



Daily Note

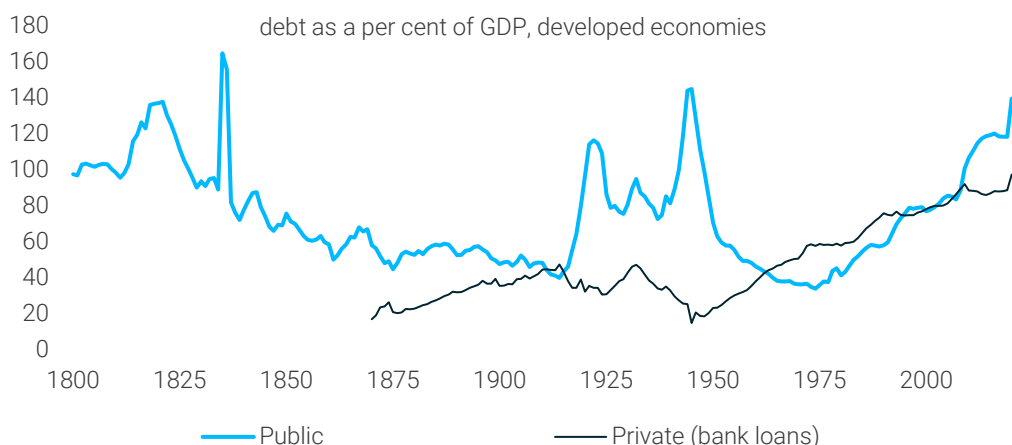
INFLATION WAS ALWAYS THE ENDGAME

Dario Perkins

- **Macroeconomic policy suffers from its own inherent Minsky dynamic**
- **Belief in the death of inflation has contributed to today's inflationary surge**
- **Inflation is the only socially acceptable "way out" – no Japanese endgame**

There is beautiful irony in macroeconomics – a sort of inherent Minsky dynamic or universal Goodhart law – which means just when everyone thinks something is definitively true, it turns out to be spectacularly false. In fact, worse than that: the false belief usually sows the seeds of its own destruction. Our whole pseudo-science is susceptible to that famous Mark Twain quote "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." We see this most clearly in the long pendulum swings between fiscal and monetary orthodoxy. Just when the Keynesians think they have won the argument, they have to face their historical nemesis – stagflation. And when policymakers think they can solve all the world's problem with monetary policy alone, they always end up in some version of the liquidity trap. We also see these dynamics on a more granular level. Ignore the banking system, as the authorities did in the early 2000s, and find yourself in a banking crisis. Regulate the banks and push financial bubbles into shadow banking and institutional investors. Financial markets are viral. To control is to distort.

Chart 1: Combined public and private debt is at historical highs



Sources: MacroHistory, TS Lombard.

It is with this sense of irony, bordering on superstition, that we should rethink everything that has happened over the past decade. The 2008 crisis shocked everyone. As an industry, financial markets suffered a sort of collective PTSD. Investors spent the next decade looking for black swans that never arrived. The euro crisis in 2010. The debt limit in 2011. The euro crisis again in 2012. Oil in 2014. China in 2014, and in 2016, and in 2019, and again in 2021. Mallmageddon in

2018. The thing that happened in repo markets – which nobody fully understood – in 2019. Sellside economists analysed every potential threat in excruciating detail, looking for that one problem their clients feared most – “another Lehman moment”. And policymakers reacted in the same way, hypersensitive to every potential market threat. The authorities had their own PTSD to deal with. Nobody wanted to return to the crisis of 2008, with its chaotically arranged market communique and rescue packages finalized at 4:00 a.m. At every opportunity, central banks cut interest rates and added more QE. Deep down, they knew these policies would not benefit the average Joe, but they seemed very effective at propping up asset prices. And with inflation showing no signs of life, there was no real cost to this endless financial lifeline. What harm could it do?

Chart 2: Time to monetize the debt



Sources: Bank of England, Federal Reserve, TS Lombard.

Inflation did not budge, in large part because fiscal policy was continuously, and egregiously, too tight. Only China – the one part of the world that weaponized its state balance sheet – was able to move the dial on the global CPI. But every brief burst of reflation sizzled out as soon as the stimulus was reversed. Overall, the global fiscal-monetary policy was deeply disinflationary. If yields at 800-year lows did not make this point blindingly obvious, negative nominal rates – which everyone scrambled to explain when they first appeared – should have settled the debate. When Adam Tooze eventually writes his volume on this whole unfortunate story, his chapter on NIRP will be the part that makes policymakers and investors blush most. Negative interest rates were the “tell”. When investors will pay governments for the privilege of lending them money, the old rules of economics have clearly broken down. Now there is no limit on government debt. And deflation takes over from inflation as the dominant challenge facing central banks. It is no wonder that MMT was “winning” in the 2010s. When rates are zero, everything MMT says is true. MMT just reminded the mainstream about things it had forgotten. And the mainstream resented it.

After five years of investors asking me to identify “the end of the cycle”, the black swan arrived in a form few had imagined (as is the way with black swans) – the COVID pandemic. And by then, policymakers and investors had taken the “new rules” of the 2010s for granted. Secular stagflation would never end. Moderate inflation, let alone prices rising at “double digits”, was something that seemed unimaginable. So, policymakers put everything they had learned into practice. Central banks immediately backstopped the shadow bank system. The Fed widened its swap lines for dollar liquidity. And governments, knowing that monetary policy would not be enough, launched their biggest fiscal support programme since World War II. There were no questions about whether we could “afford it” anymore, and inflation was something only

“boomers” cared about. The policy response was extremely successful. By freezing the credit cycle – bankruptcies fell to historic lows – the authorities prevented a depression.

The irony was that the COVID was nothing like the global financial crisis. In the end, this was a supply shock, not just a demand shock. The combination of lockdowns and income support was highly inflationary, which the spasms and reflexivity of international supply chains amplified. For a while, there were good reasons to think this inflation episode would be transitory – prices would not fall, but inflation would come down. Yet the supply problems have continued, first in labour markets and then with the war in Ukraine. Stagflation beckoned. For central banks this was unacceptable, so they raised rates aggressively, as if their credibility depended on it. No central banker wanted to become a case study in monetary failure. But governments will have different ideas. For elected officials, inflation is a “cost-of-living crisis”, and a reason to provide fresh rounds of fiscal support. So, now we find ourselves in a radically different situation, broadly the “inverse” of where we were a decade ago. Inflation is too high; and with both monetary and fiscal policy pivoting a full 180 degrees, we again have a “tug of war”. Only this is a battle that pushes in the direction of higher interest rates, rather than the disinflation and the NIRP of the post-GFC era.

What is the point of this rear-view mirror rundown of the last decade? When you look back at the entire period, it feels as if there was a certain inevitability to where we have ended up – and where we are headed. Despite what some pundits thought, Japan-style deflation was never the endgame. For modern democratic societies, inflation is the only socially acceptable way out. We tried the “orthodox approach” after the GFC. Now the “unorthodox approach” beckons.