



MWC

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## The Boy Who Cried Wolf: Is An Inflationary Decade Ahead?

“...though the Villagers heard the cry, they did not run to help him as they had before. ‘He cannot fool us again,’ they said. The Wolf killed a great many of the Boy’s sheep and then slipped away into the forest.”

Æsop

As the story goes, a boy guarding over sheep jokingly cries wolf, twice. After returning to the village twice, the locals decide not to respond when the boy cries again. Little did the villagers know that this time the wolf *was* attacking the sheep.

Similarly, the global paradigm of recent decades with its repeated warnings of inflation has consistently reinforced disinflation. Now, as trust in public institutions continues to erode, populist policies could serve as the bedrock of a new inflationary paradigm. **We suspect the monetary developments of 2020, coupled with the recent paradigm shift, could push inflation rates significantly higher. Policymakers and investors at large are reluctant to acknowledge this possibility. Decades of the deflationary paradigm have rendered them wholly skeptical of a potential wolf attack: spiking inflation.**

As perennial worriers, we worry about the next ‘problem’ we may face. During the spirit of the recent festive season, Auld Lang Syne came to mind: “Should auld acquaintance be forgot and ever brought to mind”? Could the old acquaintance be inflation, arising from the ashes of the Covid crisis?

In contrast to previous commentaries, this time we present a more technical paper on a subject that keeps us awake at nights...

### Will inflation make a comeback?

#### Key Concerns

- Recent developments – politicians’ growing control over credit creation, average inflation targeting policy, and the historic expansion of the broad monetary aggregate – suggest the 2020s could become an inflationary era.
- The vaccine breakthrough could bring back pre-Covid-19 spending habits. Such a return could increase monetary velocity and drive up inflation.

Although low inflation may likely to be the story over the next couple of years, the huge amount of policy stimulus could push up inflation further ahead. Central banks, in theory, have the tools to nip any rise in the bud. So the bigger risk would be if there is an institutional slide towards accepting, or even welcoming, higher inflation.

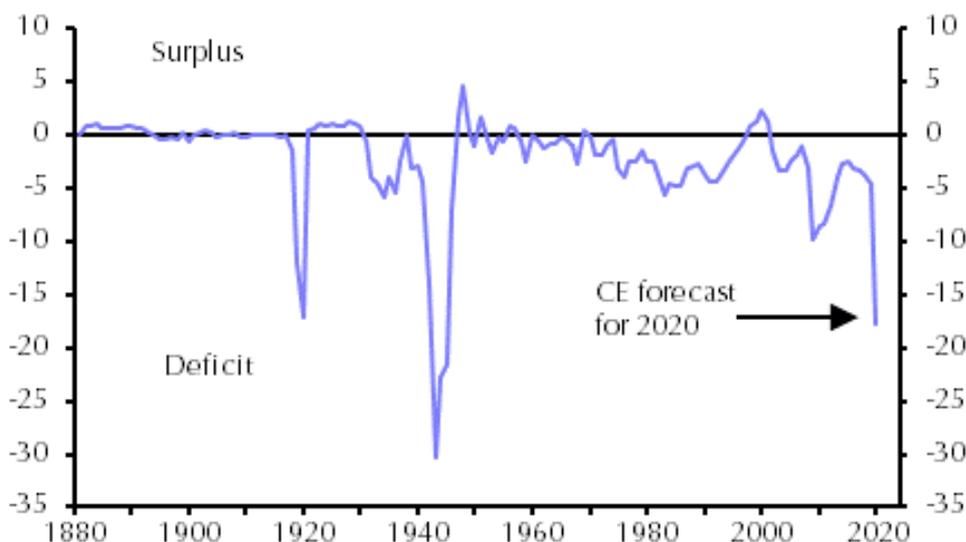
- Crucially, the big fiscal giveaways mean that this money is ending up in the hands of those most likely to spend it (i.e. firms and households). This is very different to the quantitative easing seen after the financial crisis, when fiscal policy was more restrained and the money ended up stuck in the financial sector. Still, the links between money growth, demand and inflation are not automatic. Uncertainty about the virus means that firms and households may want to hold higher precautionary cash balances for some time. Even if they do spend the money, there is likely to be spare capacity for a while to prevent inflation rising. But once these factors fade, then the extra demand could fuel inflation. The extent of this would depend on factors such as the strength of workers' bargaining power and the stability of inflation expectations.
- Assuming that the current policy stimulus is a one-off, then the rise in inflation should be temporary too. Moreover, central banks have the tools to nip any rise in inflation in the bud by reversing the rise in the money supply (i.e. quantitative tightening) and raising interest rates. However, there are two risks. The first is that central banks simply get it wrong; they try to stop inflation but act too late. Indeed, the last period of high inflation in major developed economies, the "Great Inflation" of the late 1960s and 1970s, was accidental rather than a deliberate strategy. The second is that there is an institutional slide towards accepting, or even encouraging, higher inflation. Some governments might keep running substantial (inflationary) deficits even after the crisis; some might seek to inflate away their debt; and some might put pressure on central banks to keep interest rates and the costs of servicing their debt low. Of course, monetary policy was devolved to independent, inflation-targeting central banks precisely to prevent governments allowing inflation to rise for their own benefit. But the current inflation-targeting regimes are not set in stone; the current shift towards "average inflation targeting" (enabling an overshoot of the inflation target) could prove to be the thin end of the wedge and the melding of monetary and fiscal policy may blur the boundaries of where one starts and the other ends.
- Inflation risks are particularly high in countries where central banks are vulnerable to political pressure and where government debt burdens look unsustainable (in both cases, mainly emerging markets). Among developed countries, inflation risks are highest in the US and perhaps the UK, as we can imagine both running permanently bigger fiscal deficits after the crisis. Risks are lower in Japan, given low inflation expectations are so entrenched, and the euro-zone, given its institutional structures. Indeed, it is possible that later this decade, there could be a period of divergence in inflation rates in the major developed economies not seen since the early 1980s and early 1990s.
- The huge amount of stimulus that policymakers have provided has certainly been the right thing to do. But it has also led to fears that a sharp rise in inflation is around the corner once economies recover. In this commentary, we try to put the stimulus into perspective and discuss policymakers' role in determining whether this becomes a serious inflationary

threat. We concentrate on the major developed markets, where the amount of money injected into the economy has been most striking. After almost three decades of low inflation, could we about to enter a new era of high inflation?

