
Some Lessons from The Great Inflation and Disinflation

Peter Hooper
Chief Economist
Deutsche Bank Securities
Peter.hooper@db.com
1 212 250-7352

Torsten Slok
Senior Economist
Deutsche Bank Securities
Torsten.slok@db.com
1 212 250-2155

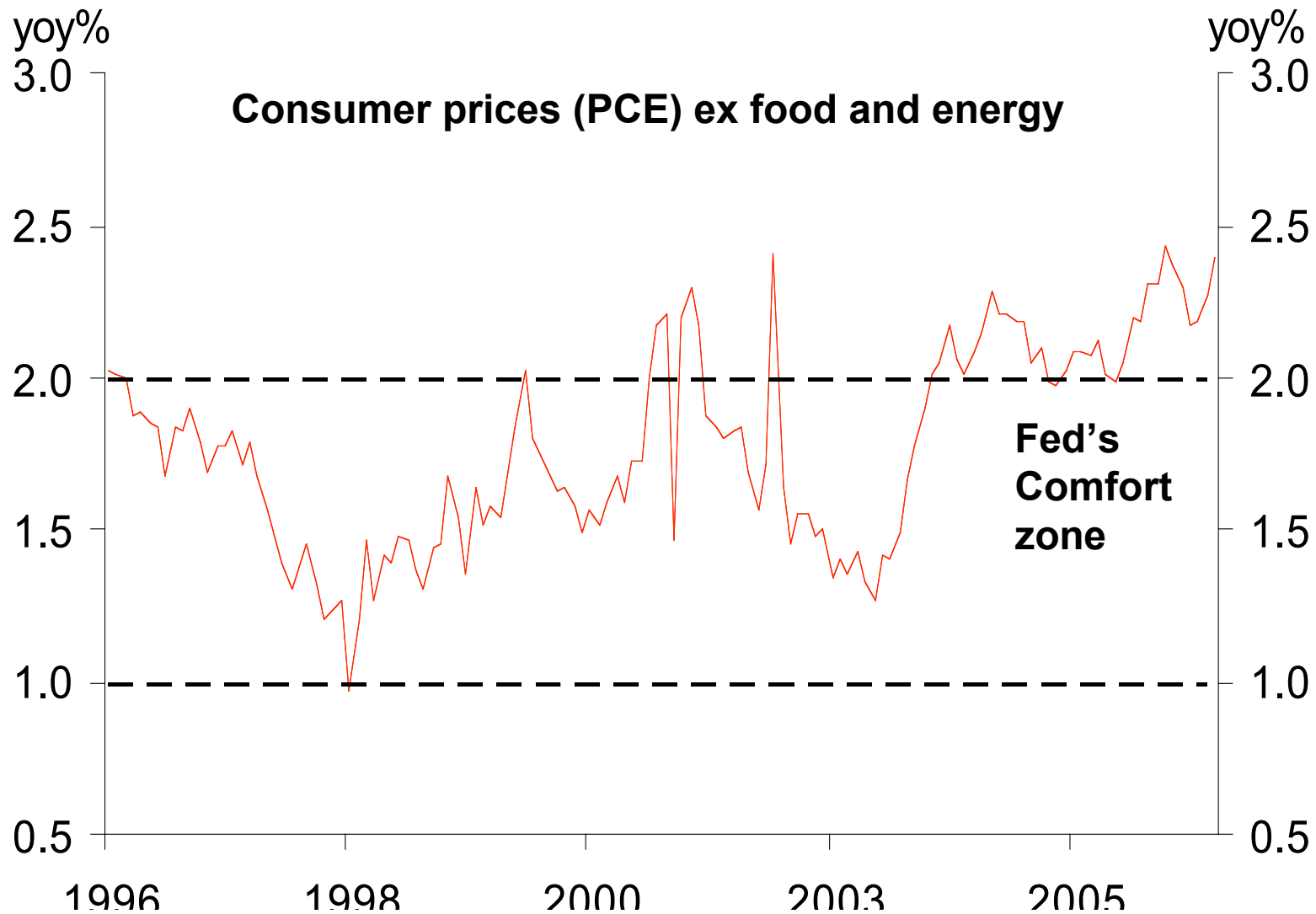


A Passion to Perform.

