



Dr. Peter Warburton: Inflation or Stagflation? And how will it occur?

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Erik: Joining me now is Dr. Peter Warburton, Director and Chief Economist for Economics Perspectives Limited.

Dr. Warburton, it is such a pleasure to get you on the program, because something I have been thinking about for years and, frankly, people ridicule me about, is it seems to me like if you look at all of the policy decisions of the last several years and the people who have criticized them – myself included – it seems to me like what’s going on is we can get away with these things until inflation gets in the way.

And once we have an inflation problem, all of a sudden central bankers can’t just paper over our problems by printing more money because it would exacerbate the inflation. But most people think inflation, hey, we haven’t had it in recent history. We’ve had a deflationary backdrop. It’s not a problem.

You gave a presentation back at the end of June called Blowing up the box! And what I really like about this is your perspective resonates so well with mine – that if you want to understand inflation you can’t just think about past history. You’ve got to think about not just the economics but also the political environment.

So please fill us in. What do you mean by blowing up the box? What’s the back story on how you got to this set of views?

Before we get into your slide deck – by the way, listeners, be sure to check your Research Roundup email. There is a link to download the slide deck that we’re going to be referring to throughout this interview. There’s also a detailed commentary on this subject in a separate download link.

Both of those are in your Research Roundup email. If you’re not yet registered and don’t have a Research Roundup email, just go to our home page and you’ll see a red button next to Dr. Warburton’s picture, which says [Looking for the Downloads](#).

Dr. Warburton, give us the back story, the big picture. Why are you thinking about inflation now when so many other people are ignoring it?

Dr. Warburton: Well, the truth is I’ve been thinking about inflation a long time. My first sort

of visceral reaction to the global credit crisis, which is now more than a decade past, was that the only credible resolution for the global credit crisis was a resurgence of inflation.

And of course the first thing that happened in 2010-11 was we got some inflation. We got some commodity- and oil-price inflation. And it looked as though we were on the way to a more inflationary world.

But of course that was a very temporary interlude followed by five years plus of disinflation and clearly a very dominant view that inflation was irrelevant to the conduct of investment and asset management.

But my gut reaction, which is also I think my considered reaction, is that there are many forces that bear down upon the longer term outlook for inflation. Clearly, central bank policy, monetary policy is one. But the political-economic environment is another. Socioeconomic tensions is another. Demographics is another.

You know, basically, the reason we end up in a significantly differently place in terms of inflation is a kind of societal culmination. And, in the end, monetary policy just gives way to what needs to happen to resolve the issues that have arisen, maybe built up over many years.

Erik: Dr. Warburton, as we look at your slide deck, the very first slide has this TNT explosive picture. And the heading is Blowing up the box!

What box are we talking about? I assume we're talking about a policy box of some kind. Tell us, what is this policy box? How did we get here? And what can we expect next?

Dr. Warburton: The idea of blowing up the box is that over the last 20-30 years we've constructed a policy box, which essentially has been a protection, first of all, against inflation. Secondly against unruly and excessive government spending and borrowing. And thirdly interference from politicians in the timing of managing fiscal policy decisions.

We've evolved over this long period of time. So, if you like, we want to start with the chaos of the 1970s, post- Bretton Woods.

And we've sort of constructed this box. We decided in the 1980s that inflation was probably going to be number one. We needed a policy framework that addressed high inflation, brought inflation down. We needed a policy framework that brought public sector borrowing under control. So we needed some kind of a balanced budget rule.

We had still very restricted markets. We had a lot of protectionism, a lot of controls, a lot of leftover stuff, really from the Second World War. We needed liberalization. So that's been another part of the framework of the box that we built.

And, interestingly, what we also did, we basically wanted to separate – this kind of came a bit

later – but in order to separate the inflation control part of policy from the budget control we had to set up a funding rule whereby, if the government did borrow to excess, then it was to be funded by the primary issue of government securities and not through inflation.

So that's the policy box and it served us pretty well through the '80s and '90s leading to the crisis period in the end of 2007 and onwards.

Essentially, it wasn't a perfect box. If it had been a perfect box, we wouldn't have had a financial crisis. The bit that was left out was there was no control of system leverage. And so, if you like, for me it was systemic leverage that blew that original design.

