

Strategy & Quantitative Research

Research note

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Deflationary capitalism

Key takeaways:

- Why has inflation in advanced economies remained stable, yet so weak in recent years?
- Advanced economies are facing lasting structural deflationary forces.
- Among others, demography, employment conditions and technology / digitisation.
- For a few years, business cycles were associated with boom-bust in financial markets. We no longer have inflationary end-of-expansion.
- The problem of central bankers: a target of 2% is not credible anymore.

Why has inflation in advanced economies remained stable yet so weak in recent years? The Great Recession of 2008-2009 did not lead to the dreaded deflation, and inflation remains today, in the United States and the euro area, sluggish and below the target levels set by central banks. Moreover, in 2019, in the euro area, the long-term annual inflation rate expected by financial markets is dropping to levels still unseen (+ 1.2%) and much lower than those that pushed the European Central Bank to launch its unconventional measures a few years ago. This "de-anchoring" of inflation expectations is fuelling the risk of a loss of credibility of central banks in their ability to meet their mandate of keeping overall inflation close to 2% in the medium term.

We could be delighted by this weakness in price increases, which, among other things, preserves the purchasing power of households. But the problems associated with persistently low inflation are multiple (increase of the real cost of past debt, difficult adjustment of real wages in the event of a shock). Above all, it reduces the room for a manoeuvre of monetary policy when interest rates are already at levels close to zero.

The impact of several structural phenomena have followed each other for more than thirty years. First, there is the priority to fight inflation that was advocated by many economists and implemented in the early 1980s by central bankers. However, research by Emi Nakamura, the recent recipient of the John

Bates Clark Medal, reveals that the costs of high inflation (related to label changes and price dispersion) are lower than previously thought.

In the second place, labour conditions have changed profoundly, shrinking the bargaining power of workers and suppressing the increase in wages and prices. Employment relationships have been heavily affected by the decline in unionisation (the total unionisation rate in OECD countries has been halved in 30 years), industry automation, the globalisation of production and distribution, as well as the change in the structure of low-skilled and more precarious service jobs (part-time jobs, temporary jobs, etc.).

Demographic developments have also contributed to slower growth in wages and prices. Declining birth rates and increasing longevity has led to a rapid aging of the population, affecting consumption and investment decisions that weigh on demand and inflation. For example, many retiring baby boomers are being replaced by junior employees making much lower wages.

The fourth – relatively new and less subjected to economic studies – factor is the impact of technological innovations and the digitisation of the economy. Indeed, while the current technological wave has not (yet) resulted in an acceleration of productivity, it represents a major deflationary force. And for several reasons.

First, as technology improves and spreads at constant quality (faster, more powerful computers, lighter-larger-connected TVs, expanded smartphone services, automotive equipment, audio and video communications, video games, etc.), prices have fallen. So, for the same price, quality has increased. Statistical conventions integrate these "quality" effects by decreasing the price of goods.

Furthermore, e-commerce platforms (such as Amazon and Google) have improved price transparency, increasing competition among retailers.

Finally, digital "sharing" and classified ads platforms, such as Airbnb, Uber and Craigslist, generate a supply shock that exerts a deflationary pressure on the rest of the economy (think of hoteliers and distributors of durable goods).

Moreover, we have seen the appearance of new zero-price markets in exchange for our "attention" and / or our personal data. By not including this "free" consumption in statistics, an already low rate of inflation is probably being overestimated.

These four structural transformations (priority to moderate inflation, employment conditions, demography, technology) explain how the inflationary threat - with double-digit inflation in the early 1980s - has turned into a disinflationary or even deflationary threat. The conquest of high inflation has probably gone too far. Hence, capitalism is generating business cycles with imbalances that are characterised by financial instability (boom-bust) instead of inflationary crises.

For central banks it becomes increasingly difficult to keep an inflation target close to 2%. Some economists suggest lowering the inflation target to make it easier to reach - thus restoring the credibility of central bankers. Others, such as Olivier Blanchard, propose to increase inflation targets, so that central banks regain room for manoeuvring when it comes to boosting the economy. But, if it is already difficult to reach 2% inflation, what about a target of 3% or 4%? Given the nominal and real interest rate levels, the key is certainly a more flexible and bold fiscal policy.

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