

The return of the big bad inflation?



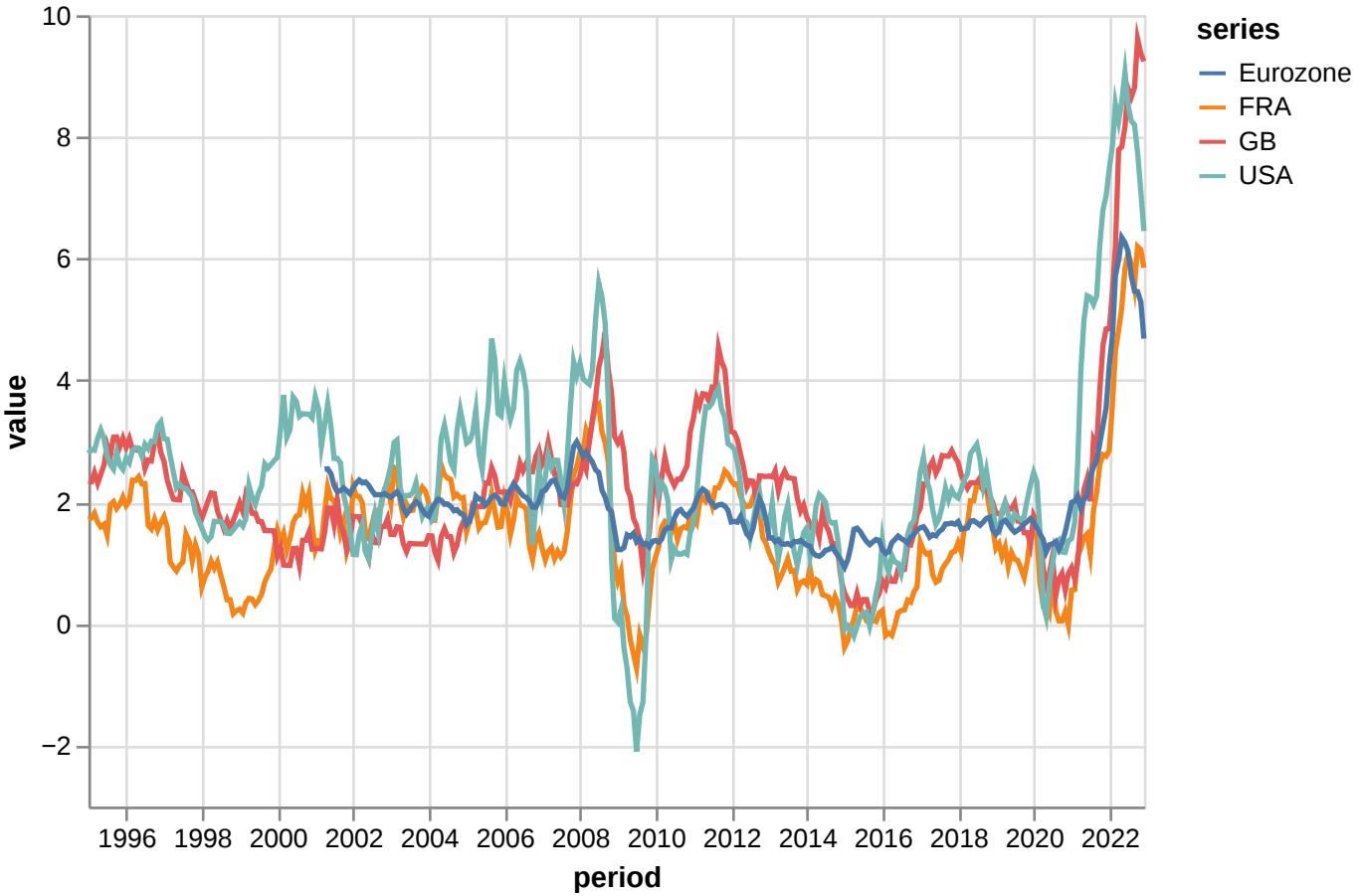
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i Plan

- Is inflation coming back? [Section 1](#)
- What is the cost of inflation? [Section 2](#)
- Where does it comes from? [Section 3](#)
- Will it last? [Section 4](#)

Is Inflation Coming back?