So out of the ashes of the financial crisis we put the box together as best we could. We made some changes. We brought in QE – so we broke the funding rule. We suspended the balanced budget rule because it was going to take a long time to repair public finances. And we ignored departures from inflation targets rather more than we had before.

So there were a number of things that we did.

But essentially, that sort of botched, patched-up, on-the-run box had some increasingly disturbing characteristics in terms of the relative fortunes of people across the income spectrum and across the world spectrum.

And it is, I think, those design faults which have brought us to this juncture now, why we have the politics that we have now, and why we have the threat of blowing up the box.

Erik: Dr. Warburton, as I head to some of these slides, it seems like a really important theme here is that the reasons that you see this policy box potentially coming to an end or blowing up has to do with financial repression.

So let's do a quick review of financial repression and how it relates to this story.

Dr. Warburton: I think it's possible, quite reasonably, to describe the objectives of central bank policies as having a desire to repress the nominal value of interest rates. And, clearly, that originally was merely to lower short-term interest rates to their practical minimum. And latterly has become a desire to suppress, repress interest rates across the whole yield curve, using large-scale asset purchases, using forward guidance, and using other technical techniques to manipulate the central bank balance sheet.

So why would you want to repress interest rates?

Well, clearly, the context here is that post-crisis the public sector debt ratio has increased very significantly. So in European countries, where it was typically maybe around 50% or 60% of GDP, it's now pretty much 100% of GDP. Obviously, some countries started higher and have gone higher still. And the US, similarly, was down in the 60-70% range pre-crisis and it's now up

in the 90s.

So the context here is wanting to minimize the burden of debt service for the government. That's a fairly obvious object to have. Otherwise, your debt-service cost rises and it squeezes out all the other programs.

So I understand the logic of financial repression.

But what's happened here is, because financial repression has been successful in its initial stages, the assumption that many people are making is that this is the world in which we remain. Indeed, some while ago this was coined "the New Normal" – a world of very low interest rates, very low inflation, very weak or stagnant growth.

But what I'm arguing here is that financial repression, if it's to be successful, has to have a second phase. It has to have a second act, if you like, if it was a play. And the second act is unanticipated inflation.

So the whole context of the presentation is to say, what is it, potentially, that brings us into a new environment in terms of much higher inflation and, indeed, of necessity, unanticipated inflation?

So that's the context of the presentation. The successful second act, as it were, of financial repression is the unanticipated inflation that depresses the capital of fixed-income assets.

Erik: Dr. Warburton, I just think this is such a timely topic, because every time I talk to anyone in professional finance about inflation, they laugh at me. And they act like, dude, you don't get it. Haven't you been paying attention? We've got a really serious problem with disinflation. We need inflation. We can't get it.

And the more I hear that, the more the contrarian in me says, boy, we must be getting close to the point where everybody is taken by surprise. I'm not sure exactly what's going to trigger it and I'm absolutely fascinated to find out.

So I think we've covered the first few slides in the deck in the conversation we've had so far.

So moving on to Slide 12 or 13, tell us a little bit more about this policy box. What is causing it to be, as you put it on Slide 13, to be hastily and arbitrarily designed?

Dr. Warburton: The box as I've drawn it on Slide 13, there are four vertical poles.

So the first one is what used to be the fully funded budget deficit. That was the budget deficit to be funded by additional issues of debt. But of course that's now been buffered by QE. In other words, the central bank has taken huge responsibility, effectively, in the short term for the funding of government deficits. That's point number one.

Point number two is obviously the balanced budget edict itself has been significantly bent by the huge impact of the financial crisis and the deep slump that followed. So we've relaxed the time scale over which we expect the budget to be balanced.

The third pole is about the free movement of goods, capital, and workers. What we've seen, really, since 2009 is a kind of de-globalization. And we've seen some capital protectionism come back. We've seen the fringes and clearly the grounds of some trade protectionism coming back. And, generally, issues about immigration have risen to the fore.

And then the fourth pole is really about the central bank inflation objective. And, increasingly now, central banks cast their objectives in terms of anchoring inflation expectations. So if inflation goes wandering either up or down relative to their objective, they tend not to take a great deal of notice provided they can point to some kind of surveys that say, oh, the market is still confident that inflation will return to its objective.

But, over this long period of time, what's happened is this rather arbitrary redesign of the box has created some unusual effects. Obviously this has been well documented in that it's conferred an advantage to those that have had financial assets. So QE boosted and protected.

