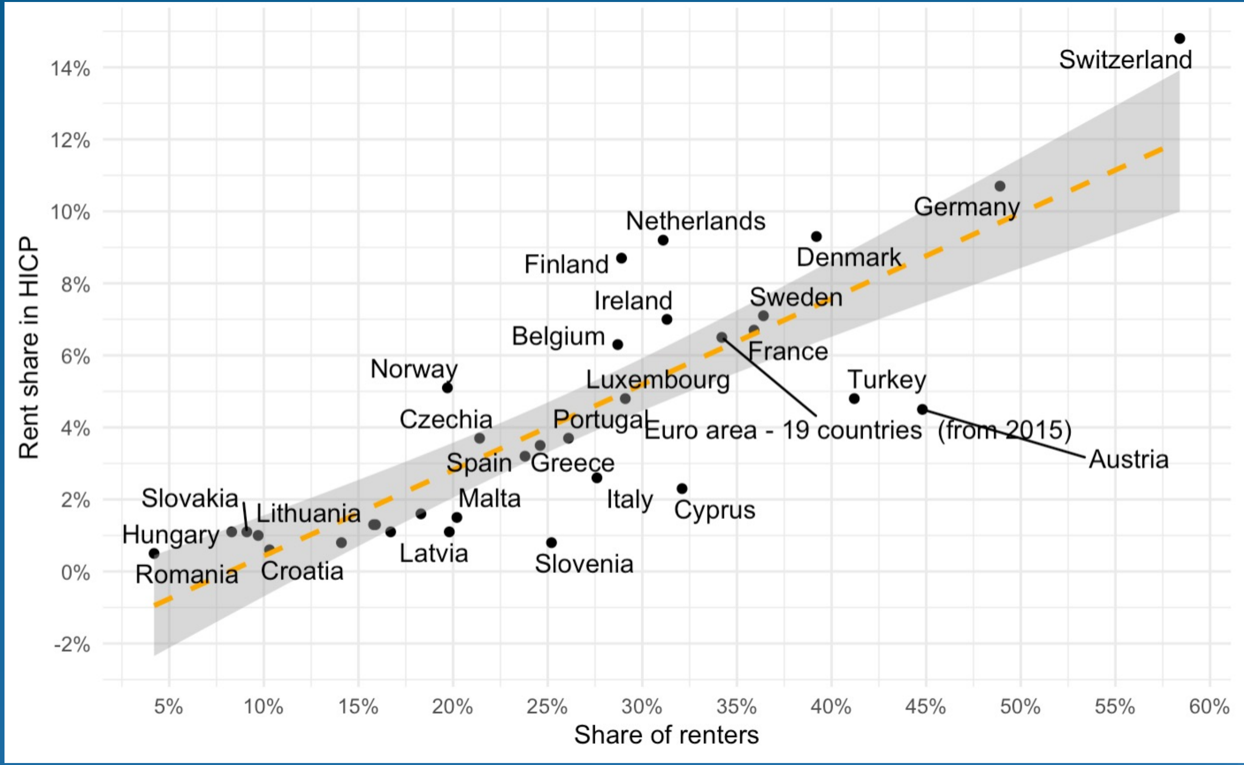
Definition of Inflation

- Consumer Price Inflation (CPI, PCE in the U.S.): average change in prices over time that consumers pay for a basket of goods and services.
- Many different ways to measure inflation: GDP deflators, wage inflation.
- Difficult to compare, over time and across countries.

- **Example** : Treatment of Owner-Occupied Housing = very challenging.
  - US: change in 1983.
  - EU: HICP (**Harmonized** Index of Consumer Prices) = only counts rents, and depends on the share of renters. Moving towards including Owner-Occupied Housing (OOH) in the CPI.
  - EU: most countries have their own price indexes including OOH.
- Other examples: quality improvements, new goods, etc.