Outline

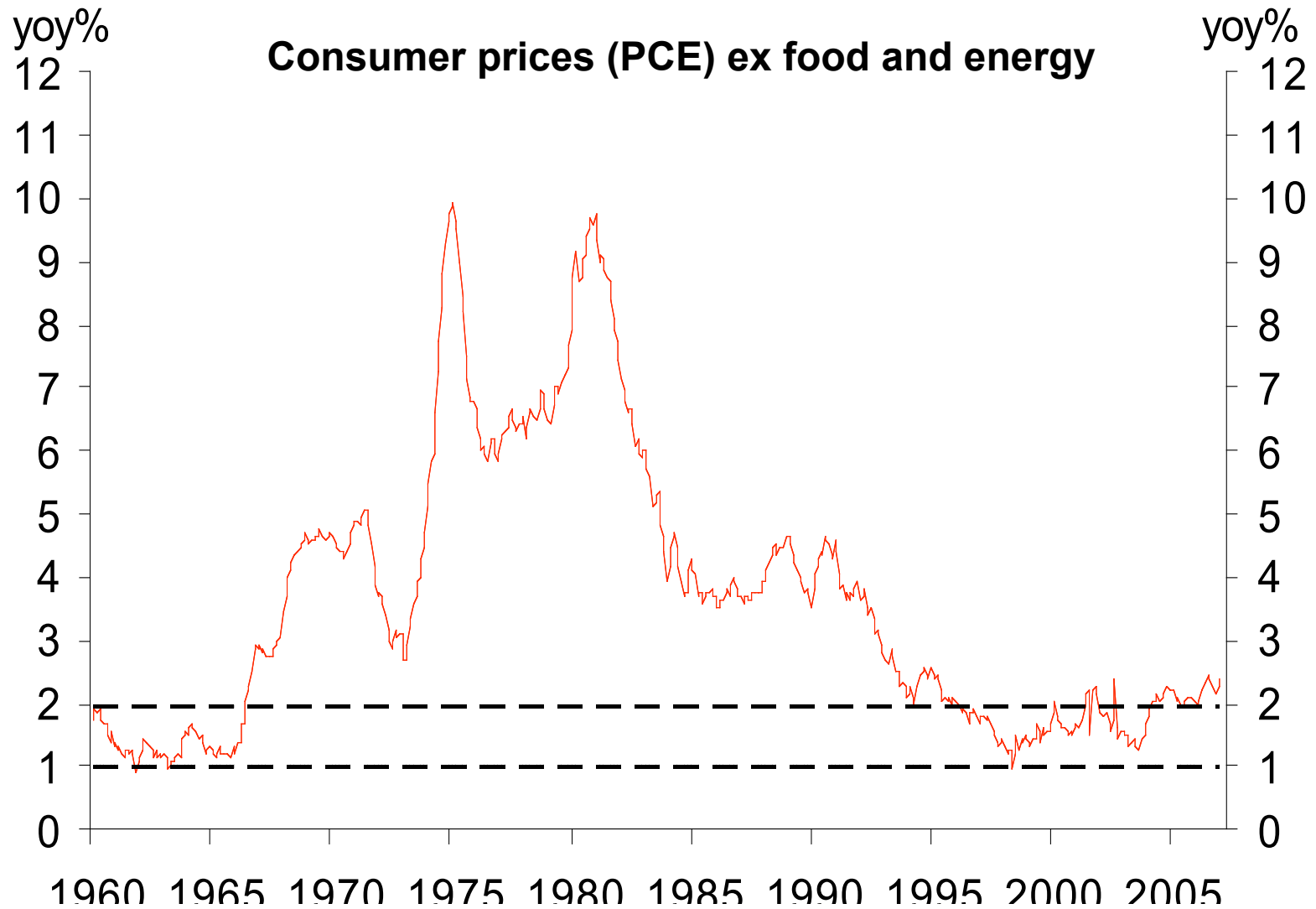
- **Quantifying trends and volatilities of inflation.**
- **Implications of inflation stabilization.**
- **Causes of the great inflation and disinflation.**
- **Could it happen again, and if so, why?**

