Should central banks be worried about rising inflation?

Inflation has risen in the Eurozone in recent months, but there is little consensus on whether Europe is heading for a persistent rise in inflation as countries emerge from the pandemic. **Markus Demary** *and* **Michael Hüther** *write that central banks may nevertheless face a dilemma over whether to take action if inflation rises further.*

When inflation is going to rise, economists first look at the underlying factors and whether these lead to a transitory increase in inflation or a persistent one. While transitory factors usually do not demand central bank responses, persistent factors demand monetary policy to lean against rising price pressures. Since the Covid-19 pandemic has effects on the supply-side as well as the demand-side of the economy, one has to analyse whether these effects are of a transitory or of a persistent nature.

Pent-up household savings

The saving rates of the household sector increased sharply in many countries as the pandemic broke out and households either refused to consume goods and services in public or were hindered from doing so because of lockdown measures. The higher saving rates could be seen already in the first quarter of 2020. The life-cycle income hypothesis from Franco Modigliani states that permanent income is used by households for permanent consumption, while transitory income will be saved.

In this case, the pandemic and the lockdowns have decreased the permanent consumption of households, like expenditures for holiday travel, restaurant visits and concerts, leading to transitory savings which have strengthened the balance sheets of many households. Thus, the willingness to pay for travel, restaurant visits, and concerts has increased, making it possible for companies in these sectors to increase prices. This has led to a higher price level but only to a transitory increase in the inflation rate.

The effects of short-term work

A short-term work system was successfully implemented by Germany during the financial crisis and has been applied across Europe during the Covid-19-crisis. Under this system, businesses can temporarily cut the hours of their employees with the government compensating workers financially for their lost earnings. The advantage of short-term work is that it lessens the pressures for companies to lay off workers during a recession and it therefore reduces their hiring costs during the recovery phase. Moreover, short-term work prevents the destruction of organisational capital during recessions.

Without short-term work, companies would have to lay off workers during a recession and they would have to compete for new workers in the recovery phase, thereby pushing up wages. Moreover, companies would have to increase the prices of their goods and services in order to compensate for these higher labour costs. This higher wage growth would give workers more financial space to increase their demands, causing inflation to pick up, leading them to demand further wage rises to compensate for higher inflation. This price-wage-spiral can then lead to permanently higher inflation. However, in the case of the Covid-19 crisis, the application of short-term work has reduced the potential for such price-wage-spirals during the recovery phase and this makes high permanent inflation less likely.

The effects of government spending

Lawrence Summers and Olivier Blanchard expect US government spending to lead to an overheating economy. Governments in all pandemic-hit countries had to increase spending, which raises the question of overheating and inflation. Thomas Sargent, in his classic study of four countries that experienced dramatic periods of inflation, suggests that persistently large deficits lead to inflation, and that previous inflationary episodes have ended with budgetary reforms. The question is whether Sargent’s results also apply to the current situation.

Although the current crisis is extraordinary, the pandemic-induced demand shock and the lockdown-induced supply shock are of a temporary nature. Once the pandemic has ended, households will travel and visit concerts and restaurants, and companies will supply goods and services again. Government spending is needed to prevent businesses running into insolvency and to support workers who have lost their jobs. Other measures are intended to increase demand, like the temporary tax-cuts in Germany. For the US, there is evidence from Olivier Armantier and his co-authors that households used their consumption checks mainly for saving and debt reduction rather than for consumption, which stands in contrast to the overheating hypothesis.

The effects of debt-deleveraging

As stated above, companies raise debt for covering costs rather than investing. We (alongside our co-author Stefan Hasenclever) have previously argued that the pandemic thereby leads to a deterioration in the balance sheet quality of these companies, thereby restricting their future access to finance. Thus, before companies start investing, they have to restore their equity capital buffers and their liquidity buffers by saving. If too many companies are involved in a debt deleveraging process, the economy might get into a situation of a demand shortage, which will lead to low inflation or mild deflation.

The prospect for oil prices

The price of oil has a very important influence on the future path of inflation. First, it determines the price of fuel for cars or for heating. Second, it determines the price of plastics, which are fundamental to many products. Thereby, rising oil prices could have second round effects on core inflation.

The oil price experienced a pandemic-induced decline as many people either worked from home or walked/cycled instead of using public transport. While mobility declined to a greater extent during the first lockdown than during the second one, oil prices have recovered from the low they hit in April last year. There is still a lack of demand for kerosene because of travel restrictions. However, demand for kerosene might increase as travel restrictions are relaxed. As soon as the oil price increases, inflation will also go up again.

A dilemma for central banks?

Given all the factors discussed above, predictions for inflation are highly uncertain, and higher inflation cannot be completely ruled out. If inflation rates rise to say four percent, central banks will have to step in. This raises a dilemma for central banks because the fight against inflation will lead to higher financing costs, slowing the economy and hindering companies from reducing their Covid-19 legacy loans.

Hindering the restructuring of balance sheets will lead to lower future investment demand and contribute to low inflation in the future. Thus, the options for central banks are, first, fighting possible transitory inflation now at the cost of running into low investment and low inflation in the future, and second, accepting higher transitory inflation now with the aim of fostering a recovery in corporate balance sheets and stable inflation in the future.

Since today's inflation spike is due to transitory factors, the second option will be the better one. However, it will be politically more controversial because central banks have to keep interest rates low in times of inflation exceeding their inflation targets. We do not expect any trade-offs for central banks between fighting inflation and supporting economies to grow and to deleverage. Instead, we see a welcome return of inflation towards its target value.

For more information, see the authors' accompanying paper published by the Institut der deutschen Wirtschaft (IW)

Note: This article gives the views of the authors, not the position of EUROPP – European Politics and Policy or the London School of Economics. Featured image credit: Martin Lamberts/ECB (CC BY-NC-ND 2.0)