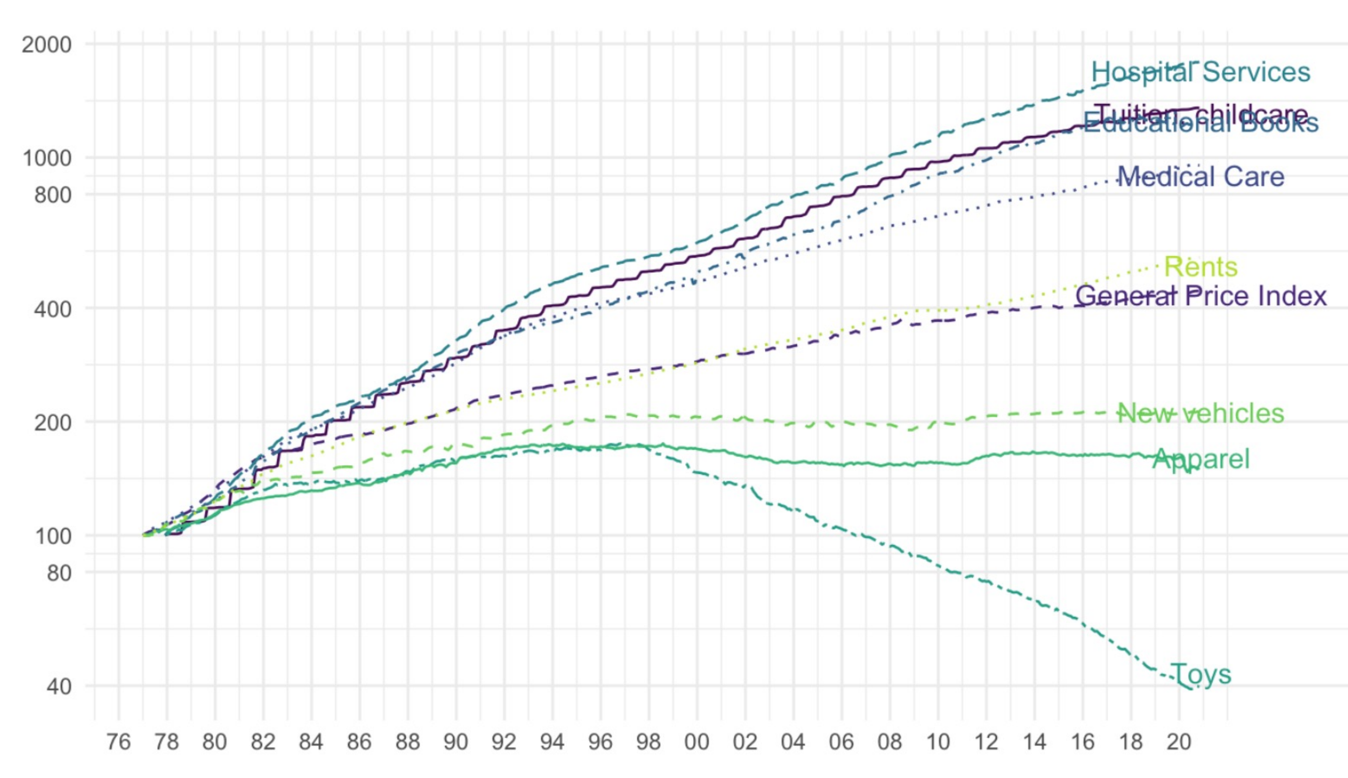
UCLA

HICP = Not that harmonized in Europe (Housing)

