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## High Inflation – likely to emerge?

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At the beginning of September, the FED announced a significant change in their policy: They officially announced the implementation of “average inflation targeting”. This allows to have a higher inflation rate for a period of time instead of being closely held to the target inflation rate of 2%.

Why did the FED announce this shift in its policy? Is inflation returning in the agenda? In this article, we intend to show the policy requirements for high(er) inflation.

### Crisis mode: Governments and Central banks had to react

The pandemic brought a sharp downturn of the global economy. In order to restore economic welfare, the Central banks offering full monetary support. At the same time, governments implemented fiscal policy tools – huge stimulus packages.

- These rescue packages result in huge budget deficits. The OECD expects fiscal primary deficits of more than 10% in their member countries this year. This will lead to rise in government debt in % of GDP by estimated 28 %-Points.
- It is widely expected that the spending programs will be extended in the next years. This will result in additional debt.
- The financing of these measures is essentially done by the central banks. Since the begin of the crisis, the big 4 central banks (US FED, ECB, BoE, BoJ) have expanded their balance sheets by purchasing assets worth 3,7 trn USD.
- The major central banks also continue to be the largest purchaser of governmental debt – regardless of the yield. Therefore, the long-term interest rates of its member states remain low despite soaring amounts of issued debt.

Interestingly, these monetary and fiscal interventions had a limited effect on inflation. There has been no rise of the CPI in major countries since the beginning of the pandemic.

### A economic new approach on the rise

At first glance, it seems that the authorities just did what had to be done. But we assume that out of this crisis a new economic approach – a paradigm shift – emerges. This shift will affect governments (fiscal side) and central banks (monetary side).

#### a) Fiscal Side

- The pandemic was the “Whatever it takes”-moment for governments. They reacted with massive spending. As a result, austerity is no virtue anymore.
- The general public is in favour of those measures. In contrast to the global financial crisis in 2008, when support was “only” used for financial institutions, most parts of the population benefit directly now.
- As a result, it becomes possible for governments to handle a much higher level of debt and primary deficits in local currency. And we assume that governments are willing to do so.

#### b) Monetary Side – expansion of the toolbox

- To keep interest rates low, central banks can introduce “yield curve control”. Low interest rates would reduce the Interest payments by the government despite an increase in debt. We assume low or even negative interest rates in the major economies for the time being.
- In addition, the threat of rising inflation can be mitigated with the concept of “Average inflation targeting”. Central banks would get more flexible on the target rate without having to give up their credibility completely.
- There is limited alternative for investors: All four major central banks face the same economic challenges. By providing similar monetary solutions, investors can not “escape” from low interest rates. The majority wants to be invested in developed markets.

### The path to high inflation – and back

In order to see rising inflation, the current fiscal and monetary measures would have to be extended:

- Even after a significant rebound of the economy, governments and central banks would stick to the chosen path. Neither side wanted to be blamed for “killing” the recovery.
- A rise in inflation would very likely be a result of rising labour costs. This would require a return to full employment and a continuation of economy growth.
- If high inflation rates arise, they would stay for sometime in our opinion. High inflation would be beneficiary for governments as the level of debt in % of GDP is reduced.
- Finally, the authorities would have to stop the party: Governments would stop the fiscal measures (primary deficits) while central banks would raise interest rates, stop yield curve control measures as well as bond purchasing programs.

### Is it a likely scenario?

We recognise a significant change by the central banks in their view of inflation. The announcement of the FED could be seen as opening the path to higher inflation. We would also expect similar statements of other major central banks.

As a result, the current “Zeitgeist” on the fiscal side as well as the usage of instruments on the monetary side could lead to higher inflation in the mid-term.

However, as long as high inflation is tolerated for a short period of time only, the overall macro-economic effects could be positive. It goes without saying that this is a risky path – the central banks must closely monitor the situation and act on a very short-term basis if necessary.

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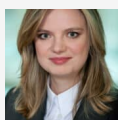
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