World capital asset values have tended to rise. In fact, they have risen powerfully out of the spring of 2009. But it always has favored those who have more of those assets in the first place.

Also, there has been a compression of real incomes. So, when we look at the income spectrum, we find that a lot of people in the lower income groups have suffered relative income declines. The economy has been growing but it hasn't boosted their after-tax incomes.

Basically, year by year the consequences have got more and more extreme.

So it's no surprise to me that what we have in the political dimension is now a clamor for a redefining of policy priorities.

And we can think about maybe some particular themes. So for some people it might be about job guarantee. Other people, it might be about a Green New Deal. Other people, it might be about boosting the defense budget. Other people, it might be about infrastructure.

But, essentially, there are multiple narratives that say, look, we've got some really important spending priorities that are not being addressed. We need a policy framework that allows them to be addressed. And if that means high deficits and more inflation, so be it.

Erik: Now, the argument of the MMT constituency is essentially, look, the only downside to printing as much money we need to fund whatever social programs might benefit society is inflation. That's the only adverse consequence. And we don't have inflation, so why not do it?

And it seems to me like the answer is because inflation has a long lead time and you can do a whole lot of damage before the symptoms actually show up.

Am I correct to think that? And, if so, what evidence maybe supports that?

Dr. Warburton: The constraints of the box that I've described, they are self-imposed. So, if you like, they are self-denying ordinances, if you want to make that allusion.

In other words, it's not that we have lost the capacity to generate faster rates of inflation. It is that we have, if you like, tied our hands behind our back. Or, rather, we've tied the politicians' hands behind their backs. And we've put very strict limits around the mandates of our central banks in support of a stable inflation objective.

But, if there are more important things going on in politics and society, then those restrictions, which are man-made – they are artificial – they are, if you like, a response to the last inflationary cycle. They are a response to the high inflation of the 1970s.

But if we want to loosen those constraints, then we can. I think a lot of confusion has arisen because of the lack of inflation that has occurred in the context of large-scale QE.

I think it would take a long time, maybe, to unpack in detail why massive additions to central bank balance sheets were not inflationary. But I think there are some good reasons why they weren't. And we can understand with hindsight much more clearly what they were.

But it is a false assumption or a false progression of logic to say that we are now incapable of generating inflation. Essentially, we have the capacity, either by requiring commercial banks to buy loads more government bonds than they currently do or making more loans than they currently do, which obviously would require that we relax some of their capital adequacy constraints.

But these are all man-made things. We can make some different choices. And, arguably, if we wanted to accommodate some other spending priorities we would naturally undermine the framework that we have built.

In other words, other priorities would have precedence and we would subordinate inflation control and budgetary bonds.

Erik: Dr. Warburton, let's go a little bit deeper on inflation targeting and the history of inflation targeting.

What is the history of inflation targeting? What is the backstory here? And what can we expect next?

Dr. Warburton: I'm looking now at Slide 25 of the pack. I'm arguing that inflation targeting is

now probably outgrowing its usefulness. Inflation targeting only got going in the 1990s.

Arguably, New Zealand was the first country to adopt formal inflation targeting. And it kind of spread across developed economies such as Australia, and UK, and Sweden and so on. And, in time, dozens and dozens and dozens of countries have adopted inflation targets.

But we have to remember that these are all 1990s babies, and some of them are 2000s babies. This is not a long-standing institutional framework. It's something that we put together relatively recently.

And, as I said, inflation targets were there for a purpose. They were there to reinforce a commitment to low and stable inflation.

But we can ask now, what happens? We've got enough evidence of inflation target regimes operating in a wide variety of countries, including in Africa and Asia and Europe. What happens when the inflation target isn't allowing a necessary adjustment to take place?

We can see on Slide 26 we've had some recent departures. We had some big inflationary departures in, for example, Vietnam in 2008 and 2011. Since then, inflation has come back into range again.

We've had big departures over the years in Russia. Yes, Russia, if you believe it has an inflation target.

And, most recently, we've seen Turkey experience, obviously, massively higher inflation than was consistent with their 5% inflation target.

So to argue that, somehow, inflation targets are sufficient to establish permanent inflation control is nonsense.

Basically, if the decisions that have been made around the conduct of monetary policy – those are decisions about public spending, decisions about the openness of markets for example – inflation targets will just become a dead letter. The inflation rate will just depart significantly and semi-permanently from the target.