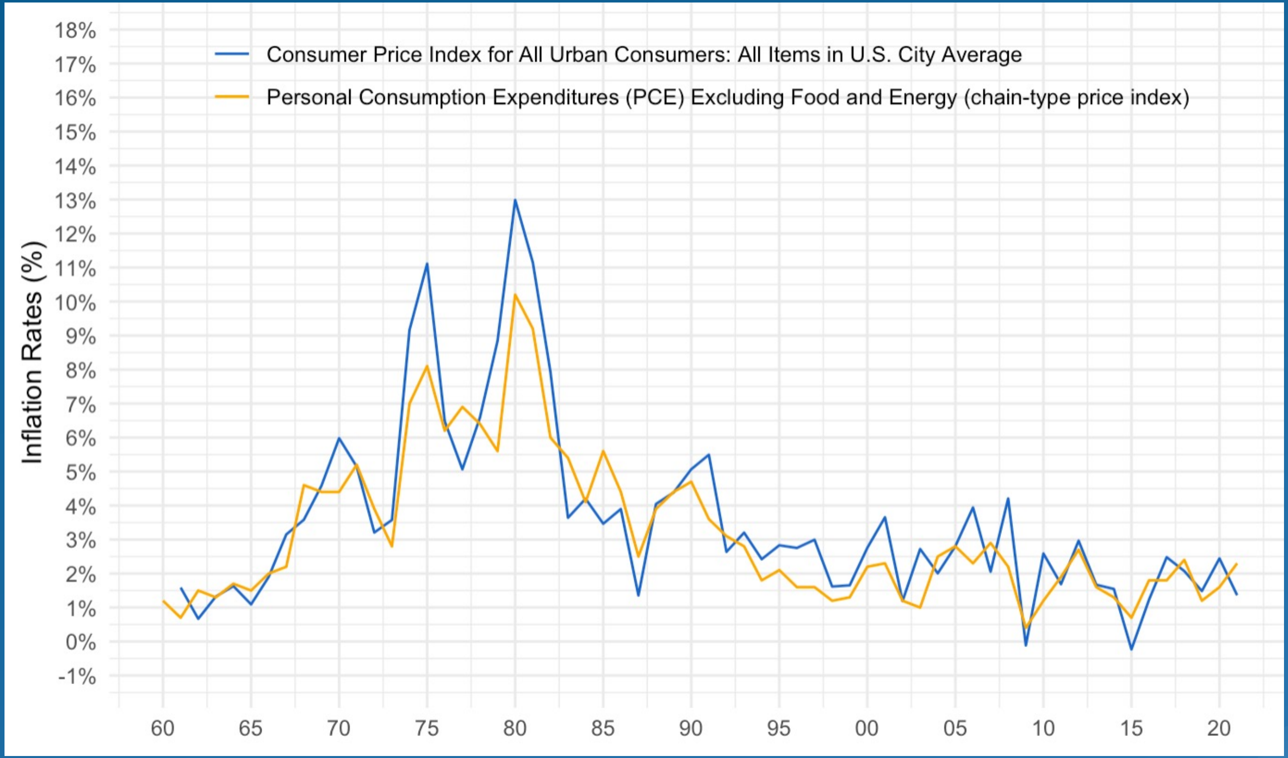


UCLA

Heterogeneous: Balassa-Samuelson.

