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Inflation phobia accelerates recessions and debt crises

Sources: IPS [Image: IMF]

The fear of inflation as a totem of solutions to the current economic crisis, fuel recession and inequality.

SYDNEY/KUALA LUMPUR – Central bank inflation phobia is dragging economies into recession and debt crises. Their dogmatic beliefs prevent them from doing the right thing. Instead, the United States follows the directions: its Federal Reserve, the Treasury Department along with the multilateral institutions emanating from Bretton Woods.

Costly recessions

These multilateral institutions - the International Monetary Fund (IMF) and the World Bank - have sounded the alarm about the likely dire consequences of policies focused on lowering inflation and the ensuing race to economic contraction.

But their dogmas prevent them from being pragmatic. Hence, their political analyses and advice are incoherent and even contradictory.

Ominously, the World Bank has warned that the world economy is currently in its greatest slowdown after the post-recession recovery of the 70s. "As central banks around the world simultaneously raise interest rates in response to inflation, the world may be approaching a global recession in 2023," he says.

Warning that rising interest rates will impact the economy, the IMF has urged countries to buckle up, acknowledging that anti-inflationary measures threaten the recovery.

For hundreds of millions of people it will feel like a recession, even if the global economy avoids two consecutive quarters of gross domestic product (GDP) contraction, which is when the recession becomes official.

He also noted that interest rate hikes by the Federal Reserve (FED), the U.S. central bank, have strengthened the dollar, raising import costs and making it more expensive to service dollar debt.

But the IMF continues to recite the mantra that "if inflation is controlled, then we can see a foundation for growth and recovery."

This contradicts all the evidence that low inflation comes at the expense of solid growth. Both output per person and productivity growth fell during three decades of low inflation. Moreover, low inflation has not prevented financial crises.

Even if growth recovers, the scars of recession remain.

For example, according to an IMF study, the Great Recession of 2007-2009 has left deep wounds. More than 200 million people are unemployed worldwide, more than 30 million more than in 2007.

A 2018 San Francisco Fed study assessed that the Great Recession cost Americans about $70,000 per capita.

The Harvard Business Review estimated that, between 2008 and 2010, the crisis "cost the U.S. government more than two trillion dollars, more than double the cost of the 17-year war in Afghanistan."

Accounting for costs

"The human and social costs are more far-reaching than the immediate temporary loss of income." These effects are usually much greater for the most vulnerable, for example, young people and the long-term unemployed, the publication said.

Different studies have documented its harmful effects on well-being, in particular mental health due to the impact of inflation-lowering policies.

Recessions in Europe and North America led to more than 10,000 suicides, increased drug abuse and other self-injurious behaviors. Adverse socio-economic and health impacts are worse in developing countries with poor social protection.

Interest rate hikes during the period 1979-1982 led to debt crises in more than 40 countries of the developing South.

The global recession of 1982 coincided with the second lowest growth rate of developing economies in the last five decades, second only to that of 2020. A decade of lost growth in many developing economies followed.

But World Bank research shows that interest rate hikes may not be enough to bring global inflation back down.

The institution even warns that major central banks' anti-inflationary measures can trigger a series of financial crises in emerging markets and developing economies, causing them lasting damage.

The external debt of developing country Governments, which is increasingly commercial, costly and repayable, has soared since the global financial crisis of 2008-2009. The pandemic has caused more debt to become unsustainable, as rich countries oppose significant relief.

No political consensus

The World Bank correctly points out that a slowdown usually requires countercyclical policy to support activity. It recognizes that the threat of inflation and limited fiscal space are prompting policymakers in many countries to withdraw supportive policies, even as the global economy slows sharply.

It also suggests that policymakers could move from reducing consumption to boosting output to generate additional investment and improve productivity and capital allocation, which are critical for growth and poverty reduction.

However, it does not offer many political guidelines, apart from the usual and irrelevant topics, for example, that central banks must communicate their policy decisions clearly, while safeguarding their independence.

It even blames the limitations of the labor market. For decades, the World Bank promoted measures to encourage labor market flexibility, ostensibly to increase participation rates, lower prices, through wages, and rehire displaced workers.

Since the 80s, these policies have accelerated productivity growth and the decline in the real incomes of the majority. They have reduced the share of labour in national income, increasing inequality.

To make matters worse, the World Bank deceptively attributes many of the policy-induced economic problems to high inflation.

In May, the IMF argued that there was no need to reduce intervention in employment and wages to avoid inflation. He called for vigilance from each central bank and forceful action against inflation, which he believes will remain significantly above the targets set for a while.

The Washington Consensus is over

In June, an IMF policy note advised that the full transfer of rising international fuel prices to domestic users be allowed. He advised recognizing the causes of the supply shocks of contemporary inflation and protecting the most vulnerable.

However, the Fund's most alarmist officials urge the opposite. In July, its chief economist urged that the top priority be to return inflation to central bank targets, which generally stand at 2%.

While acknowledging that tightening monetary policy will inevitably have a real economic cost, without any proof, he insisted that delaying it will only exacerbate the difficulties.

In August, the head of the Bank for International Settlements (BIS) urged shifting attention from demand management to supply management. He warned that central bankers had assumed for too long that supply automatically and smoothly adjusted to changes in demand.

He warned that continuing to rely primarily on the tools of aggregate demand, i.e. interest rates, to boost growth in this environment could increase the danger, as higher inflation could occur and more difficult to control.

However, the BIS's chief economist was quick to urge major economies to press ahead with steep interest rate hikes despite growing threats of recession. He didn't seem to care that the bet on raising the price of money to fight inflation might not work and that its costs might be astronomical.

Fear of inflation

Influential economists at the Federal Reserve, the Bank of England, the IMF and the BIS fear the spillover effects of inflation, mainly the supply shock, due to price and wage spirals.

However, IMF research acknowledged the paucity of empirical studies on the effects of oil price shocks on wages and the factors that affect their intensity.

The research concluded that the likelihood of these transmission effects occurring is very low due to major changes in the labor market, such as the drastic decline in unionization and collective bargaining.

The report notes that transmission is almost zero in the period 1980-1999 and that the effects are negligible in the period 2000-2019, before concluding that, in general terms, transmission has decreased over time in Europe. Other authors have come to similar conclusions.

Another investigation, from the Reserve Bank of Australia (RBA), found that the current episode has many differences from that of the 70s, when a spiral of increases in wages and prices emerged.

He concluded that there are a number of factors preventing a similar spiral from emerging now, implying that the overall risk in most advanced economies is probably quite low.

Australian professor Ross Garnaut has suggested that "the specter of a virulent spiral of prices and wages comes from our memories and not from current conditions." Regrettably, despite all the evidence, including their own, the IMF and RBA continue to call for strong action against inflation.

You can read the English version of this article here.

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