Inflation a little high for comfort recently

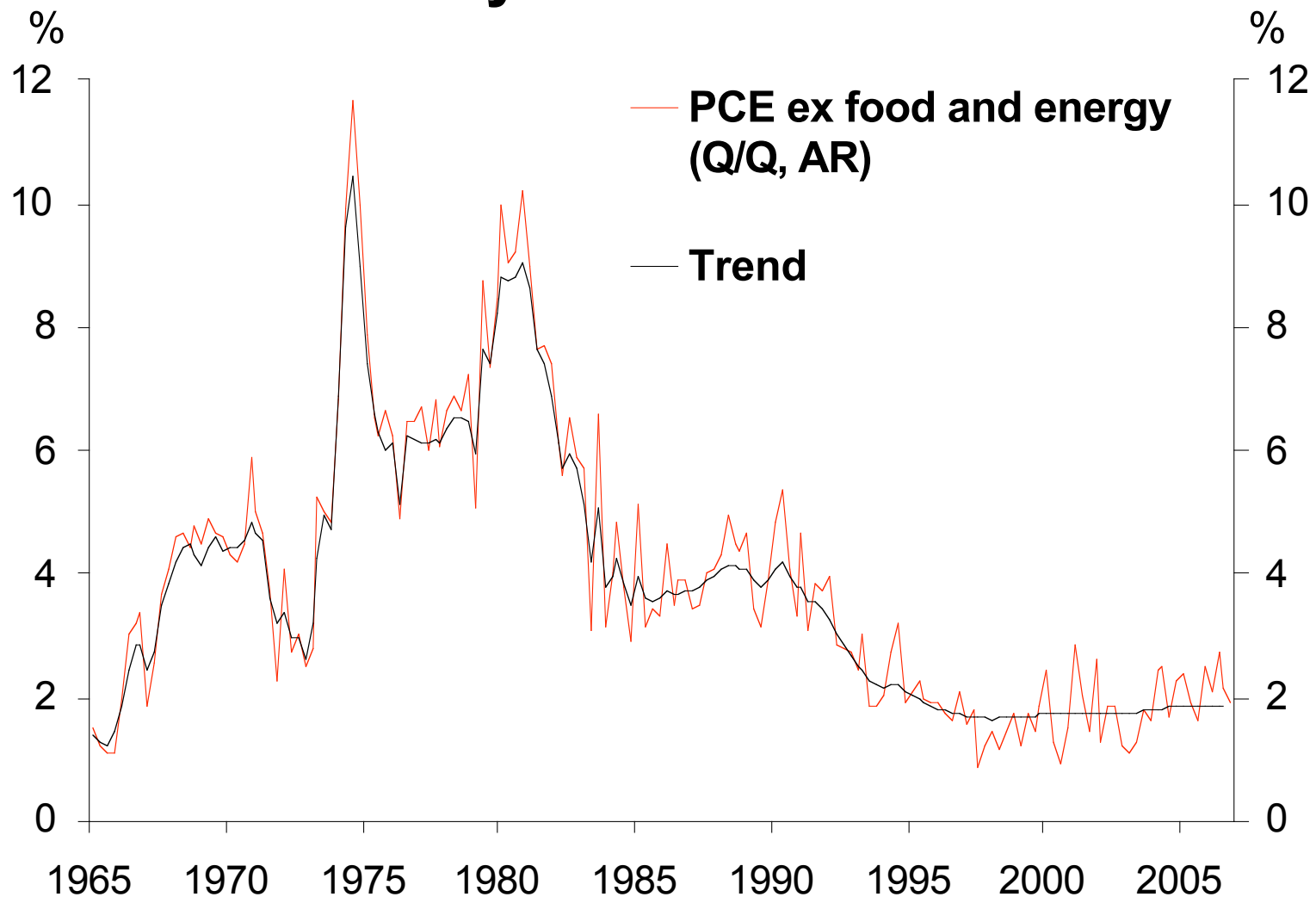


Source: BEA, DB Global Markets Research

But its been a lot higher...

