The price level cycle. A long-term perspective

Luis Reyes*

April 17, 2017

Since the beginning of 2017 several news have circulated supporting the view that this is (finally) the year inflation in developed countries will pick up. However, some sources hold the opposite view. One of the reasons why inflation may end up not taking place is the fact that... inflation is expected.

To explain this to a wide non-specialized audience in simple terms I first use a modified version of the fable the boy who cried wolf as a metaphor. In the second part I describe some of the main issues concerning the price level cycle using the Great Depression, the Great Inflation and the Global Financial Crisis as its most representative phases. Finally I provide some insights that will hopefully shed some light to the discussion about reflation.

The boy who did not cry wolf

One boring night a little boy called Peter, who was caring for the village's sheep, cried "wolf" and all the villagers ran to the top of the hill where Peter and the sheep were. Of course, when they got there they found out that there was no wolf and they were quite upset about this false alarm. The next day, instead of trusting Peter again with the task of caring for the sheep, the villagers decided to take turns caring for the sheep themselves every night.

One night the wolf actually came and took everybody by surprise. Even under the villager's watch, the wolf killed two sheep, hurt three more and scared the rest away. The guard was able to get some of the sheep back. The next day the villagers decided to invest time and resources in finding new ways to keep the wolf away for good.

They came up with a brilliant idea: build wooden cages for the sheep to sleep in, even if these cages were very uncomfortable and depressed the sheep. But the villagers kept fresh in their minds the traumatic experience with the wolf and were not ready to risk having the same problem once again, even if the sheep would suffer the consequences (hey, at least they would no longer get killed). The villagers still took turns caring for the sheep.

After several weeks of seeing no sign of the wolf (or not perceiving its presence, given that the cages were overly secure), the villagers asked Peter to care for the sheep. But in doing so, they were well aware of the fact that he was likely to cry wolf in vain again, but they cared much less than before given that they now felt confident that even if there were a wolf he would not be able to eat or scare away the sheep. Peter himself felt he would not be credible enough if he cried wolf that night, so he didn't and fell asleep instead.

That night the wolf approached the cages, but before getting there he saw Peter sleeping on the grass. The wolf gently woke up Peter and told him "boy, why don't you go home and rest properly? Even if there were nobody caring for the sheep I would not be able to eat them or scare them away".

*Centre d'Économie Paris Nord, Paris 13: luis.reyes.rtz@gmail.com, https://luisreyesortiz.org/

Peter thanked him and went home.

This story shows that the trauma of the wolf chasing the sheep made the villagers build wooden cages. These were so effective that when the wolf actually came he was not even able to cause any damage. In turn, the sheep were not necessarily better-off just because there was no wolf threat, and even the wolf himself turned out to be a reasonable animal. On the contrary, though the cages were safe, they were uncomfortable and the sheep still slept there but for no use. The situation had changed, thanks in part to the cages built.

Let us now see how this story relates to how inflation expectations keep actual inflation from taking off. For doing this, let us take a look back at previous experiences.

The price level cycle in advanced economies

Moderate inflation above 2% (the target set by several central banks) may be a good thing for the economy for several reasons. One of these reasons is that, in current circumstances, it would mean lower unemployment and higher economic growth that some economies desperately need nowadays. This may be the main reason why reflation is expected since the beginning of the year, even when a major economy (the U.S.) is considered by some to approach full employment.

However, while more growth and more employment may be desirable from the point of view of the majority, the recipe for achieving these may not be shared by all. Case in point, financial markets dislike inflation, even if it has the un-ignored potential to boost employment and economic activity that could ultimately mean good news for financial actors themselves (for instance, banks could lend more to firms and individuals so that the latter can invest more and in turn demand more credit). Other individuals not necessarily related to the financial sector may also dislike inflation, but this could be just a matter of misled perception.

To see both the virtues and evils of inflation (the wolf) let us take two extreme examples: the Great Depression of the 1930s and the Great Inflation of the 1970s. Let us first see the glass half full and discuss its virtues.

Back in the 1930s the major concern for policymakers and the general public were the unusually high unemployment rates. One of the major reasons why unemployment was of major concern is because it was an **ongoing phenomenon**. The evolution of the price level was indeed also of concern, not because it was growing too much but rather because it was not growing at all or because it was decreasing.

If anything, higher inflation would have been a blessing back then for borrowers (households, firms and governments), for it would have made their debt loads lighter. It would have also been a good deal for lenders (mainly banks) because, even if they perceived losses due to the currency devaluation, they would still lend more because there would be more credit demand precisely because the currency in which they lend would be cheaper (pretty much how the law of supply and demand works, via prices and volumes).

Let us now see the glass half empty and analyze the evils of inflation, which today are much fresher in the collective memory than its virtues. Forty-one years after the Great Depression the main concern was the then ongoing phenomenon of a quite different nature: the collapse of the Bretton Woods system. The price cycle was such that inflation was now in the upper end.