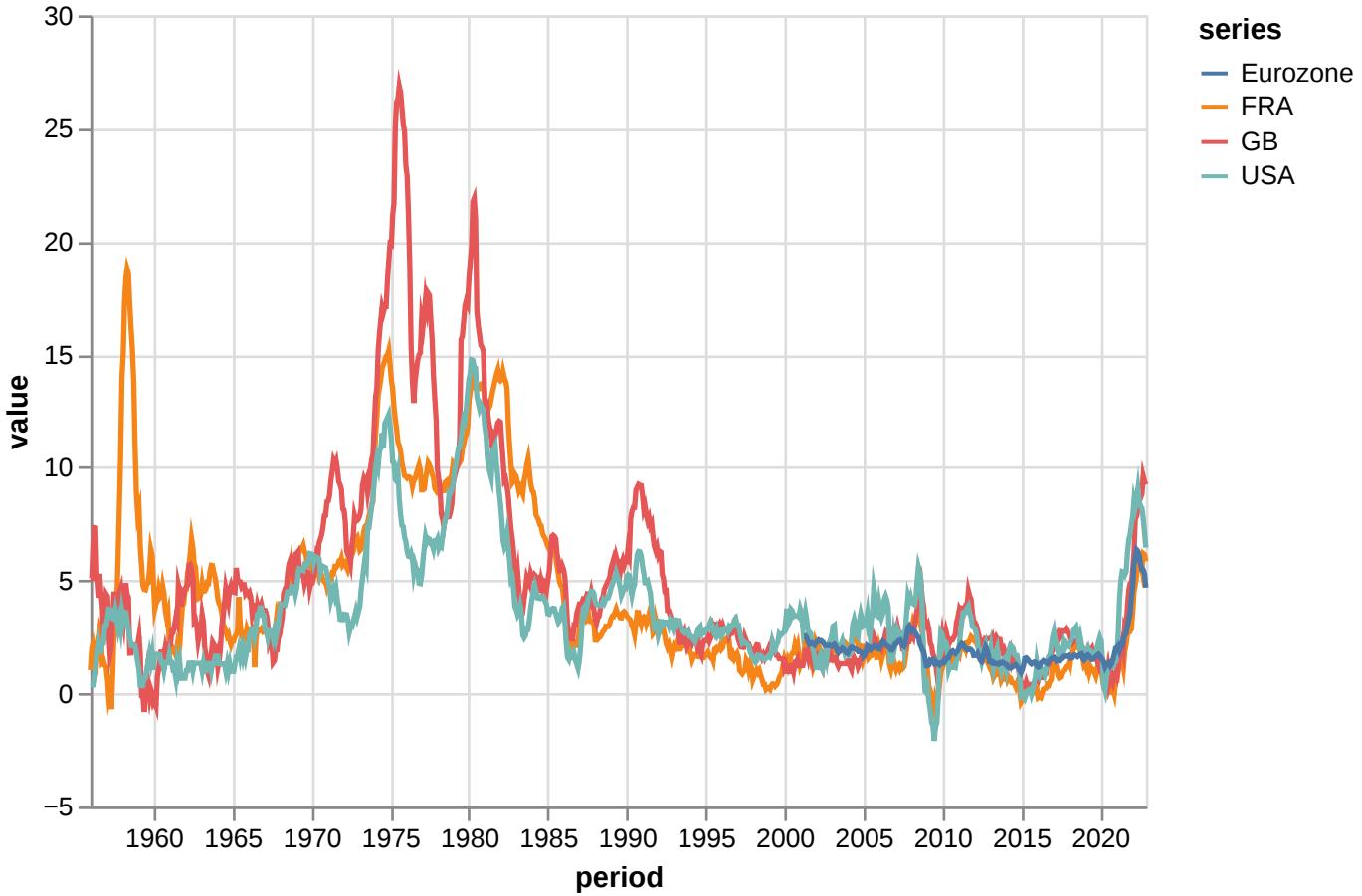
Inflation



CPI Inflation (Source IMF)

- Inflation rates are currently very high
- At levels never seen by European Central Bank, since its creation in 1998