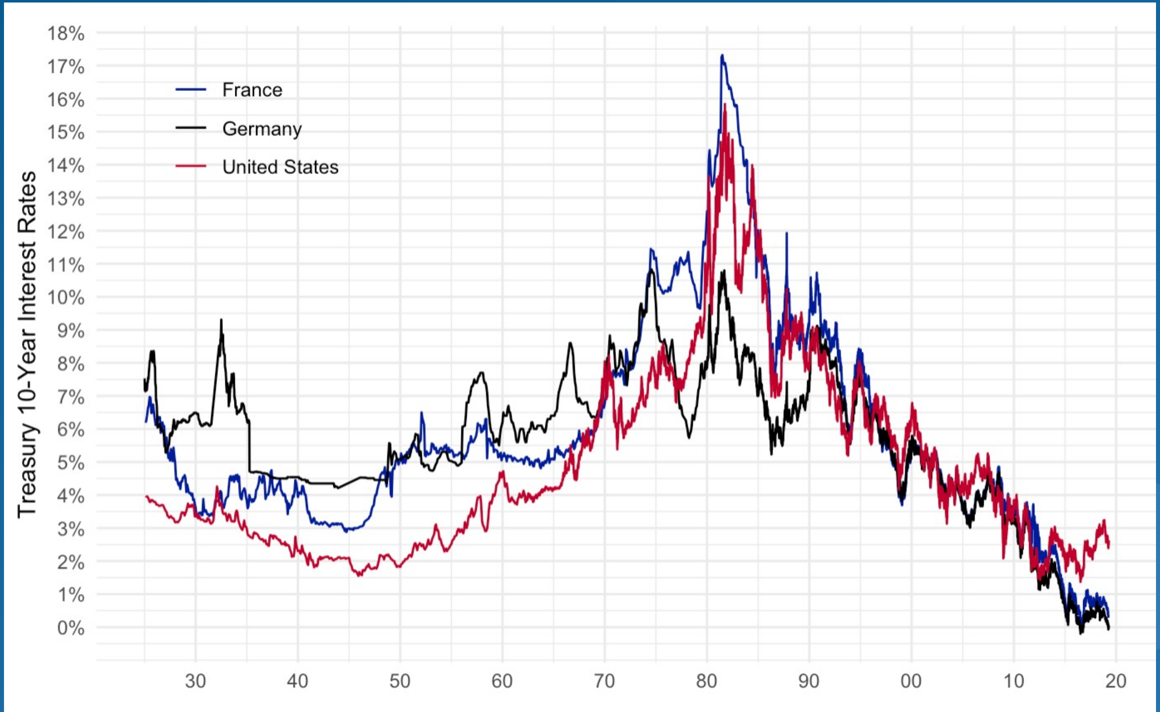


Example: U.S. Inflation

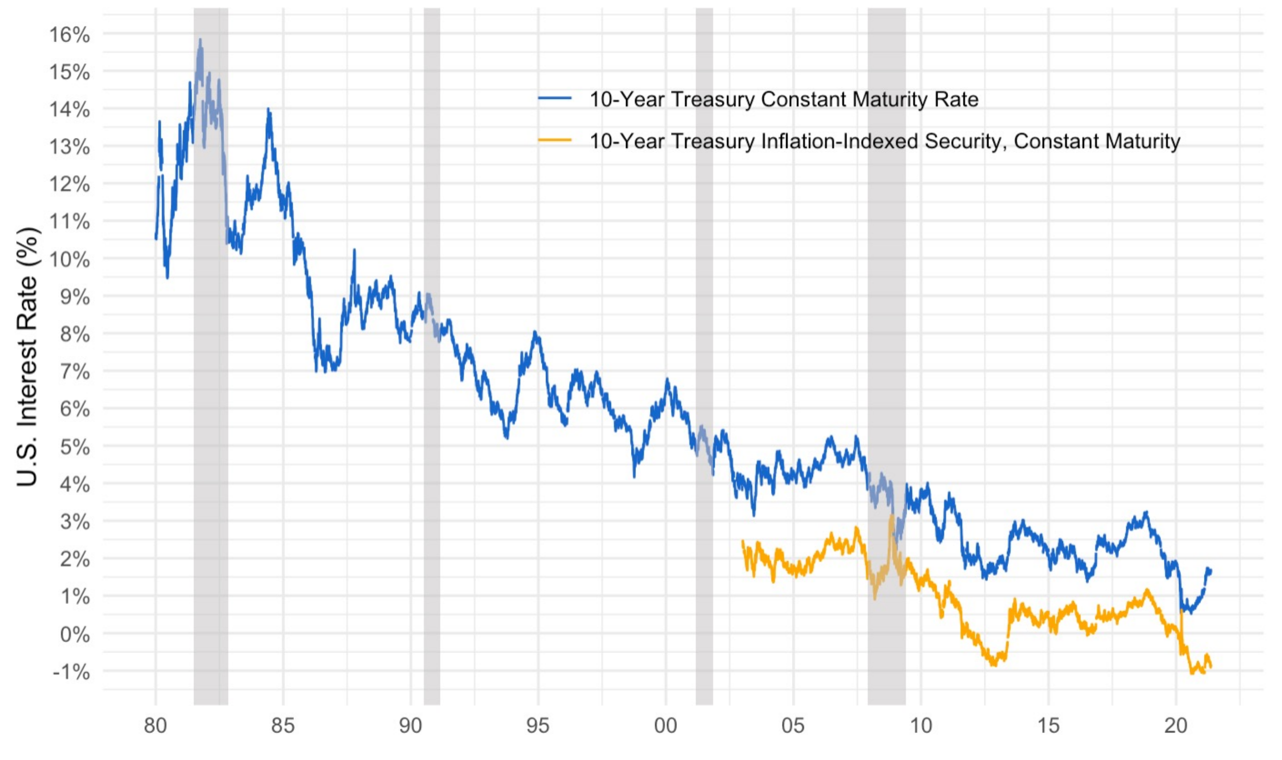


UCLA

10-Year Treasury Rates since 1920