### A huge, two-pronged stimulus

There are two key facts about the recent stimulus that mean it has big inflationary potential. The first is that it has combined a big fiscal stimulus and big central bank asset purchases. We shall see later why this is so important. And the second is the sheer scale of both. The rises in fiscal deficits have generally dwarfed the size of those seen after the global financial crisis. The US, for example, is expected in 2020 run its biggest ever peacetime deficit.

Chart 1: US Government Balance (% of GDP)

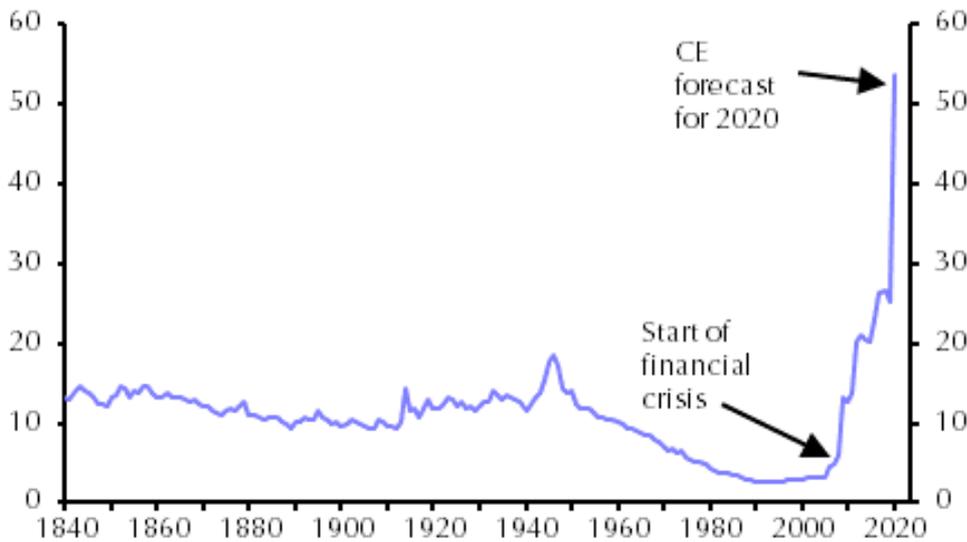


Sources: Maddison, Capital Economics

Similarly, central bank asset purchases have generally been on a scale not seen before. Chart 2 shows that the monetary base, or M0\*, as a share of GDP in the UK has far surpassed the level seen after the financial crisis, which was already the highest since data began in 1840.

(\*The narrowest measure of the money supply is the so-called M0, often referred to as the monetary base. This consists of currency in circulation, together with commercial banks' reserves with the central bank.)

Chart 2: UK Monetary Base (As a % of GDP)

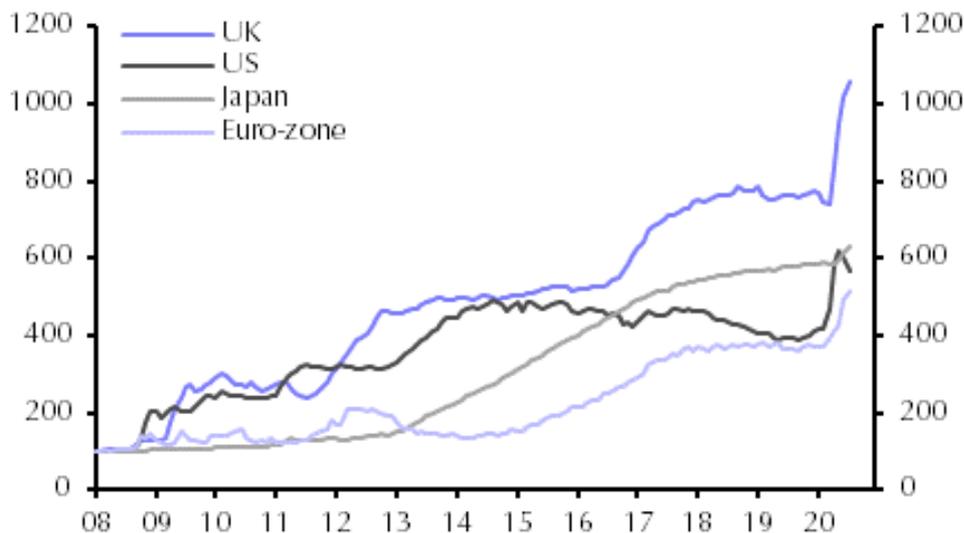


Sources: Bank of England, Capital Economics

Even going back further, it has been rare to see this powerful a stimulus. That is particularly true of past pandemics, which have generally produced little in way of a policy response. This reflects a variety of institutional and structural constraints, including the smaller role of the state and frameworks like the Gold Standard that prevented a significant loosening of monetary and fiscal policy.

It is the (digital) “money printing” by central banks that raises the biggest inflationary eyebrow. Central banks’ actions, whether through quantitative easing (QE) or the various liquidity programmes, have already hugely boosted the monetary base in the US, UK and euro-zone. Japan has seen a relatively small rise. (Chart 3)

Chart 3: Monetary Base (Jan. 2008 = 100) (Latest = July)



Source: Refinitiv

## Money ending up in the right place

We stress at the outset that what rings potential inflationary alarm bells is the fact that this money-printing has been combined with a big fiscal stimulus. We explain below that the current situation effectively amounts to debt monetisation.