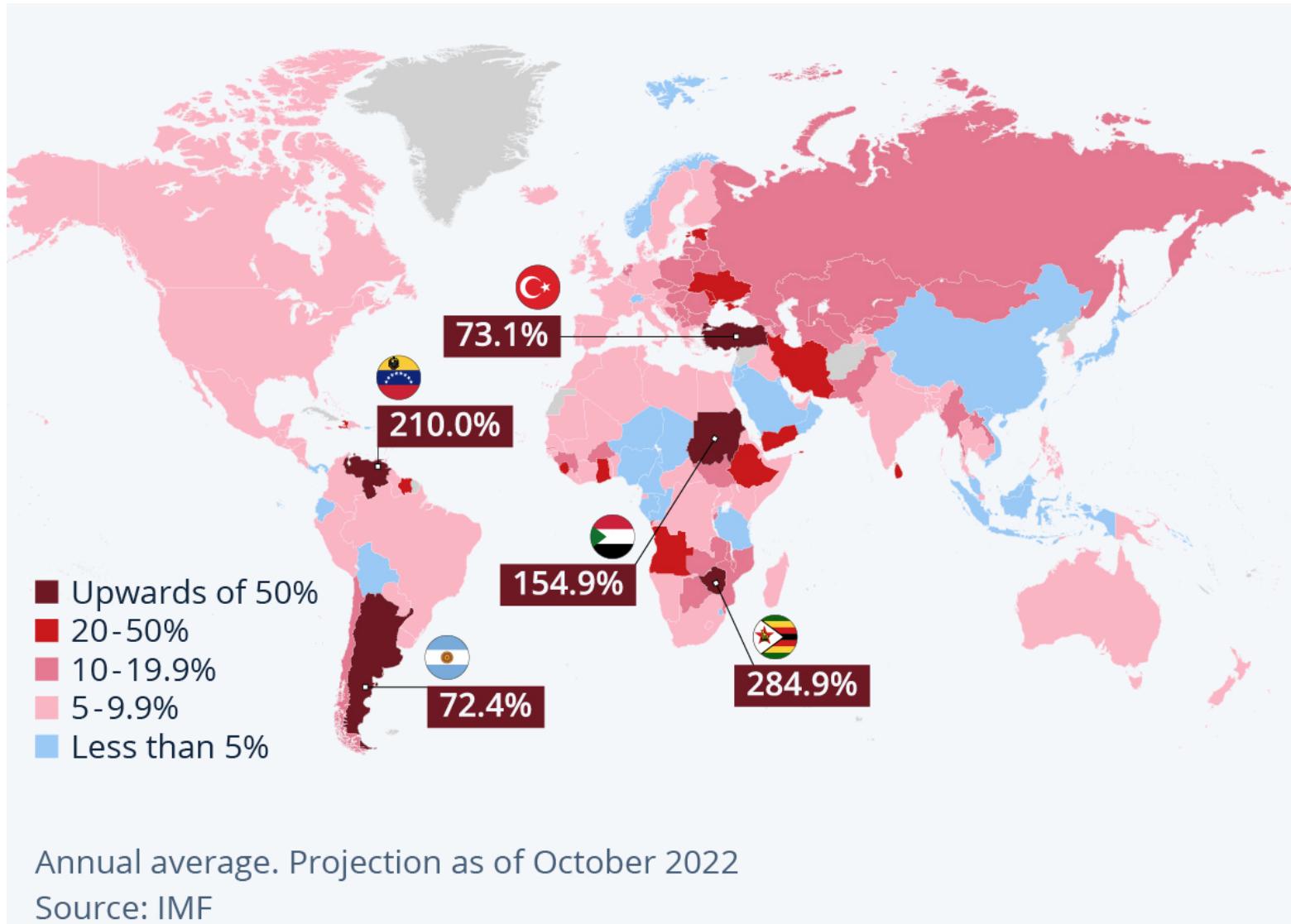
Inflation



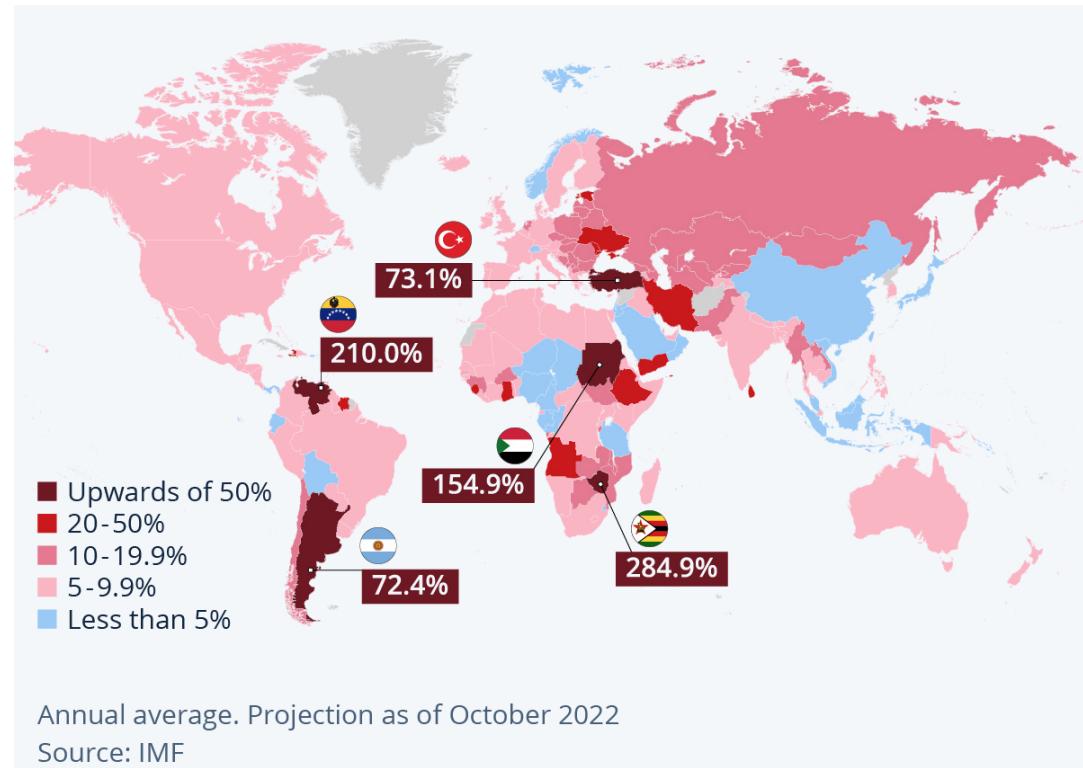
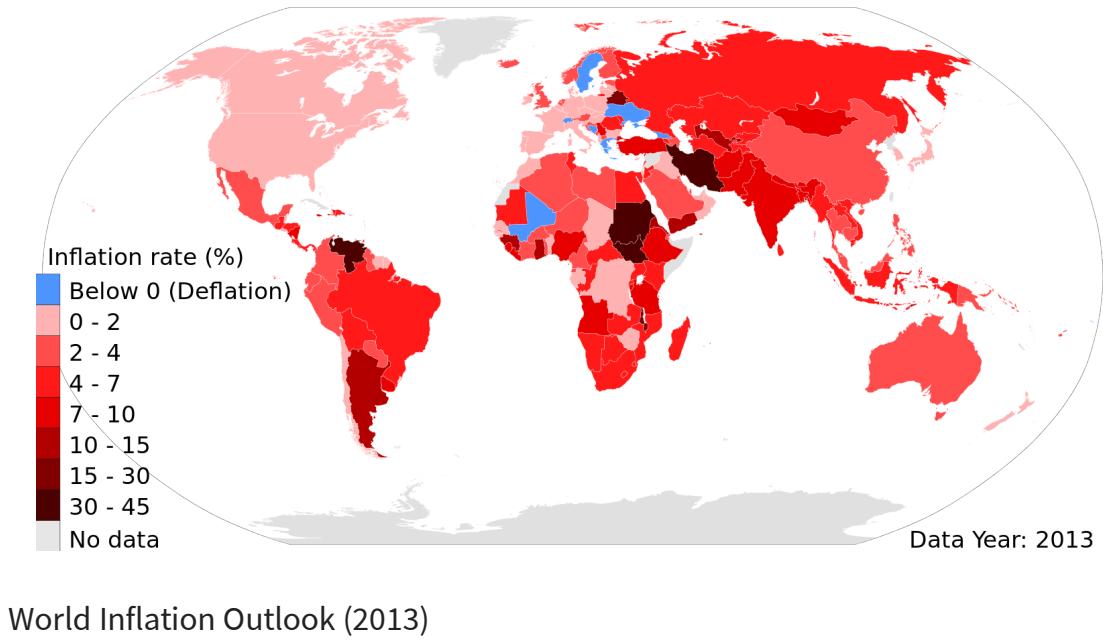
CPI Inflation (Source IMF)

