ADVISER INSIDER

WHATEVER HAPPENED TO INFLATION?

Negative interest rates have uncoupled conventional inflation dynamics, and a pensions crisis is looming. Here's what central banks need to do

JULIEN JAMMET
Pentagram Wealth Management
Geneva

After inflation peaked in the wake of the 1979 oil shock and following the dramatic rises in public deficits in developed economies – which together forced central banks to hike interest rates aggressively – the world has experienced a 35-year cycle of declining long-term nominal rates. This has been accompanied by a significant slowdown in inflation and an ever-growing pile of public debt.

Of course, price stability is the main mandate for the European Central Bank (ECB), which has a 2% inflation target. That specific mandate has been respected.

But the 2008 global financial crisis tested the creativity of central banks. In addition to traditional measures, the ECB decided to implement negative interest rates to avoid deflation and support consumption. It achieved that objective, but now the key dilemma is how to create inflation amid negative rates – all without damaging the recovery.

LESS THAN ZERO

Unlike the US Federal Reserve, the ECB went into negative territory for its deposit rates, which had some major consequences, including a capital loss for those who put money into the safest investments.

This represented a major change for investors and acted as a drag on inflation. If you know ex ante that your investment will not bring you any positive return over the next couple of years, you cannot afford high inflation.

In addition, sustained inflation in Europe faces some significant structural headwinds.

First, population growth is stagnant, rising from 508 million in 2015 to just 528 million in 2020, according Eurostat.

Second, the population is ageing: 18.5% of the European population was over the age of 65 in 2014, and this is expected to reach 25% by 2050. Older people consume less and prefer to save money, increasing demand for income products, which pushes rates lower.

PENSION FUNDING CRISIS

As a consequence, the funding of the pension system will become a key issue, and the gap will increase if rates remain low.

To solve this, you either keep inflation as low as possible to achieve decent real interest rates, or you increase the public debt.

In 2018, the debt-to-GDP ratio surpassed the pre-crisis level. The homo economicus who sees a bigger debt burden tends to become less confident, and the savings rates move higher: this is what David Ricardo underlined two centuries ago.

There are several key points to consider about the current dynamic. First, the mandatory deleveraging of the private sector has a direct impact on global activity. Second, the accession of robotics and artificial intelligence creates disruption in many traditional sectors and is a direct threat to employment. Disruptive businesses require fewer workers and are light in capital (Publicis has 78,000 employees for $11.8 billion in revenues, whereas Facebook has 25,000 employees for $40 billion in revenues).

Third, the development of e-commerce enables consumers to compare prices in real time and therefore improves the efficiency of homo economicus.

And finally, despite an unemployment rate that has returned to pre-crisis levels, wages are not on this rise. This is one result of the poor quality of the jobs created, mainly due to the transition from manufacturing to low-skilled services as robotics gain traction.

So how can we create inflation? The current economic environment in Europe, with economic growth of more than 2%, does not require capital to be subsidised so heavily, and a normalisation of monetary policy is warranted. But by doing this the ECB may revive a potential sovereign debt crisis.

WHAT NOT TO DO

The ECB might be in a corner, but it has the unique opportunity to be creative. The Japanese experience has shown that excessively low nominal interest rates for an extended period neither create inflation nor reduce debt.

Given that every investor knows that public debt will never be paid off, central banks could decide to erase a certain percentage of public debt and at the same time increase interest rates to send a clear message to indebted governments.

To assure financial stability, central banks could also commit to stepping in and reintroducing asset-purchasing programmes at any time to support the economy as needed.

In short, Draghi's 'whatever it takes' approach should be applied to keep nominal rates above zero.