### Debt monetisation: are we already there?

On the face of it, it might look like major economies have not yet reached the stage of debt monetisation. Where central banks are buying government bonds, it is on the secondary market, is supposed to be only temporary and the primary aim is not to fund government borrowing. But in terms of their macro-economic effects, debt monetisation and the current situation basically amount to the same thing. Accordingly, debt monetisation is not a magic tool which policymakers have yet to deploy and can whip out as a last resort. There is no formal, universally agreed definition of debt monetisation. But it is generally considered to have two defining characteristics that make it distinct from central banks' purchases of government bonds through asset purchase programmes like quantitative easing (QE).

- The first is that it involves the central bank funding the government directly, rather than just buying its debt in the secondary market. This can occur by the central bank buying new bonds straight from the government either directly or in auctions (the primary market); or by doing away with government bonds altogether and the central bank simply handing money to the government. So far in this crisis, plenty of central banks have bought government debt in the secondary market via their asset purchase programmes. But only a few have funded their government directly. This includes the Indonesian central bank (which is buying government debt at auction) and the Philippines central bank (which has bought debt directly from the government under a three month repo agreement). Note that although the Bank of England extended a direct loan to the UK Treasury under the Ways and Means facility, this was essentially just a bridging loan.
- The second supposedly distinguishing feature of debt monetisation is that it is permanent rather than temporary. In other words, the debt held by the central bank never gets sold back to the market/the government never has to repay the money given to it by the central bank. This equates to a form of so-called "helicopter drop", meaning that government debt never rises. On the face of it, no major economies are doing this yet either, given that the government bonds bought in the asset purchase programmes are supposed to be sold back to the markets at some point.

But when it comes to their macro-economic effects, debt monetisation and the current situation in which asset purchase programmes are facilitating fiscal expansions amount to pretty much the same thing. Regardless of whether the central bank is operating in the secondary market or not, the result is the same. Government debt held by the private sector is lower than it would be

otherwise and bond yields are lower than they would be otherwise. As for the permanence point, this may just be illusory. **The “permanent” rise in the money supply could be reversed in the future (not least as central banks seek to quell the resulting inflation pressures), just as the current “temporary” asset purchase programmes may never get reversed at all and turn out to have been debt monetisation after all.**

Admittedly, there is still a difference in the central bank’s motives in these two scenarios. When the central bank buys bonds in the secondary market, it generally does so to meet its own objectives such as maintaining the functioning of financial markets or meeting its inflation target. In contrast, direct financing is likely to be done with the sole intent of funding government spending. The latter would therefore appear to be a more dangerous blurring of the line between central banks and governments, setting the precedent for governments to ask central banks for money whenever they need it.

However, even under recent asset purchase programmes, this line has already blurred significantly. For example, some central banks (including the US Fed) have abandoned quantitative constraints on the amount of their asset purchases, while the explicit targets for government bond yields used by the Bank of Japan and the Bank of Australia have increased the overlap between monetary and fiscal policy even further. Accordingly, debt monetisation and the current set-up are basically the same. This has two key implications. First, debt monetisation does not have to be a dirty word. The reason it has negative connotations is that it has often caused big problems in the past, with government spending getting out of control and a descent into inflation and hyperinflation (e.g. Weimar Germany, Zimbabwe). But this is generally because of the institutional breakdown that accompanied it. Such institutional failure does not have to happen now so long as central banks retain their independence and arrangements remain transparent. As Willem Buiter, a former UK MPC member has put it, “independence doesn’t mean having to say no to a request for direct monetisation. It means you can say yes or no.”

So in countries where central bank credibility is not an issue and inflation is not a big risk, a case can easily be made for the direct financing of governments where the debt market might not be able to digest the volume of debt needed in the short-term. This is especially the case for countries without QE programmes and those Emerging Markets which don’t have deep and liquid capital markets. Indeed, we may well see more direct central bank purchases of government debt. Former RBI chief Raghuram Rajan has argued for direct monetary financing in India – indeed, the practice was common there until 1997. Reserve Bank of New Zealand Governor Orr has said that he is open-minded on the issue of the direct monetisation of government debt. And the Chinese government wants to issue special treasury bonds (which are used for funding specific projects), which it apparently wants the PBOC to take directly onto its balance sheet.

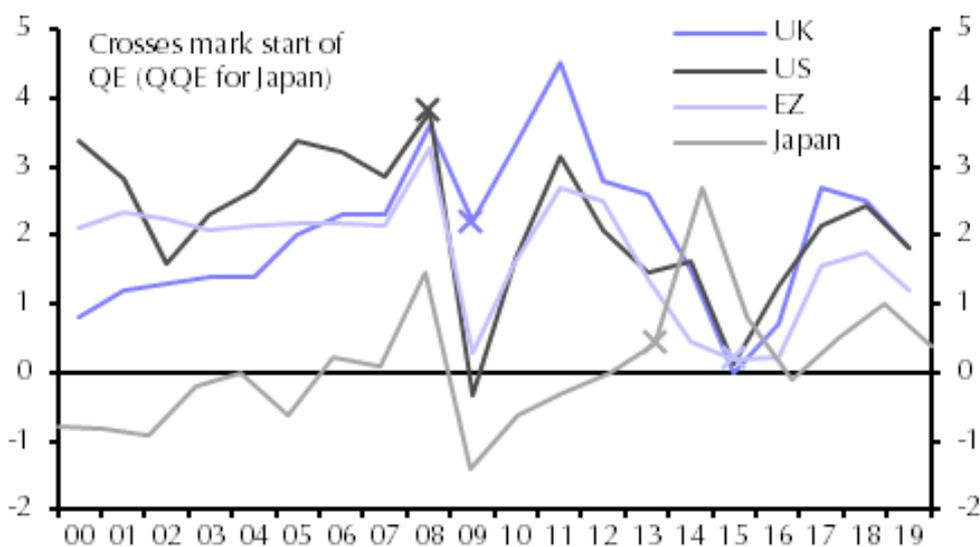
The other, less reassuring, implication of all this is that debt monetisation and helicopter drops are not magic tools which can be whipped out of the toolbox when all else has failed. To all intents and purposes, they would look the same and have the same results as the policies we are seeing now. In other words, central banks would “print” money electronically and governments