- There were even higher levels in the 70s (and 50s in France)
- All economists / policymakers remember this period

Emerging / Developed Markets



Emerging / Developed Markets



- Inflation has never disappeared from the world
- The problem is quite different in developed and emerging countries¹

1. Among issues that are specific to developing countries: institutions credibility, exchange rate vulnerabilities...

Why should we fear inflation?

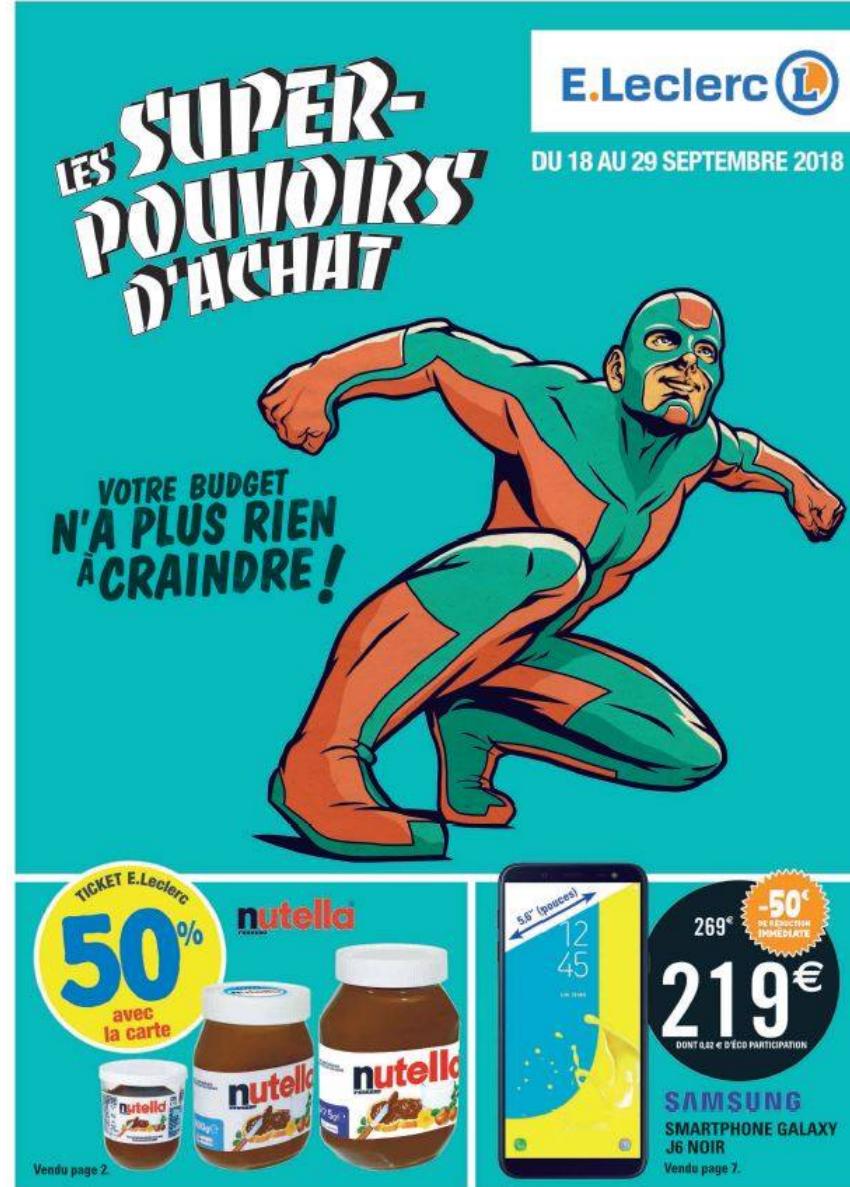


Keynesian Dog. (Dall E-2)