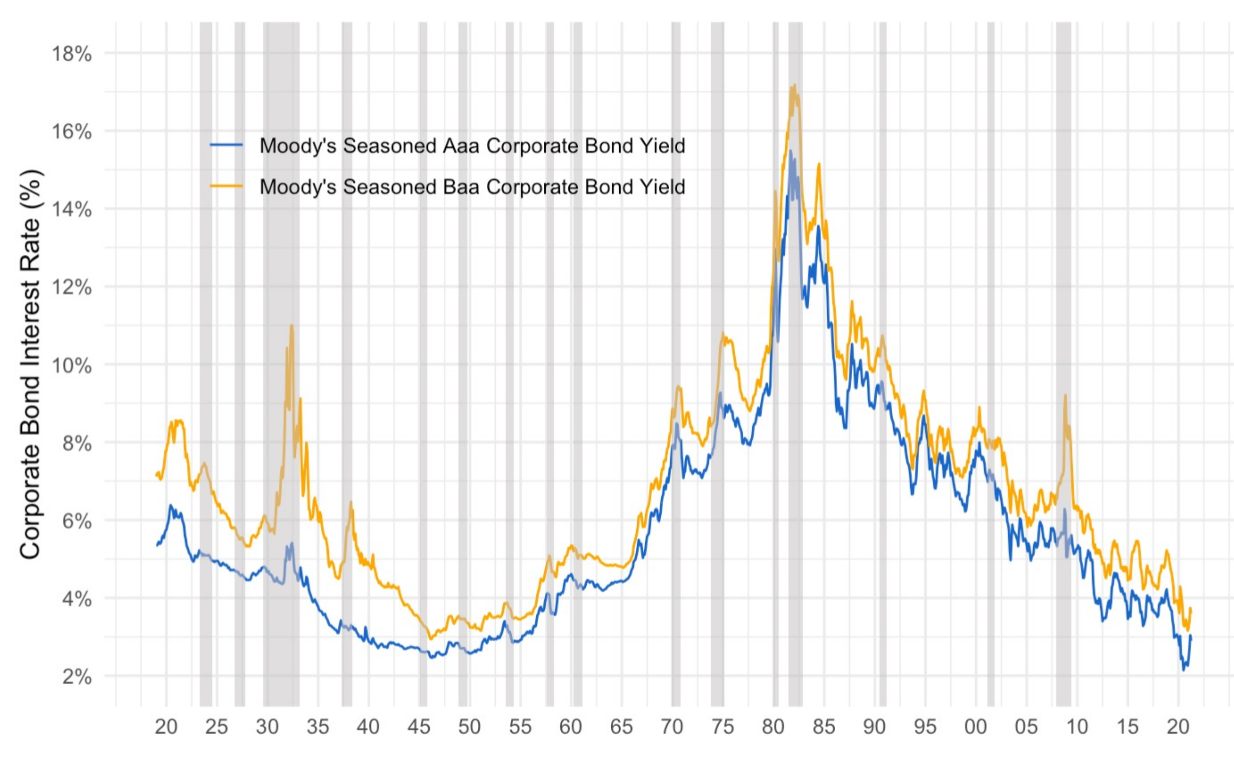


Nominal VS real (inflation-indexed) yields



UCLA

Corporate Bonds



UCLA

Fall in real rates: what are the key drivers ?