So my point is that we might not think that we can be put in the same category – in countries like the US and the UK – as Turkey, Vietnam, and Russia. But the principle still applies. If something more important needs to happen, inflation target is effectively disregarded, suspended, and so on.

What's really interesting, if you look at Slide 27, is we think, well, during the 1970s, that chaotic period, there were essentially no differences in the relative experience of those in the middle of the income distribution, the bottom of the income distribution, and the top of the income distribution.

We have to go to the 1980s and 1990s and the adoption of inflation targeting to find increasing disparity. So the whole issue of income inequality has arisen in the context of the policy box that we put in place to put inflation into the controlled policy framework, and budget to be balanced, and all of that.

So, if you like, we have created a fertile environment for dislocation of outcomes throughout society. And I'm arguing that, if you like, it is this protracted period of dislocated outcomes, that's what brings us to the point now.

And this is why the 2020 US presidential election is so significant. Because it is now a battle ground for extreme policy proposals. And the voice of fiscal conservatism, the voice of the balanced budget and spending within our means and all of that, that voice is barely heard.

Essentially, the constraints that are in place at the moment, and on which so much of asset allocation strategy is based, I think are looking increasingly fragile. And the adoption of different policies, either by an ongoing Trump administration or an incoming Democratic administration, I think are incompatible with this policy framework staying in place.

Erik: With regard to how quickly these things change, help us understand what the driving factors would be.

Let's suppose, for example, if I look politically at what's going on, the voices are very, very loud.

Especially, on the political left the viewpoint is, look, we've bailed out Wall Street for way too long, way too many times. It's time to bail out Main Street.

We need to institute universal basic income. We need to institute forgiveness of existing student loan debts. We need to institute federal programs to provide free college tuition. We need to do a long list of other things.

Nobody who's saying these things is offering the caveat: but I've also looked at Dr. Warburton's research and I have some concerns about the potential inflationary impacts. No one is saying that.

So is this a matter of when there is a change of political control. When there's, let's say, a Democratic administration in the White House or Democratic control of the Congress that might lead to a lot of spending programs that suddenly inflation expectations change overnight?

Or is this something that always has a lag effect where it's going to take a while before the effects are felt?

Dr. Warburton: It's difficult to know exactly over what time scale even what looks like a very

likely shift in policy behavior will occur.

But the whole nature of financial markets is to be forward looking. And it is the point at which investors begin to be unsettled on the horizon that they are used to investing and where they begin to see capital risks for which they require compensation.

Now, as I say, there is a battle going on between financial repression – and the most recent, I think, blatant example of that was the radical readjustment of the Federal Reserve's balance sheet management announced in March, which effectively turned us around from a \$360 billion injection of further securities into the market to a \$240 billion subtraction. And there was a \$600 billion per annum turnaround in behavior.

So, if you like, the Fed has doubled down on its repression and substantially changed the prospective balance in the Treasury market as a consequence.

But, clearly, that's a trick that it can only pull occasionally. And not to say – obviously, the Fed could revert to full-blown QE. And maybe this time it might buy a wider variety of assets.

I think many people from different points of view see the return of large-scale asset purchases as a very likely scenario.

So you could say, well, I want to hold on to my financial assets because the central bank is going to be backstopping capital values and therefore I feel secure in that assumption.

But, obviously, countries are going to change their policies at different times and in different degrees. I think there are going to be some very important judgments about the extent to which you really want to leave significant portions of your portfolio in a fixed-income market where policy is likely to change radically and quickly.

Erik: Something that's caught a lot of people's attention is the breakout through a very significant technical level in gold recently. And, normally, there is a very strong inverse correlation between the US dollar index and gold. And it seems like gold is suddenly outperforming the expectations that the value of the dollar would imply.

Is this potentially a sign of the market waking up to and recognizing that inflation is about to pick up?

Dr. Warburton: Not necessarily. I think obviously the ownership of gold is now quite diverse. I think it is no longer dominated by those who hold gold very specifically as an inflation hedge.

So I think the better way to understand this is if you correlate the value of negative-yielding government bonds (or total bonds) in the system with the gold price recently, you'll find you get a pretty similar curve. So you can say it is merely the subtraction of real yield. In other words, real yields going back down again to zero or below zero.

If you like, that is the propellant for the gold price in the most recent period. In other words, the opportunity cost of holding gold has gone down.