Ricardian Cat. (Dall E-2)

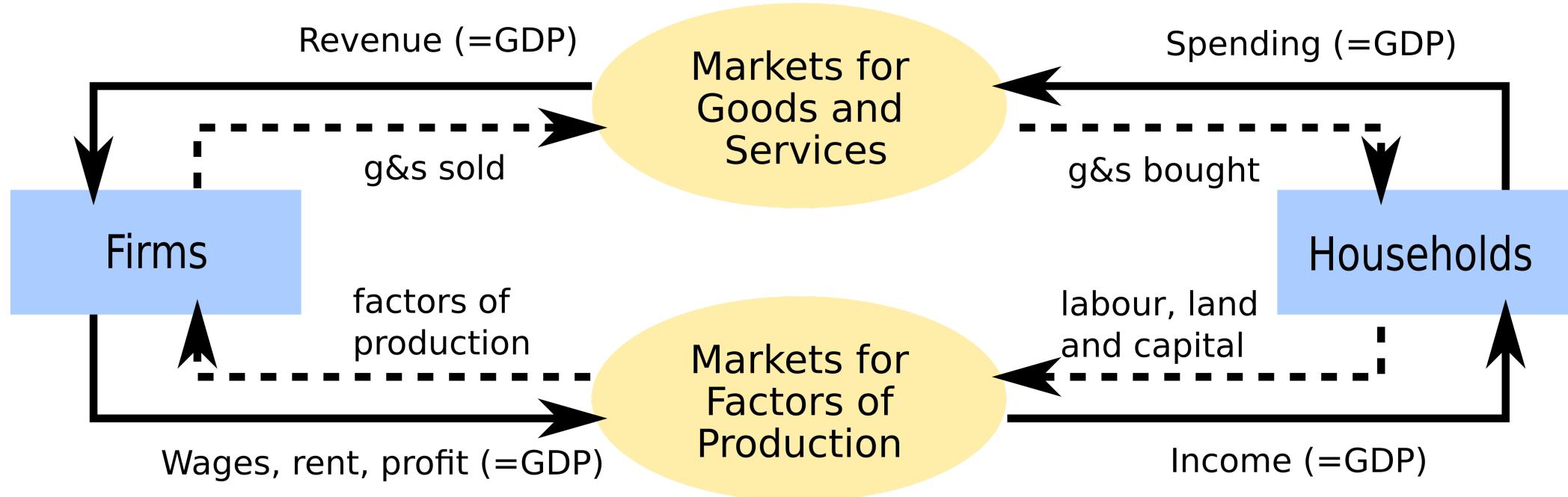
- increase in cost of living
- wasted savings
- excessive inflation / hyperinflation
- deflation
- uncertainty



Publicité Leclerc

Cost of Living

The Money Illusion



The Circle Flow Diagram

- By definition: total real income equals total revenue
- As long as GDP grows there is *no aggregate loss in purchasing power*
- The consensus to increase purchasing power is a fool's game
- ... But some categories (workers, bottom earners...) can loose more

Redistributive Effects of Inflation

Inflation has *redistributive* effects through different channels¹:

- consumption channel
- wealth redistribution channel
- renegotiation channel

1. Data comes from *Inflation and Inequality* by Xavier Jaravel and *The costs of being poor: inflation inequality leads to three million more people in poverty 2022*, by Wimer Collyer and Jaravel.

Redistributive Effects of Inflation: the consumption channel



- Not everybody consumes the same consumption goods¹
- The consumption basket depends on income
- Inflation hits some goods more than others
- And affects some households more than others
- Which ones?

