Deflation Then Inflation

At this time of COVID19 pandemic, social and economic disruption and recession, I can see instantaneous deflation due to the demand shock, but I also see a longer term trend of rising prices. This could present investment opportunities, and risks, and would certainly complicate monetary policy.

Given the acute reduction in demand, deflation is the more visible risk. With total and partial lockdowns, people cannot move about to spend, and unemployment is rising so people may have their purchasing power severely impaired. Overlay this with pessimistic sentiment and demand is further reduced. Deflation or at the very least disinflation should occur.

There is always, a however. Prices have been weak for the past two decades mainly from innovation, trade and globalization. Optimized supply chains and production plans mean that for a level of output, costs are constantly being minimized. For this to work, society must choose efficiency over robustness, be willing to trade freely, be happy for free markets to operate regardless of distribution of utility or welfare.

With the global trade war, incepted almost a decade ago but accelerated with the Trump Presidency, productive efficiency will suffer, raising costs.

With the COVID19 induced economic crisis, humans will raise robustness at the expense of efficiency, raising costs.

Governments have greatly increased their national debts to finance emergency fiscal support. These debts will take a long time to pay down. Governments will encourage inflation to erode the real value of their national debts. The high debt levels also risk disorderly devaluations and hyperinflation from loss of confidence.

In order to finance fiscal stimulus, tax rates will rise and tax codes will become more progressive. The net transfer of wealth from rich to poor will increase the propensity to consume, encouraging higher inflation. A corollary to this is that governments will try to reduce the external purchasing power of their currencies (or improve their terms of trade), which could encourage currency devaluations, which could in turn trigger currency regimes such as Bretton Woods.