could spend more freely because they would not have to issue as much debt to the market as otherwise. It might be argued that a helicopter drop might make governments more willing to spend if their debt was not rising, while households would be more likely to spend their giveaway if they did not have to fear taxes rising to pay for it further ahead. However, governments hardly seem to be letting high debt levels hold them back from providing assistance to their economies at the moment. Moreover, policymakers would still have to deal with any rise in inflation further ahead resulting from the permanent rise in the money supply, in the same way that policymakers will have to deal with any rise in inflation eventually resulting from current policies. This could be done – for example, by imposing controls on lending or raising interest rates – the so-called ‘yield curve control’, but such measures would impose costs on the economy and the financial system, and policymakers might not have the willpower to do it. Moreover, it might involve measures that would equate to the reversal of the initial helicopter drop, underlining the point earlier that the appearance of a permanent write-off of government debt could end up being illusory anyway.

Crucially, this means not only that the money supply is rising sharply, but that this rise in money will end up in the hands of those most likely to spend it. The financial institutions that have bought bonds from the government and sold bonds to the central bank have essentially just acted as a go-between. So the money printed by the central bank has ultimately gone to the households and firms who have been recipients of the fiscal giveaways. Indeed, the magnitudes of the money printing and the fiscal stimulus have generally been very similar so far.

This is a key way in which this episode differs from the QE after the global financial crisis. Many people point to that episode as proof that large amounts of QE don’t fuel activity or inflation. The monetary base expanded sharply on the back of large QE programmes by central banks, yet inflation showed no noticeable pick-up. (Chart 4) Indeed, despite having the sharpest rise in asset purchases, Japan is still struggling to break away from deflation.

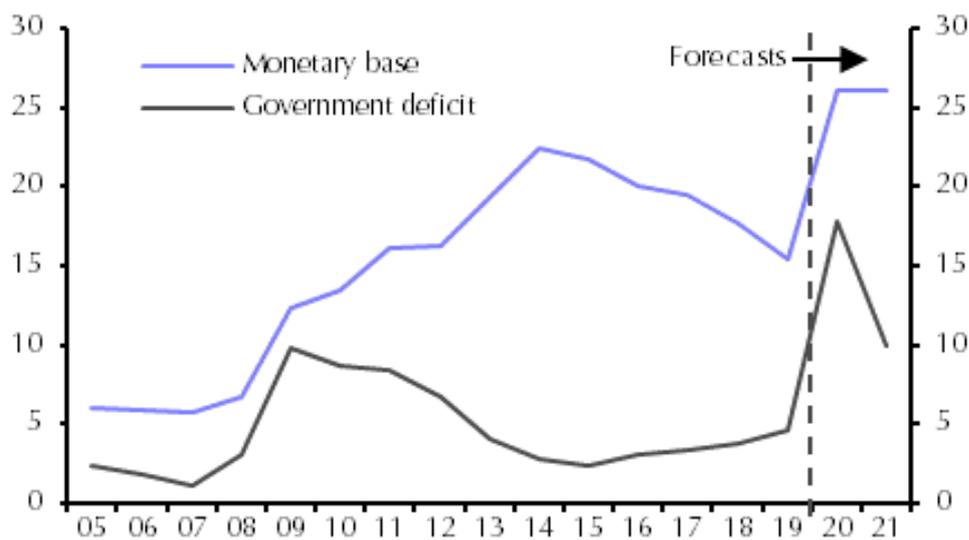
Chart 4: CPI Inflation (%)



Source: Refinitiv

But there is a crucial difference between then and now, namely that fiscal policy back then was not being loosened at the same time as QE. Other than during the first few months, QE was accompanied by falling government borrowing (both in total and cyclically-adjusted terms) in the US, UK and Japan, and broadly stable borrowing in the euro-zone. (See Chart 5 for the US.) So although QE still provided a direct boost to the money supply, this money got lost in the financial sector. Accordingly, the only way in which QE was ever going to boost activity and inflation was via the financial sector – for example, the investors who had sold bonds to the central bank rebalancing their portfolios by buying other assets and pushing asset prices up and borrowing costs down. Even if such channels did work, the effect was mainly to boost asset, rather than consumer, prices.

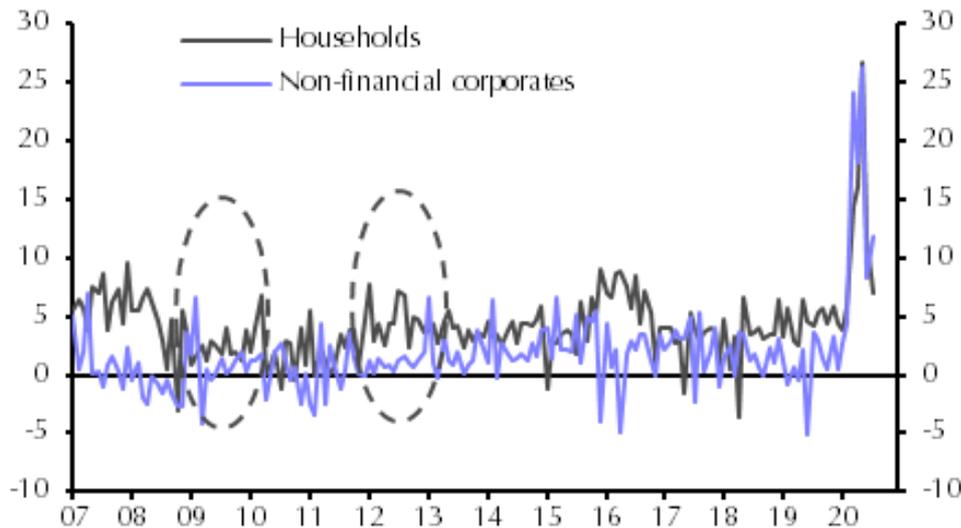
Chart 5: US Monetary Base & Government Deficit (As a % of GDP)



Sources: Refinitiv, Capital Economics

Indeed, we can already see the difference between now and the post-financial crisis episode in what is happening to corporates' and households' deposits. Chart 6 shows how UK Households and non-financial firms saw no discernible change in their money holdings during the main periods of QE in 2009/10 and 2012/13 (shown by the dotted circles). By contrast, their money holdings have risen sharply in the past couple of months. The rise in the money supply that we expect by the end of 2021 is equivalent to around a third of households' and non-financial corporates' combined holdings in the UK and euro-zone, and around a fifth of those in the US.