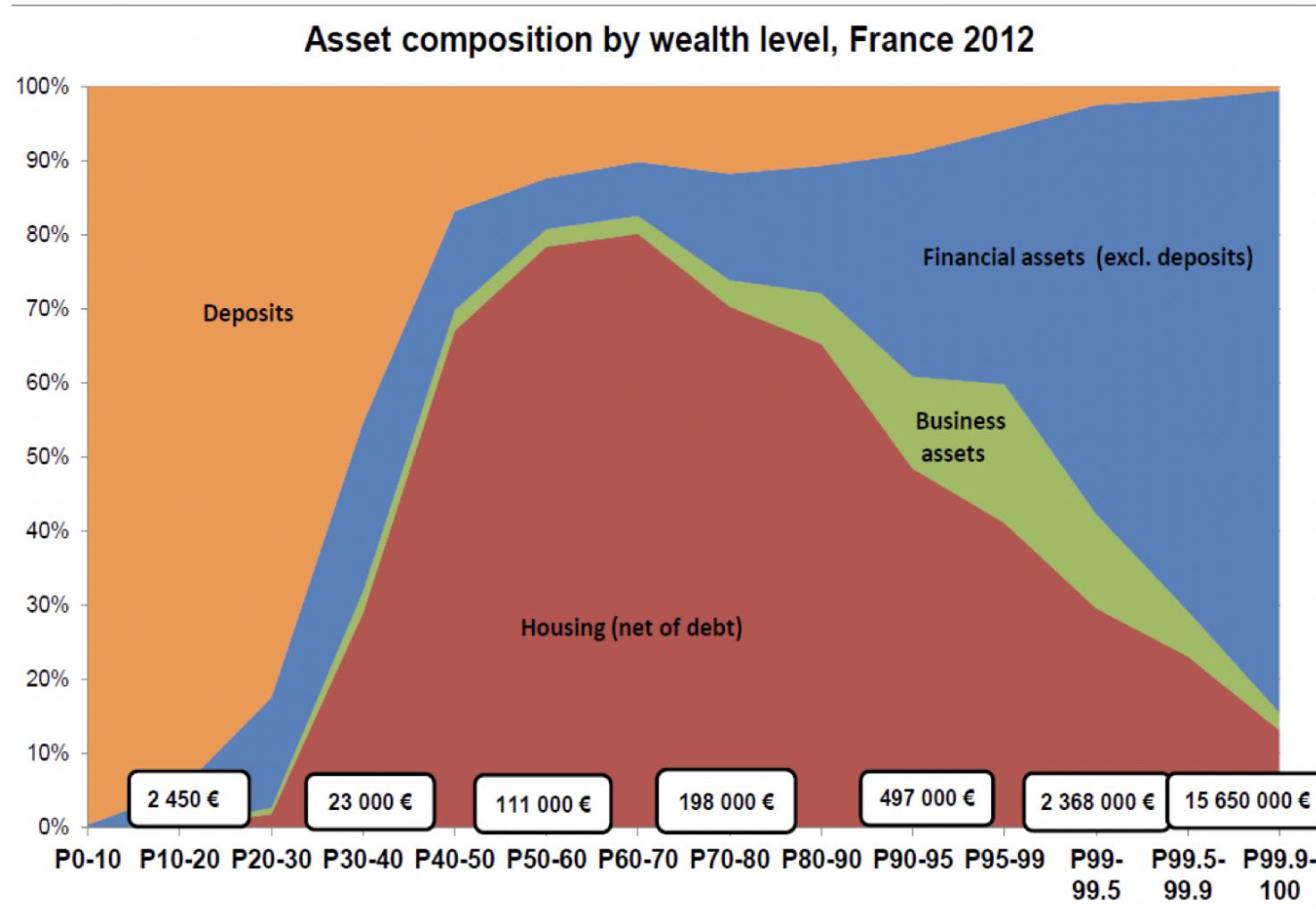
1. using economists' jargon, we say that consumption preferences are nonhomogenous (or not scale invariant)

Consumption Inequality in the United States

- In the last 20 years, the bottom earners had the lowest growth in real income. This is even clearer when incorporating inflation inequality.

Redistributive Effects of Inflation

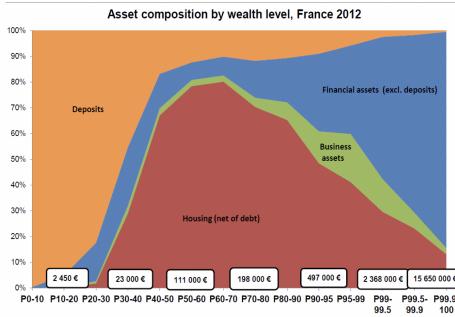
Savers and Borrowers



Composition of Assets across the Wealth Distribution

Redistributive Effects of Inflation

Savers and Borrowers



Composition of Assets across the Wealth Distribution

- In general inflation benefits borrowers rather than savers
 - but this depends on how assets/liabilities are indexed to inflation
- Recently, a lot of attention in the literature¹ has been devoted to “Wealty Hand to Mouth”: wealthy household, with low available income because their wealth is illiquid. They are very exposed to changes in their cost of living.

1. Seminal paper: *Monetary Policy According to HANK*, 2018, by Kaplan, Moll, Violante

Redistributive Effects of Inflation: between different agents in the economy



Olivier Blanchard
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...

1/8. A point which is often lost in discussions of inflation and central bank policy. Inflation is fundamentally the outcome of the distributional conflict, between firms, workers, and taxpayers. It stops only when the various players are forced to accept the outcome.