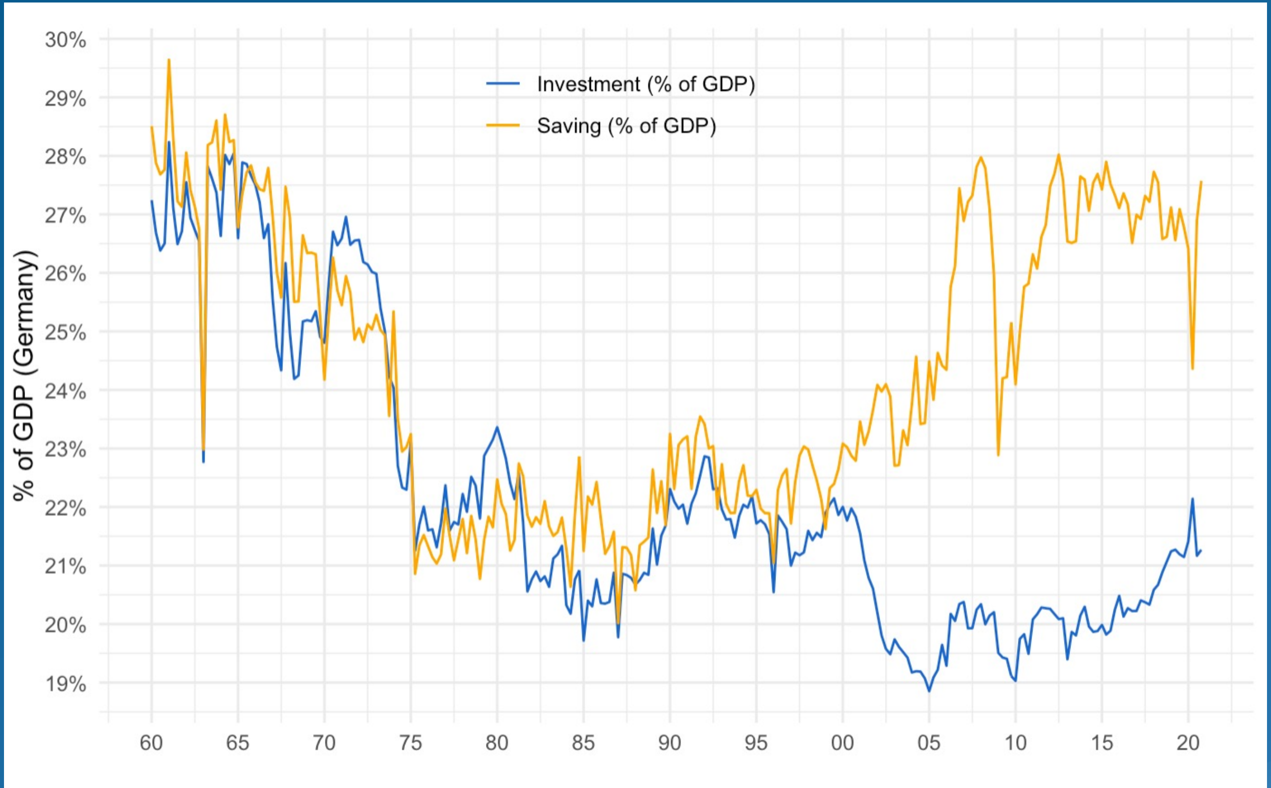
- Real interest rates = market-clearing prices => Excess of savings supply over investment demand: “savings glut” or “secular stagnation”.

- ↗ in savings **supply**:
  - Demographic changes & **pension reforms** taken in response.
  - ↗ Income Inequality.
  - Fiscal: ↗ Consumption taxes, ↘ profit / capital taxes.
  - ↗ Mercantilist trade tactics (China, Germany (?)).
  - ↗ Precautionary saving after East Asia financial crisis.

- ↘ in investment **demand**:
  - ↘ population growth (Hansen).
  - ↘ capital intensity of new technologies (GAFA vs. manufacturing).