Chart 6: UK Money Holdings (Monthly Change, £bn)



Source: Refinitiv

## The murky links between money and inflation

So money growth has risen sharply and that extra money has gone to those most likely to spend it. Contrary to what traditional monetarists would have you believe, the link between money growth and inflation is still not automatic. For inflation to result, faster money growth would need to give a big boost to demand for goods and services and this extra demand would then need to fuel inflation. But neither seems likely in the near term.

For a start, uncertainty about the virus means that firms and households may want to hold higher precautionary money balances for some time yet. During the crisis, the velocity of circulation (the ratio of GDP to broad money) has fallen sharply. We doubt that this will suddenly rebound, even as lockdowns ease.

Even if money growth boosts demand, there ought to be spare capacity in the economy for a while that will prevent inflation rising. But at some point, uncertainty surrounding the virus will fade and the economy will return to full employment. Then, the risk of a rise in inflation as firms and households seek to reduce their excess money balances could be rather higher. Whether this risk materialises depends on various factors. One is the size of the excess money balances at this point. People could just sit on their money for long enough for economies to grow sufficiently in the meantime simply to absorb these excess money balances. That said, this would take quite some time to play out.

Another factor to consider is how firms and households seek to reduce their excess money balances. If they spend them on goods and services, then this will boost aggregate demand. But they might instead use them to repay the debt they took on during the crisis and/or repay other debt. This will partly depend on the distribution of the excess money balances. They are most likely to be inflationary if they are concentrated in households, especially households with a higher propensity to consume.

And finally, there is no exact relationship between aggregate demand and inflation. In open economies, some of the resulting rise in aggregate demand would just result in more imports being sucked in. Inflation might also be less likely to pick up in countries where the so-called Phillips Curve (the relationship between activity and inflation) is weak, perhaps due to the stability of inflation expectations or weak bargaining power of labour. There might also be some offsetting downward pressure on inflation from other factors. For example, we have argued elsewhere that the coronavirus crisis could be the trigger for a rise in investment in the digital economy that boosts productivity growth and therefore puts downward pressure on unit labour costs and inflation. However, the counterpoint to that is the de-globalisation of supply chains which inherently should be inflationary.

Accordingly, there is no straightforward way to predict what inflation might do further ahead. But to give a ball-park upper estimate, suppose that, come 2023, economies are broadly back to “normal”, any output gaps have been eliminated and firms and households spend all of their excess money holdings. It is estimated these would be equivalent to between 10% and 15% of GDP at this point. The resulting boost to aggregate demand in the major developed economies would have the potential to boost inflation by around 2 to 3 percentage points per annum for around five years. (Using the quantity theory of money of  $MV=PT$  i.e. money supply  $\times$  velocity of circulation = price level  $\times$  transactions or output.) So an economy that usually experiences inflation of about 2% would instead see inflation of 4% or 5% for a few years.

This would hardly be disastrous relative to the double-digit rates of inflation that were seen in many economies in the 1970s and 1980s. And if we assume that the current policy stimulus is a one-off, then the rise in inflation should be temporary too.

However, there are three ways in which this could all morph into a more sustained rise in inflation. The first is if the initial rise boosted inflation expectations and kicked off a wage-price spiral. The second is if bank lending does take off on the back of the sharp rise in commercial banks’ reserves. And the third is if the policy stimulus does not prove to be a one-off after all. Take the UK, for example, where we expect virtually of the government’s debt issuance to be hoovered up by the central bank over this year and next, and the broad money supply to be around 25% higher at the end of 2021 than at the end of 2019. Thereafter, imagine that the government ran an annual deficit of, say, 10% of GDP and that the Bank of England kept funding it all by money printing. In that case, the broad money supply by 2025 would be 50% higher than its end-2019 level, and by 2030, about twice as high. That would be on a par with the expansion in the money supply seen between 1974 and 1980.

### **Inflation could be stopped... in theory**

Policymakers, in theory, have the tools to nip any rise in inflation in the bud. For a start, central banks could reverse the rise in the money supply – or measures to that effect. Most obviously, they could reverse the asset purchases by buying the assets back i.e. switching

from quantitative easing to quantitative tightening. This would extinguish the rise in commercial banks' reserves and the rise in broad money that accompanied it.

If they were worried about the upward impact this would have on government bond yields, central banks could shrink the monetary base by other means or simply 'manage' the yield curve itself.