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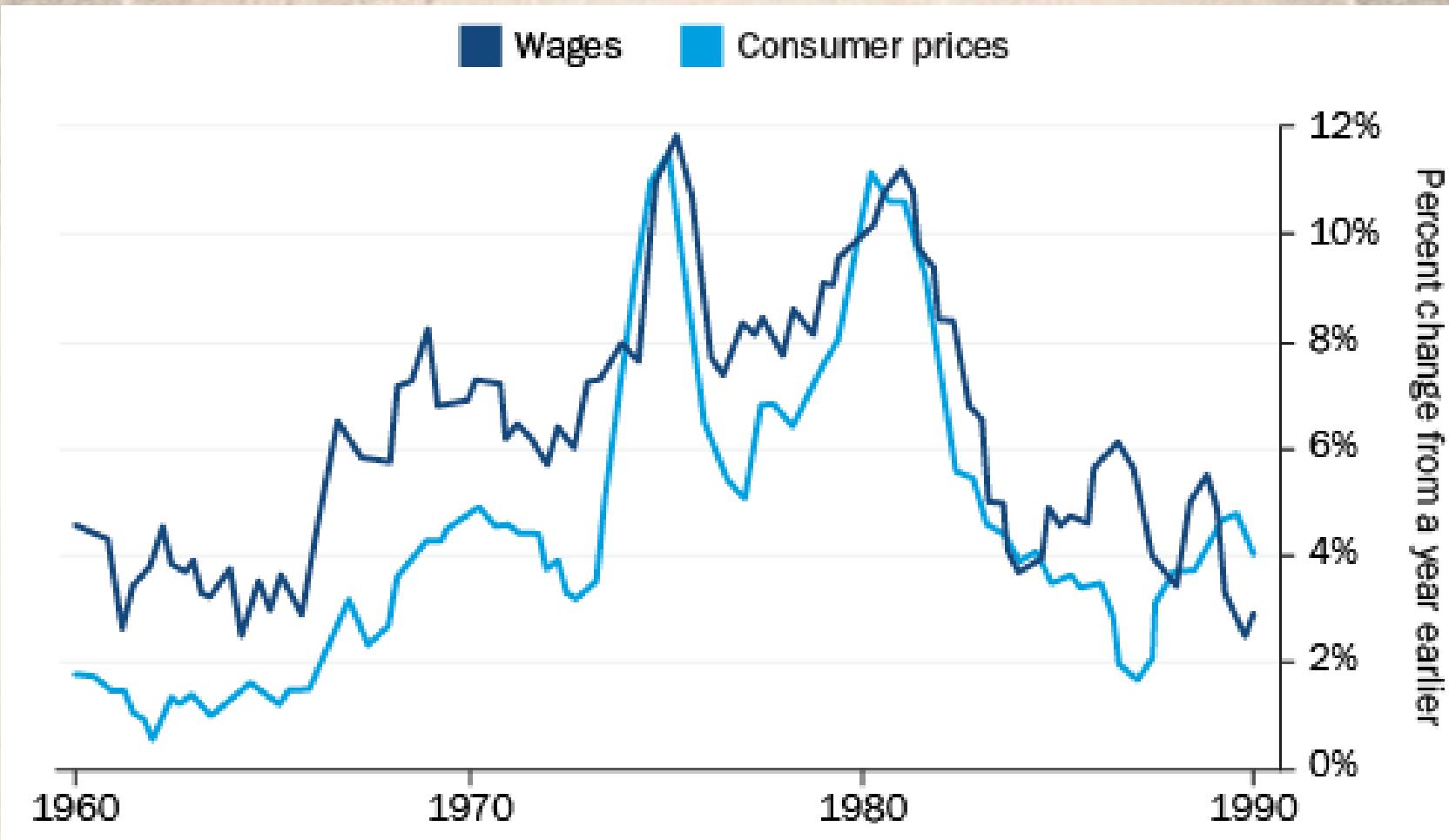
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... To understand the context, we need to go back in history.

