Why inflation is low and central banks are confused and what can be done about it.

For central banks the world over, inflation is too low, apparently. Continued efforts to reflate economies have led to some growth and employment but have not had much impact on inflation. As asset markets make new highs and valuations get more stretched, labour markets become tighter and growth stabilizes, central banks are at a loss as to why their policies have not created more inflation. Despite highly accommodative policies we continue to see weak consumer price inflation and weak wage growth.

One distinction that perhaps blunts measurement is that there are various strata of society and each has their own consumption patterns and thus price baskets. From 1982 – 2016, the Forbes Cost of Living Extremely Well Index (CLEWI), has risen at 5% per annum compared with the CPI which rose at 3% per annum. A 2% gap over 35 years adds up. Manhattan luxury housing has risen at a pace of over 6% p.a. over the last 10 years compared with 0% for the Case Shiller 20 City Composite Index. Coutts Luxury Price Index rose 6% YOY compared with a UK CPI of 2% and in China, the Hurun Luxury Price Index rose at 3.6% July YOY compared with a CPI of 1.4%.

Aggregate CPI numbers are blunted by acute inequality. The CPI basket is weighted towards goods which for the rich are at saturation and for the poor are facing low demand. The economy relevant to the rich is vibrant, healthy and inflationary. For the poor, stagnant wages and a shrinking share output and income cap demand.

Central bank efforts have not targeted the right areas, which are employment and real output. By focusing on asset solutions and funding costs, regulators have enriched those with outsized access to credit and high exposure to investments in assets. By suppressing the USD yield curve, the Fed supports higher valuations for equities and credit which are generally owned by higher income and more wealthy people. This section of society, being wealthier, save a greater proportion of incremental wealth so that the wealth creation fails to trickle down and the velocity of money falls, limiting the transmission towards higher inflation.

Low interest rates also alter the labour to capital mix by distorting prices. Low interest rates and easy access to credit encourages investment in fixed capital relative to labour. A firm can borrow to fund wages but it the cheaper credit becomes the cheaper it is to invest in fixed capital that can be depreciated aggressively increasing the returns on investment in future time periods. Put simply, a firm can own fixed capital but it can only rent labour. When rates are low, it makes sense to own your factors of production rather than rent them. Low rates skew the labour capital mix and suppress wages.

Another effect is that as QE was undertaken, inflation expectations were raised. Conventional economics indicates that rate cuts and monetary expansion lead to higher inflation. This did not happen. Instead inflation was low and assets rose. The inflation to money supply relationship is not precise and since there is a vector of goods and prices, it is not clear in which goods markets the inflation will take place in. If there is excess capacity in a particular market, even if demand manifests there, output may rise to compensate for any inflationary pressure and prices might even fall, theoretically. To complicate matters, for all practical intents and purposes, this vector of markets into which money could flow includes not only goods and services but assets as well. If inflation expectations were being driven up the response could have been to consume in the current period or to buy claims on future production, in other words, equities or high yielding credit.

Policy needs to look not only at aggregates but also at the structure of an economy. A country has to decide if its policy is there to serve the many or the few, the rich or the poor. And while the right answer is obvious so is the outcome. Even assuming away cynical behaviour, any policy that favours the poor against the rich, in relative or absolute terms, will likely encourage tax or regulatory arbitrage. An internationally coordinated solution is needed to ensure that if tax advantages are sought then they are the result of true immigration. This is difficult but adoption of Common Reporting Standards, for example, are a step in the right direction.

An internationally coordinated tax system would either require convergence of tax rates, or will encourage physical or true immigration, sometimes to the detriment of the source country. Tax convergence is unreasonable given the needs of individual countries. A tiered global, national, state tax system might be a solution but the coordination it would require to design let alone implement is still far away.

Tax funded transfers are only one way of addressing inequality, not just of wealth but of impact on the economy. A better understanding of how interest rates impact the economy at the micro level will also make for better central bank policy. Current efficacy of policy has been questioned not just by the public but by central banks themselves. To carry on a policy when its impact is not well understood is inadvisable.

The distortionary impact of interest rate policy on business planning could advise a tax code that applied a policy-externality-weighted expense system to calculate tax credits to compensate. To encourage a reduction in youth unemployment, a company hiring under 25’s could deduct more than 100% of their wage costs when calculating their taxable income, for example. Such a system of weighted expense tax deductibility could be used to fine tune behaviour to achieve policy goals.

Compensatory training and skills upgrading could be provided and tax-funded to lower wealth and income people to reduce the skills gap and narrow the potential wealth trajectory.

Real estate taxes can also narrow the wealth gap as real estate is a significant store of wealth. Real estate should be a resource or used for dwelling and not investment. Supernormal profits should be taxed and used to fund the less wealthy.

The purpose of these apparently socialist and redistributive policies is not to pursue a social agenda but to address a fundamental inadequacy of policy. Its aims are to increase development, growth and employment for the majority of the population and not an aggregate that is highly skewed because of acute inequality. It is hoped that by rethinking and redesigning policy, the interests of the many are served over the interests of the few.