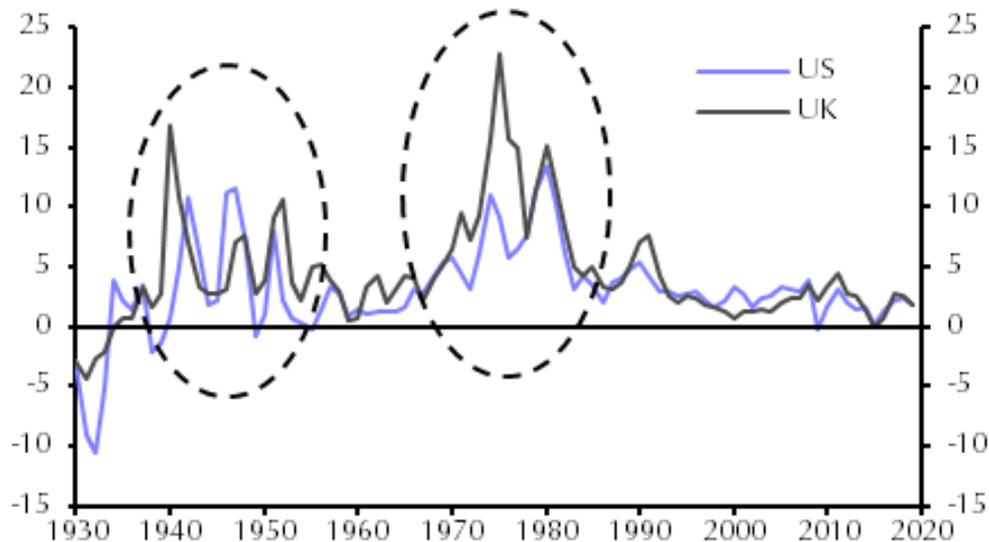
As we stressed earlier, there have been two components to this stimulus – the money printing by central banks, and the fiscal stimulus by governments which has redistributed money from financial institutions to firms and households. The measures discussed so far deal with the first element. As for the second, governments could raise taxes and/or cut spending to make people "pay the money back". In turn, government bond issuance would fall and money would get "redistributed" back to investors. But it seems highly unlikely that most governments would do this, especially given that low interest rates will enable most governments to carry their higher levels of debt quite easily. So to offset the inflationary effects of the permanent fiscal stimulus, central banks would need to raise interest rates too. Raising interest rates, however, would become the 'Hard place' facing central banks with the 'Rock' of the massive amounts of government debt and the serviceability of (or ability to pay the interest on) that debt behind them.

### **An institutional slide towards higher inflation?**

But just because a rise in inflation could be stopped does not mean that it would be stopped. There are two main risks.

The first is that central banks might simply get it wrong. They could want to stop the rise in inflation but act too late. Such a policy error would occur if policymakers were taken by surprise by the speed at which inflationary pressures built up and failed to deploy their tools quickly enough. Indeed, it is worth noting that the major inflationary periods in recent history – namely the period of high inflation after the Second World War and the "Great Inflation" of the 1970s – were not deliberate. (These episodes are shown in Chart 7 for the US and UK.) The episode of high inflation after the Second World War primarily reflected the lifting of wartime price controls. As for the 1970s, there are various theories about why policymakers allowed inflation to get so high, but they all essentially relate to policy mistakes – including mistakenly still believing in a trade-off between unemployment and inflation; failing to realise that trend GDP growth had fallen and therefore mis-estimating the output gap; and thinking that inflation triggered by non-monetary factors, such as higher oil prices, could not be brought down by monetary policy.

Chart 7: US &amp; UK CPI Inflation (%)



Sources: Bank of England, Maddison

Another way in which high inflation might become entrenched is if there were an institutional slide towards accepting, or even encouraging, high inflation. It is easy to see why governments, in the current circumstances, might want to go down this route. For some, higher inflation might seem like an easy way to reverse their rise in public sector debt. Admittedly, many countries will be able to tolerate their higher debt levels, especially if they can use financial repression (measures to artificially lower bond yields – Eurozone, Switzerland) to help them do so. However high inflation might not actually reduce debt burdens by that much, and that even if it did, the benefits might be outweighed by the other costs that high inflation brings. There are three key reasons why high inflation would not be as helpful in reducing debt burdens as is often assumed:

- First, **a rise in inflation would push up new borrowing costs**, making it more expensive to finance deficits and refinance maturing debt. There would still be an initial drop in the debt ratio, given that most government debt does not mature straightaway. However, the average maturity of government debt is not that long, plus we expect most countries to be running a budget deficit over the next couple of years. **The bond market reaction would therefore be crucial.** In a favourable scenario, markets might take a while to react (as historically they have done) and would also believe that the rise in inflation was only temporary. But given the difficulties of raising inflation by a fixed amount for a set length of time, there is a risk that markets would instead doubt that inflation would be brought under control again. **Indeed, if bond yields rose by more than inflation, inflation could even end up raising a government's debt burden eventually.** Governments could seek to sidestep these issues with the bond market, either by monetising the debt and/or by financial repression (i.e. forcing the private sector to buy debt at below market prices). But these strategies would also have severe drawbacks and could risk letting inflation get completely out of control.
- **The second key problem is that high inflation may harm real economic growth.** Not only would this be undesirable in and of itself, but it would also lessen the drop in the debt to GDP ratio. The *process* of raising inflation could also cause problems. Indeed, one of the key problems in all this is that raising inflation is hard and imprecise. With aggressive

enough policies, it *could* be done. But trying to raise inflation through large amounts of QE, for example, would risk inflating another asset price bubble which, when it burst, could prompt another financial and economic crisis.

- **The third problem relates to bringing inflation back down again, which would probably require a sharp slowdown in the real economy.** Of course, governments could simply choose to live with high inflation once the debt burden had been reduced, but this would also inflict significant long-term damage on the economy, by reducing investment and distorting price signals.

For all these reasons, when inflation has been used to reduce debt in the past, it has usually happened because a government has resorted to this out of desperation and weakness, rather than because it has judged that it is in the best interests of the economy in the long term. Fortunately, most countries can just tolerate their high levels of debt – meaning that they can, and probably will, avoid going down the inflation route. Even countries where debt is not on a sustainable path might not try to inflate away their debt either. For some, including the individual euro-zone countries, higher inflation might not be an option, while for others, including Brazil and Mexico, the alternatives of austerity combined with financial repression might be preferred. But if this does not work, then some of these countries may resort to inflation further ahead. So, too, might Italy if it were ever to leave the euro-zone.