UCLA

Germany. Too fast S-I. Riester + Fiscal Reforms.



UCLA

Fall in inflation: what are the drivers ?

- Do we know what determines world inflation ?
- **Key factors** : globalization (e.g. toys), entering of China in WTO with high productivity growth, etc.
- **Phillips curve** reasoning:
  - Savings glut, low aggregate demand ⇒ low inflation.
  - Massive Biden stimulus ⇒ opposite direction => overheating ?
- But, reasons to be skeptical of the Phillips curve:
  - 2007-09: no deflation (not even disinflation) despite world recession, driven by deleveraging (fall in demand). Remains a puzzle.
  - Historically Phillips curves have been observed under **fixed** exchange rates, **not floating** rates ⇒ real exchange rates, not inflation ?
- At least we should be cautious ⇒ Do we know what determines world inflation ? Most probably not slack.

Hard to see a Phillips curve under floating ? (grey)

Consistent with Phillips = **FIXED**

In **contradiction** with Phillips = **FLOATING**

High Inflation

Low Inflation

Low Unemploy.

High Unemploy.

Overheating: low unemployment, high inflation

- 1960-69: Vietnam War, Kennedy
- 1990-95: post pegging to $ boom
- 2000-07: post €-entry boom
- 2000-07: post €-entry boom
- 2000-07: post €-entry boom
- 2005-07: post €-entry boom
- 2005-08: real estate & banking boom

Stagflation = high unemployment, high inflation

- 1971-79: end of Bretton Woods
- 2001-08: not pegging to $ anymore
- 2008-10: post-currency crisis

Missing deflation : high unemployment, inflation

- 1933-37: $ devaluation in 33
- 1990-93: bubble burst
- 2007-09: financial crisis
- 2007-09: financial crisis
- 2011-13: European austerity, debt crisis

Missing inflation: low unemployment, low inflation

- 1986-90: real estate bubble, after Plaza
- 1997-01: Internet bubble, irrational exuberance
- 1997-02
- 2000-05
- 2010-19: commodities boom
- 2017-20: Trump stimulus

Deflation & growth: low unemployment, deflation

- 2011-16: post Swiss Franc appreciation

Deflationary Environment: high unemploy. & deflation

- 1929-33: Hoover deflation
- 1930-33: Brüning deflation
- 1931-33: Laval deflation
- 1997-02: after the 1997 Asian financial crisis
- 1997-00: Crisis, pegged to $
- 2010-15: austerity (debt crisis)
- 2014-16: European austerity
- 2014-16: European austerity
- 2014-16: European austerity

Source: Geerolf (2020)

Key debates: what's next ?

- Real rates = what is the relative importance of **fundamentals** - excess savings VS investment imbalances - vs. monetary **policy**?
- Note: monetary policy is trying to respond to low aggregate demand / low inflation, so the two are not independent.
- When has secular stagnation / savings glut started ? 1970s (Petrodollars) ? 1990s ? (banking crises) 2010s ? (negative rates)
- Low interest rates lead to "too much" risk taking, **bubbles** (like cryptos), chasing for yield in particular ?
  - How much is due to monetary policy itself ?
  - How much is the result of too much money chasing too few assets ? (secular stagnation)
- Will the Joe Biden's fiscal policy change this ? Will U.S. public debt "soak up" savings ? What about Europe ? (e.g. Germany ?)

Key debates

OPINION | REVIEW & OUTLOOK

Japan's VAT Blunder

A consumption-tax increase hits growth as the coronavirus looms.

By The Editorial Board

Feb. 17, 2020 11:23 am ET

PRINT TEXT

BEN BERNANKE

Germany's trade surplus is a problem

Ben S. Bernanke · Friday, April 3, 2015

Opinion **Sovereign bonds**

The rush for Argentina's 100-year bond points to an investment bubble

Demand for debt intensifies as QE policies inject liquidity into the markets

GILLIAN TETT + Add to myFT

German move to raise VAT found puzzling

By **Mark Landler**

Nov. 15, 2005

UCLA

Thank You