Wages and salary

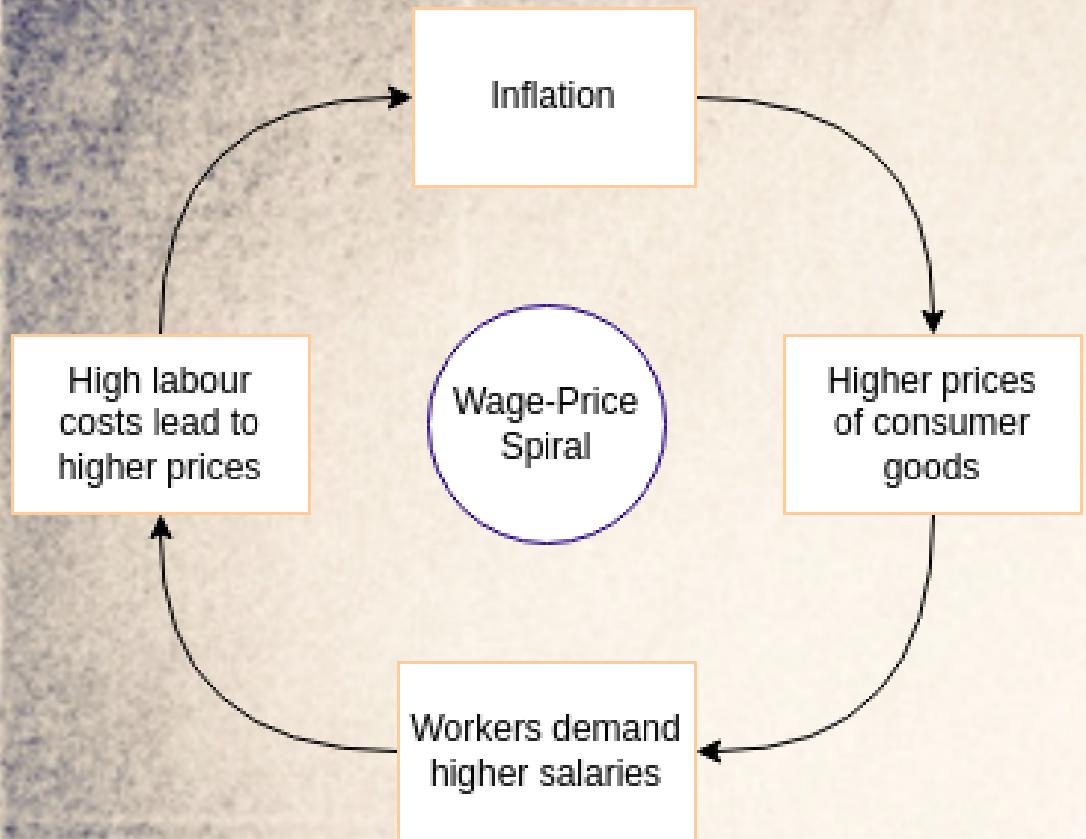


Growth in wage rates and consumer prices, US

There is a clear correlation between cost of living and salary.

In the 60s and 70s price inflation and wage inflation were *accelerating* together.

The inflation spiral



It lead economists to believe there was a wage-price inflation spiral...

- prices increase
- ⇒ workers demand higher wages
- ⇒ production costs increase
- ⇒ prices increase,

The inflation spiral



Reagan against the inflation spiral

On the bright side: it has demonstrated a central bank can get rid of inflation

On the dark side: who wants to engineer a recession???

...And advocate policy measures to limit inflation

- Nixon: 1970, price-freeze on wage and prices
- to no avail

This inflation stopped with the Volcker plan

- Fed raised interest rates from 11% to 20% !
- inflation was brought under control at the cost of a deep recession in 1982/1983

The inflation spiral



The wage-price inflation spiral as a painting in the style of Andy Warhol. Dall-E 2

But the nexus wage / price still remains relevant:

- more inflation triggers more wage / price negotiation...
- ... and has the potential to redistribute purchasing power between firms, consumers, workers

Nowadays out of control wage-price spirals are believed to be unlikely events

- agents correctly anticipate future inflation
- incorporate these expectations into wage- and price-setting
- when all markets are in equilibrium, inflation returns towards equilibrium

Summary

Covid19 was both

- a demand shock
- a supply shock

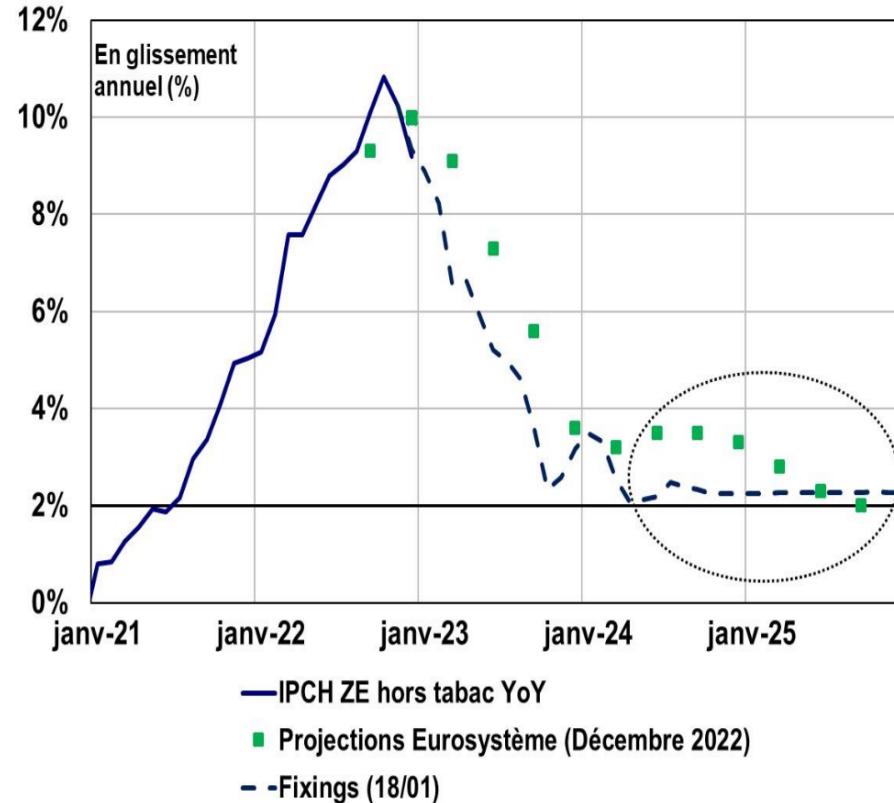
which offsetted each other.

After covid and Ukraine's

- demand recovered fully
- but there are persistent supply shocks
 - labour market shortages
 - increased cost of energy
 - disorganization of supply chain

All these effects add up

- to create inflationary pressures



The Market bets on future inflation using swaps. The price of these swaps provide an implicit probability estimate of the market.

- The Market expects inflation to decrease and back to its target in the middle of 2024
- It also expects central bank not to raise interest rates after mid 23