For other governments, high inflation might seem like a price worth paying to keep running deficits even after the crisis is over. Some might succumb to pressure to keep support programmes running indefinitely. Some will be under pressure to raise spending on health services. And some may simply see the “magic money tree” (allusion to MMT – Modern Monetary Theory – that stipulates that interest rates be set to zero allowing governments to borrow indefinitely) that paid for the coronavirus crisis as a route to finance all sorts of other objectives. Some governments might also put pressure on central banks to keep interest rates low (regardless of the impact on inflation) to ensure that the costs of servicing their already high level of debt stay low.

Of course, the reason that so many central banks were made independent in recent years was precisely to prevent such scenarios. Indeed, we have covered above why the effective financing of government spending by central banks does not need to get out of control or have inflationary consequences, so long as an adequate institutional framework is in place. This would allow a central bank to stop monetising government debt when it wanted. On the face of it, then, the chances of a shift to a high-inflationary era would seem to be far less than in the past when governments exerted much greater control over monetary policy. But it may be that central banks also take a deliberately more lax approach to inflation. Their existing inflation-targeting frameworks are not set in stone and have become increasingly flexible since they were introduced. The latest shift, being led by the US Fed, is towards “average inflation targeting”, the idea being that central banks should aim to achieve their objective on average over a period of time, such as a whole economic cycle. This paves the way for a period of overshoots of inflation targets after the current undershoots. That could turn out to be the thin end of the wedge. After

all, the current inflation-targeting regime has clear shortcomings. We could eventually see a more fundamental shake-up of inflation-targeting – framed by governments and central banks as improving the conduct of monetary policy, but with the result nonetheless being higher inflation. This might include a rise in the inflation target itself (which many argue would help to get around the problem of official nominal interest rates running up against the zero lower bound). Alternatively, some sort of change in the monetary policy regime that would allow central banks to operate with a wider inflation target in order both to acknowledge the difficulty of targeting precise inflation rates and to put more weight on other factors (like financial stability).

It may be hard to imagine a shift to a high inflation era now, when inflation has been low for so long. But when there have been major shifts in the inflationary environment before, whether from low to high inflation or vice versa, expectations were generally slow to adjust, precisely because people and financial markets were too influenced by what had happened recently (recency bias).

### **Where are the risks greatest?**

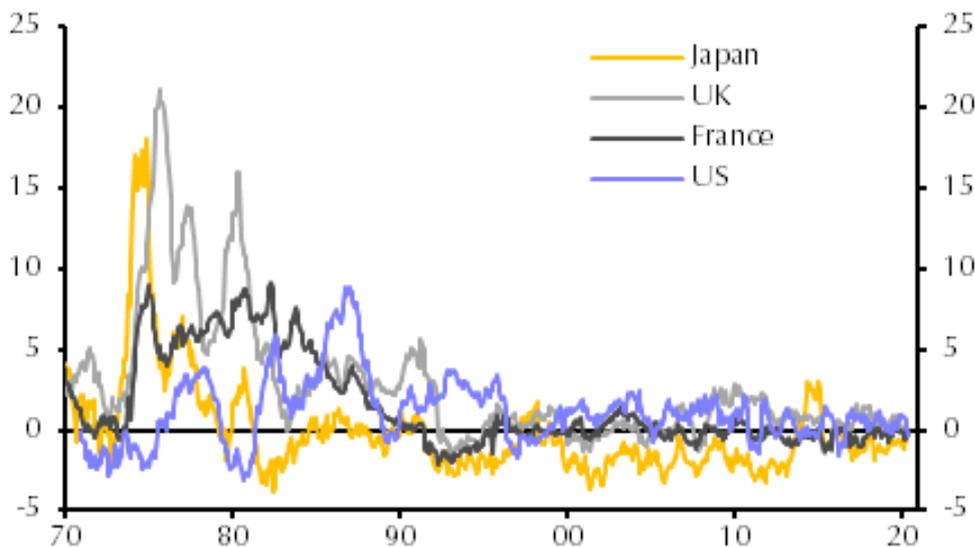
The risks of inflation are arguably biggest in those countries where governments have the greatest incentive to allow, or encourage, inflation. This includes those whose public sector debt after the crisis will be on an unsustainable path and who view higher inflation as preferable to the other options of austerity or default. For now, this group includes hardly any countries, but it could grow if countries struggle to reduce their debt burden by other means (to include, for example, Brazil and South Africa). It also includes governments that are most likely to continue running deficits even after the crisis, which we think includes the US and UK.

Inflation risks are also highest in countries where central banks are most likely to allow higher inflation. This includes those countries where central banks have limited independence and they are vulnerable to political pressure. These are most likely to be emerging markets. India is a good recent example; political pressure from the government culminated in 2018 in the resignation of the Governor of the RBI and the appointment of a government ally. But it also includes countries where monetary policy frameworks might be adapted to permit higher inflation – with the US again potentially fitting the bill.

Inflation risks are lower in Japan and the euro-zone. Both seem likely to try to bring fiscal deficits down after the crisis – Japan because of its already very high level of public sector debt and the euro-zone because of the monetary union’s fiscal rules. Admittedly, these fiscal rules have been suspended in the euro-zone for this year and will not be re-imposed next year; but we doubt that they will be abandoned indefinitely given the need for fiscal discipline in the single currency area and the strong preference in Germany and other northern economies for prudent fiscal policy. Meanwhile the constraints of monetary union will bear down on inflation in the euro-zone; if an individual country like Italy, for example, wanted to inflate away its debt, it has no independent control over its monetary policy to do so. Moreover, the ECB has a history of tightening policy too early rather than too late.

Accordingly, we could end up with a divergence in inflation rates among the major developed economies. Such a divergence is not unprecedented. But the last time a major one was seen was in the early 1980s. Chart 8, shows the difference between inflation rates in the major developed economies with inflation in Germany:

Chart 8: CPI Inflation (% point difference with Germany)



Source: Refinitiv

## Conclusions

Any inflationary threat may still be years away. Low inflation is still likely to be seen in the near-term. Further ahead, though, the picture could be very different. This depends both on the impact of the large amount of money that has been pumped into economies and how policymakers' attitudes towards inflation evolve post-coronavirus.