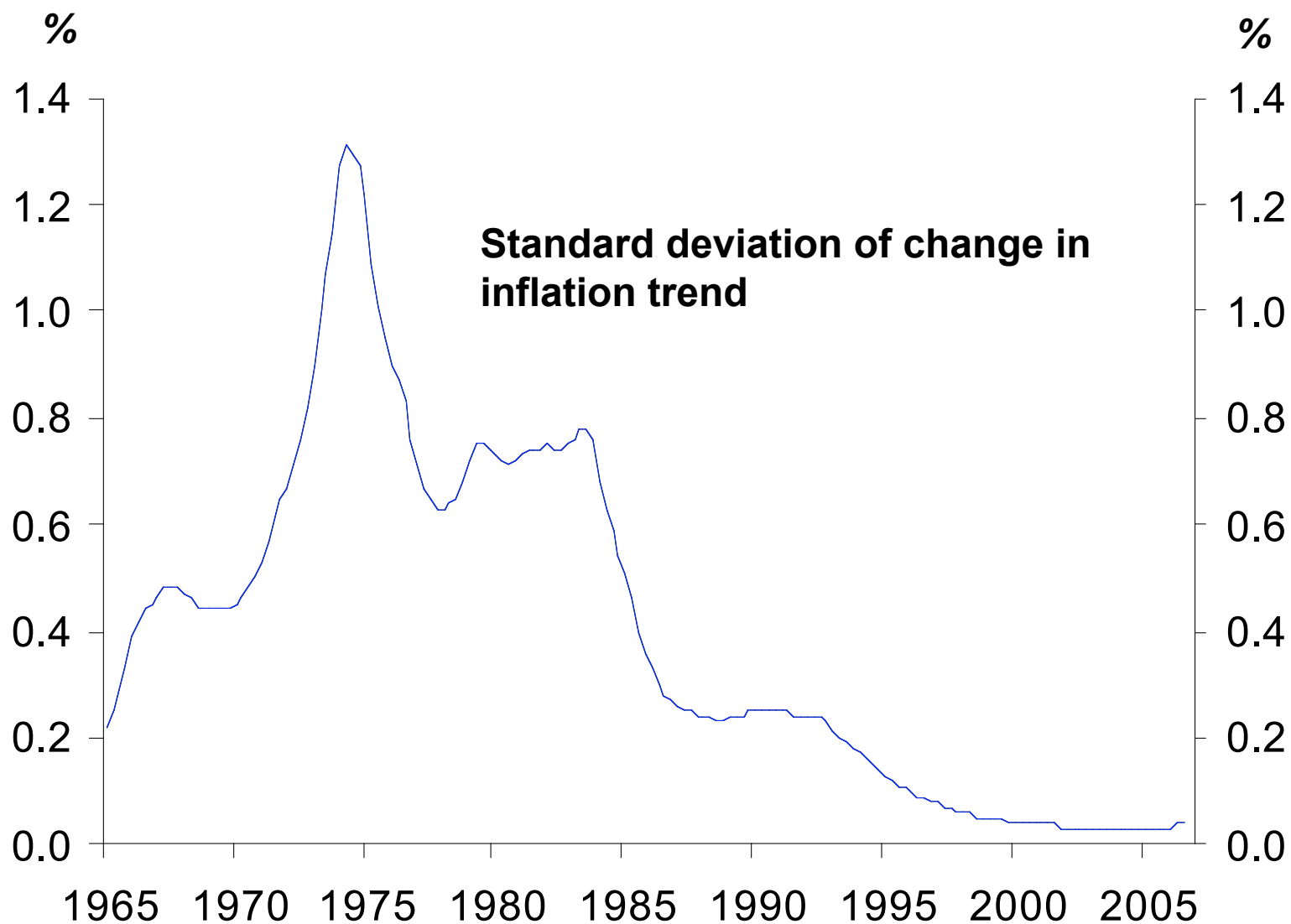


Inflation trend has fallen dramatically since early 80s



