EFFICIENT GROUP

Weekly Economic Newsletter

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ECONOMIC COMMENTARY - By Francois Stofberg

Inflation isn't always a bad thing. In the past, demand driven inflation pointed towards a healthy, vibrant economy. An economy where final consumers earned greater incomes and bought excessively more goods. In these economies, credit is freely available for consumers who want to buy homes, boats, and fancy cars, but it's also available for businesses who want to expand and penetrate new markets.

Without the correct regulations, however, it all ends quite bad, for everyone; history has been the best teacher. In the Bretton Woods era, fiscal expansion pushed interest rates higher until yields in the US reached record highs, the great depression followed. Then monetarism (using monetary policy to control business cycles) entered the fold of policy makers, who now decided to keep interest rates as low as possible. This ultimately lead to the environment that caused the great recession. Another extremely bad scenario, often associated with developing countries, is hyperinflation (inflation › 50%).

But, as I said inflation is not always a bad thing, often it speaks of a healthy, growing economy. Inflation also serves another purpose. Inflation increases the nominal size of an economy; which implies that debt, expressed as a percentage of GDP, becomes increasingly smaller over time. After the global financial crisis, governments started buying debt at a rapid rate to try and save drowning companies (both private and state-owned). The result was that global debt, as a percentage of GDP, reached all-time highs. If rich countries can now get inflation back, they can effectively reduce their over-laden debt books without having to "pay back the money".

How do countries get inflation back is the question? A combination of three approaches is used. Countries can import higher prices by keeping local exchange rates weak. This approach is difficult to maintain, just ask the Swedish government or China who last year spent $1 trillion to keep the Yuan under control. Central banks can try and fuel inflation expectations by increasing interest rates and give guidance to markets about upcoming hiking cycles. This approach is even more difficult considering the deflationary environment richest countries are in. The final approach, and most likely to succeed in the rich world, is the natural occurrence whereby "full" employment is reached. Once there is not more spare capacity in the labour market (the largest driver of inflation in the rich world), firms have no choice but to increase wages, and hands-down some of the inflationary pressure on consumers.