We think that there are broadly three possible scenarios. The first is that the huge policy stimulus does nothing to inflation, just as the QE after the financial crisis did nothing. Eventually economies just grow into their higher money balances. This may be the case for Japan, where the rise in the money supply has been relatively small and the structural forces bearing down on inflation are very strong. For some other major developed economies, though, the inflationary potential of the recent stimulus seems higher.

Supposing that an inflationary threat did emerge, then there are two possible outcomes. The first is that policymakers manage to head it off by tightening policy. Interest rates would therefore probably rise faster in the second half of this decade than financial markets think. Even with financial repression, government bond yields (and yields on other assets) would rise more quickly than most assume. The other scenario is that policymakers allow inflation to rise, whether

accidentally or deliberately. In that case, we would be on the brink of a transition to a new – and largely unanticipated – inflationary era.

Different countries may end up going in different directions. Whereas a sustained shift to permanently higher deficits seems unlikely within the constraints of the euro-zone, it would be much easier for this to happen in the US and UK. In fact, the US was running significant fiscal deficits even before the coronavirus hit. If we do see the low-inflation era in developed economies draw to a close, it seems most likely to happen first in the US, and perhaps the UK.

*We leave you with a few other quotes that we came across while researching this paper.*

*Having a little inflation is like being a little pregnant.* **Leon Henderson**

*Blessed are the young for they shall inherit the national debt.* **Herbert Hoover**

*It is a way to take people's wealth from them without having to openly raise taxes. Inflation is the most universal tax of all.* **Thomas Sowell**

*Governments are likely to continue printing money to pay their debts with devalued money. That's the easiest and least controversial way to reduce the debt burdens and without raising taxes.* **Ray Dalio**

*The definition of a central banker is someone who will permit inflation in anything except wages.*  
**Russell Napier**

*It is well enough that people of the nation do not understand our banking and monetary system, for if they did, I believe there would be a revolution before tomorrow morning.* **Henry Ford**

*In the past couple of decades, the 2% inflation target behaved like a ceiling. In the next twenty-years, the 2% inflation target will become a floor.* **Kevin Muir**

*I do not think it is an exaggeration to say history is largely a history of inflation, usually inflations engineered by governments for the gain of governments.* **Friedrich August von Hayek**

*If you impose inflation on stagnation, you get stagflation.* **Alan Greenspan**

*Currencies don't float, they just sink at different rates.* **Clyde Harrison**

*The fact that an opinion has been widely held is no evidence whatsoever that it is not utterly absurd.*  
**Bertrand Russell**

## Economic Data Table December 2020

Stock Markets	Month	Q4 20	YTD	GDP YoY	Interest Rates	Inflation Rate
United States	3.71%	12.61%	16.26%	-2.80%	0.25%	1.20%
Euro Area	1.72%	11.24%	-5.14%	-4.30%	-0.50%	-0.30%
Germany	3.17%	7.36%	0.43%	-4.00%	-0.50%	-0.30%
France	0.60%	15.57%	-7.14%	-3.90%	-0.50%	0.20%
Italy	0.78%	16.92%	-5.42%	-5.00%	-0.50%	-0.20%
Spain	-0.04%	20.21%	-15.45%	-9.00%	-0.50%	-0.50%
Greece	9.78%	29.49%	-11.75%	-11.70%	-0.50%	-2.10%
Switzerland	2.17%	5.07%	0.82%	-1.60%	-0.75%	-0.70%
United Kingdom	3.10%	10.13%	-14.34%	-8.60%	0.10%	0.30%
Brazil	9.30%	25.81%	2.92%	-3.90%	2.00%	4.31%
Russia	5.84%	13.19%	7.98%	-3.40%	4.25%	4.90%
India	8.16%	25.44%	15.75%	-7.50%	4.00%	6.93%
China	5.06%	13.60%	27.21%	4.90%	3.85%	-0.50%
Japan	3.82%	18.37%	16.01%	-5.80%	-0.10%	-0.90%
MSCI World Equity Index	4.53%	14.35%	14.34%			

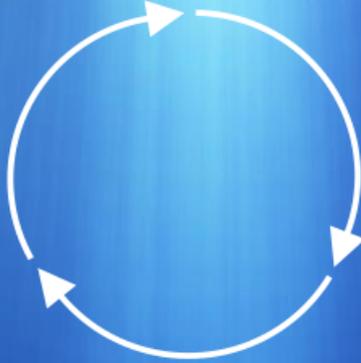
Bond Indices	Monthly	Q4 20	YTD
Barclays Capital U.S. Aggregate Bond Index	-0.34%	-0.03%	5.16%
Barclays Global Aggregate ex-USD Float-Adjusted Index (Hedged)	0.05%	0.62%	3.48%
J.P. Morgan Government Bond Index Emerging Markets Global Core Index (Local Currency)	2.84%	7.88%	-2.18%
Barclays Global Aggregate ex USD 10% Issuer Capped (Hedged) Index	0.46%	0.99%	2.59%

Currencies	Monthly	Q4 20	YTD	Price
EUR/USD	2.40%	4.23%	8.94%	1.22
GBP/USD	2.64%	5.86%	3.11%	1.37
EUR/GBP	-0.26%	-1.53%	5.67%	0.89
USD/CHF	-2.61%	-3.84%	-8.54%	0.89
EUR/CHF	-0.28%	0.21%	-0.37%	1.08
USD/JPY	-1.02%	-2.12%	-4.98%	103.21
GBP/CHF	-0.06%	1.74%	-5.78%	1.21

Commodities	Monthly	Q4 20	YTD	Price
Gold	6.72%	0.59%	24.99%	1896.49
Oil (WTI Crude, NYMEX)	6.58%	20.16%	-20.95%	48.27



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