Why inflation is not lurking in the shadows

*In a recent op-ed in the FT, economist Stephen Roach suggested a future of stagflation as a combined result of the increasing brittleness of supply chains and the pent-up consumer demand caused by the lockdown. But he is wrong, **Bob Hancké** suggests. The real world is considerably more complicated.*

A few days ago, Stephen Roach, erstwhile of JP Morgan, author of several books on the world economy, and economist at Yale University, published a remarkable op-ed in the FT. He sketched a future of stagflation as a result of the increasing brittleness of supply chains that we discovered during and after the Covid-19 crisis and the pent-up consumer demand that the lockdown imposed. The moment, he suggested, that citizens are allowed to go shopping again as they did a few months ago, even a single bottleneck in supply chains might have dramatic effects on prices. Too much money, a result of pent-up demand, will chase too few goods, a result of broken supply chains, and inflation is born.

He has certainly come up with an interesting take on an old argument. But he is fundamentally wrong. In essence, the argument reiterates a fear of many new classical economists who take their cues from Milton Friedman's assertion that inflation is always a monetary phenomenon. If that is the mantra you follow, you don't need a good explanation, just an 'over-supply' of money for inflation to follow as day follows night. That's why the fiscal response to the financial crisis ten years ago was supposed to herald accelerating inflation (it never happened) and that's why the current fiscal response again has inflation lurking in the shadows. But the real world is slightly more complicated than these simple, almost tautological, views suggest.

What supply chains are and are not

First of all, the key feature of the brittle just-in-time (JIT) supply systems that do so much of the work in this argument is not that suppliers are located thousands of miles away in Asia, but in the close vicinity of the place where parts are used. Most car plants with tight JIT arrangements, for example, have their main systems suppliers within a few minutes or maximum a few hours ride. Cost obviously matters in such a production link, but quality, competencies and flexibility matter much, much more for interior and seating systems, heating and cooling systems, brake and drive train systems etc. Input prices have fallen for the standard parts that can be produced far away, but considerably less so for the sophisticated systems that key suppliers produce.

Many small cheap parts do, of course, make cheap big inputs. Since nuts and bolts made in Vietnam are an order of magnitude cheaper than those made in Germany or France, the thousands of nuts and bolts in a car thus quickly add up. Re-shoring is, in that scenario, a recipe for inflation: the basic good remains the same but the input prices go through the roof.

Industry 4.0

Perhaps: the caveat is that while companies are considering re-shoring, they have also thought about alternatives to conventional manufacturing. The ability to combine automated production, additive manufacturing (aka 3-D printing), and sophisticated skills certainly will allow European companies very soon to produce much more sophisticated parts competitively. The first two bring prices of small series down, while the skills assure quality and flexibility. So, we would pay relatively less for a more customised, better product. Technically speaking that is the opposite of inflation.

Where are the bottlenecks?

Technically, stagflation is a combination of low growth and high inflation. But the pent up demand can probably be easily accommodated: supply chains are now running at less than 50% capacity. That's why it is so important to have furlough schemes for workers: not only does it stop people from starving or becoming homeless, it also assures companies of a skilled workforce when the economy picks up again. I fail to see perennial, structural supply bottlenecks in manufacturing.

Things might be slightly different in the service sectors, but I wonder exactly how. If you didn't have a monthly hair cut for three months, you need one now, not three: once it's cut, it's cut. Even if you went to the restaurant seven times a week over the next few months, your demand is maxed out: there is no eighth or ninth day in the week. And there is no pent-up demand for many clerical-type services (insurance, banks, …). Even the so-called 'stimulus' fiscal measures hardly warrant the term. They remind me more of a patient in a steel lung that 'stimulates' her to breathe, not an injection of performance-enhancing drugs. And if we were to go back to normal, that's where we are then: back to normal.

The economic effects of deep uncertainty

In addition, the future is going to be very uncertain for many households for a very long time: virus, robots, debt, weaker trade unions, and a host of other crisis factors. We know the micro-economic effect of uncertainty: all other things being equal, it increases savings. But if saving rates go up, consumption levels fall; if public debt is already high, there will be very little countercyclical fiscal push in the system. The likely outcome is deflation, not inflation.

How high is bad inflation?

Finally, it is not a bad idea to keep some perspective: even if inflation were to rise, a 4% inflation rate is hardly a catastrophe. The current consensus of about 2% is almost certainly too low in a volatile world in which technology moves quickly and trade unions are weak. Even the hawkish German Finance minister Wolfgang Schäuble thought wage inflation was too low a few years ago.

In any case, a higher inflation rate for a few years would simply mean that we balance out the deflation of the past 10-15 years and essentially a return to normal. And it would indeed have the advantage that debt is silently eroded: we would simply use inflation to clean up the financial crisis and the Covid-19 crisis.

No one knows the future. That's why we develop different scenarios, based on theoretical workhorses, and of how they may play out. Concentrating on one small link in a logical chain, ignoring any of the many counterarguments, and blowing that one link out of proportion produces a doomsday scenario. Marxists had a copyright on such analyses. They predicted 20 out of the last seven recessions…

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About the author

Bob Hancké – *LSE*
Bob Hancké is an Associate Professor of Political Economy at the London School of Economics and Political Science.