But the broader point I think that I would make here is – and this goes back to blowing up the box – is to say, if the whole idea of central banks being in some sense independent actors at the heart of the financial system aiming to control inflation, if that whole idea is obsolete, then, clearly, we might look to things like gold to be telling us that there is a general loss of confidence in central banking.

And one picture that I have is – it's a bit like Superman and kryptonite – basically gold price is a bit like kryptonite to central bankers. They like to feel that they have provided a stable financial system and that the yield that you get on inflation-protected government bonds is better in every respect to gold bullion that you have to pay to be stored and looked after.

But the reality is that, recently, gold has been outperforming inflation-protected bonds, which suggests that there is something more serious going on.

Erik: The last time that we went through quantitative easing and the market's reaction to it, there were widespread predictions that QE was going to unleash high inflation. Some people even went so far as to say hyperinflation. And of course many people would argue that that didn't happen as predicted.

I would say that the inflation occurred. It just happened in asset markets rather than in the broader economy.

What are the things that we need to watch for? Obviously, if we're looking at forgiveness of student loans and free college tuition, that's completely different than buying bonds to suppress interest rates.

What are the things that are most likely to unleash consumer price inflation in the broader economy? And how might the next experience with QE differ from previous ones?

Dr. Warburton: The way in which we might expect to see inflation return in the first instance might very well be through food and commodity prices. A lot of the work that we do on inflation is to try and integrate what's happening on the supply side, on the producer side of the goods and services market.

And I think the environment that we're heading into is a tough one for producers. I think that there are going to be all kinds of challenges to the continuity of supply. I think that diminished competition obviously is putting us more at risk of deliberate constriction of supply, of food and commodities and natural resources.

I think one avenue that we could expect to see inflation surprise might, again, very well be food

price inflation. Potentially, perhaps, another spike in crude oil prices. But also copper, iron ore – again, some of these key industrial metals could also surprise to the upside.

Erik: Dr. Warburton, as we discuss the potential of coming inflation, one of the prognostications that I've seen from some very smart people is they're saying, hey, what's coming is 1970s or worse stagflation – stagnant economic conditions where we don't really see growth in the economy but we still have price inflation anyway.

Is the recipe set to deliver that kind of outcome?

Dr. Warburton: I think that's a risk that we should take much more seriously. I'd be ready to agree that we are probably late-cycle in terms of global activity indicators.

But I think what's fascinating about the latest batch of data, which we analyzed in some detail, is that the by numbers of countries that have a higher inflation rate – that is measured in terms of their GDP, their national accounts – higher inflation rate of a year ago significantly outnumbers those with a lower inflation rate.

And, at the same time, the number of those with a lower growth rate, a lower real GDP growth rate, significantly outnumbers those with a higher GDP growth rate of a year ago.

So, if you like, the twist in terms of numbers of countries is very clearly towards a more stagflationary outcome.

We've always sought to keep the activity and the inflation narrative separate. And, I think, for good reason, because all four combinations are regularly recorded in economic history.

So what it means, I think, in the broader analysis, is that at the moment you might say that computer services, and electronics, and aerospace and defense, might be quite favored sectors for the environment that is today. But we're moving into an environment where we should expect to see food producers, maybe pharmaceuticals, health care, beverages, those kinds of sectors to gain more pricing power. And to obviously to be able to increase their margins. And presumably record higher investor returns.

It's still early days. But I think there's indications of the next twist will be in a stagflationary direction.

Erik: Well, Dr. Warburton, this has been a fascinating interview for me. Something I've said for 10 years now is I'm not smart enough to know when inflation is coming. But I predict it's going to be the return of inflation that really is going to bring about some difficult times for the economy.

In any event, you are the Chief Economist for Economic Perspectives Limited. For our institutional audience who may be interested in following your work or learning more about

Economic Perspectives, how can people contact you and follow your work?

Dr. Warburton: You can find us at our website www.EconomicPerspectives.co.uk. And you can [find me on LinkedIn](#) or, indeed, [Economic Perspectives is on LinkedIn](#). Or shoot us an email at info@economicperspectives.co.uk. We'd be delighted to engage with you and share some sample research.

Erik: Fantastic. Well, thanks so much for a fantastic interview. Patrick Ceresna and I will be back as MacroVoices continues, right here at macrovoices.com.