In 1971 the values of gold and that of the dollar parted ways, and from then on exchange rate regimes are chosen *à la carte*. The dollar devaluation provoked by the end of gold convertibility made oil-exporting countries poorer, so that they raised oil prices as a compensatory measure. Throughout the rest of the decade the main concern was excessive inflation (via accelerating oil prices), which further lowered the value of the currencies of the countries involved.

This in turn brought about important problems for workers (loss of purchasing power), non-financial firms (difficulty to set prices appropriately), governments (hardship in managing the energy crisis) and particularly banks. Since the latter's business is lending money, the devaluation induced by higher-than-expected inflation made their profit-seeking activities much more difficult. While this was happening, they were also lending elsewhere (emerging economies and for real estate purchases, for instance) and looking for different ways to hedge against these heavy losses.

Forty-seven years after the Bretton Woods system collapsed, price stability is back. This means in part that debts (as share of value added) are heavy and there is no growth nor enough employment for all who wish to work, particularly so after the Global Financial Crisis. Deflation and high unemployment *should be* the main concern. Inflation is indeed expected and desired, but not by all. Now that a large part of economic activity is in the non-tradables sector (an important part of which are in finance-related activities) in advanced countries, the few lucky ones who have a job may prefer not to have inflation threaten the industry they work in.

As a consequence of the major inflationary shocks of the seventies and the sectoral shift just described, the policies implemented for the past forty years have gone in the direction of guaranteeing a 2% inflation target, so much that it is now very difficult even to achieve that already low bar.

Inflation (the wolf) is no longer a threat. On the contrary, it may even provide a helping hand in these troubled times. But the economic policies and institutions (the wooden cages) that guarantee that the job market (the sheep) works properly are no longer adapted for the pressing problems of our times.

Some may simply argue that "a wolf is a wolf", meaning that its most basic instinct is killing, therefore he is not welcome. In the same fashion, inflation may be perceived as an evil (even when it is not excessive). However, neither the wolf nor inflation are innately "bad". We may be able to get along with both as long as we accept them as natural inhabitants of the ecosystem we live in and treat them with justice, while at the same time trying to do the least possible harm to all parties involved in the story. All this taking into account the exogenous and endogenous changes taking place in the ecosystem.

Final comments

The reader may have noticed that I highlighted in bold the words "ongoing phenomenon" above when referring to the main concern during the Great Depression, which was naturally important because it was indeed relevant, but also because it was a phenomenon affecting the immediate livelihood of a large proportion of the population. The same applies to the period known as the Great Inflation, during which inflation was of much greater concern than other economic issues because it was then happening.

However simple and seemingly useless this statement may seem, let us remember the wise words of Claudio Borio (a major official from the Bank of International Settlements): "Concepts rise to prominence and fall into oblivion before possibly resurrecting. They do so because the economic environment changes, sometimes slowly but profoundly, at other times suddenly and violently. But they do so also because the discipline [economics] is not immune to fashion and fads." Fashion and fads distort the evolution of ideas, and sometimes they make contradictory policies and reality overlap.

Now, seen from another angle and taking a look at the other side of the inflation-unemployment trade-off for these episodes, during the Great Depression high inflation was *not* the main concern, but it ended up being the solution starting 1933 with the New Deal.

In contrast, during the Great Inflation high unemployment was *not* the main concern but, sadly, it ended up being the solution in the early 1980s with the Volcker shock and the Great Moderation that followed in great part thanks from the former.

Since the Global Financial Crisis that began almost nine years ago, the major concern again is (or at least should be) unemployment (rather than, say, structural reforms or further interventions in the Middle East), and inflation is the expected and desired solution. However, this overly discussed solution may end up becoming an aborted mission...

One reason why inflation may be difficult to bring about today is that the economic policies and institutions of our day were created in and for a non-inflationary world. During the Bretton Woods years, and even almost a decade after its collapse, financial markets were being punished with inflation, and this contrasted with dynamic investment in the real sector. Since the 1980s the roles reversed and now financial markets have the upper hand, but they are overly comfortable with this situation, even if low inflation is now against their own interests.

By generating so much expectation for the return of inflation, financial markets are now well prepared for when it comes. Nevertheless, what they expect is actually in their power and they are not letting go of the lever for the authorities to manage, in part because liberalization has gone too far. Authorities now have less regulatory power over financial markets than in the past, thanks in part to their lobbying for price stability. Other related phenomena that have facilitated the fight against inflation are outsourcing, mechanization and off-shoring by non-financial firms, privatization of public enterprises, liberalization of capital and goods markets, as well as globalization.

Reflation is far from being a surprise, so much that (compared to the 1930s) it may not even happen. During the past thirty-seven years 'market forces' have taken power away from authorities so much that the latter are no longer capable of undoing the harm done to the job market. Neither do authorities nor financial markets seem to care. Unfortunately, as long as the power to act remains in the hands of financial markets, unemployment will remain high... but hey, at least the price level has been tamed.