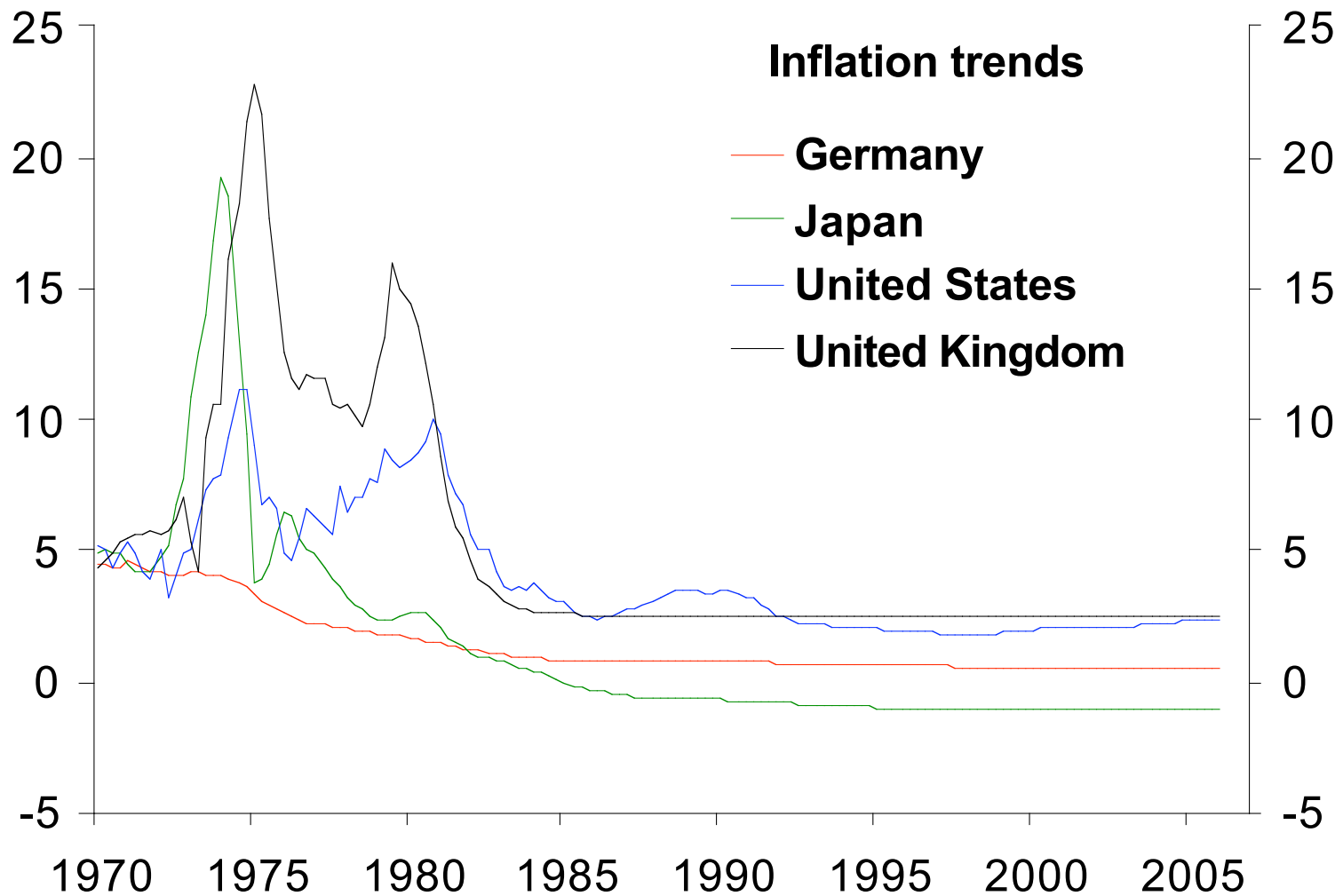
Source: BEA, DB Global Markets Research

Volatility of inflation has plunged too



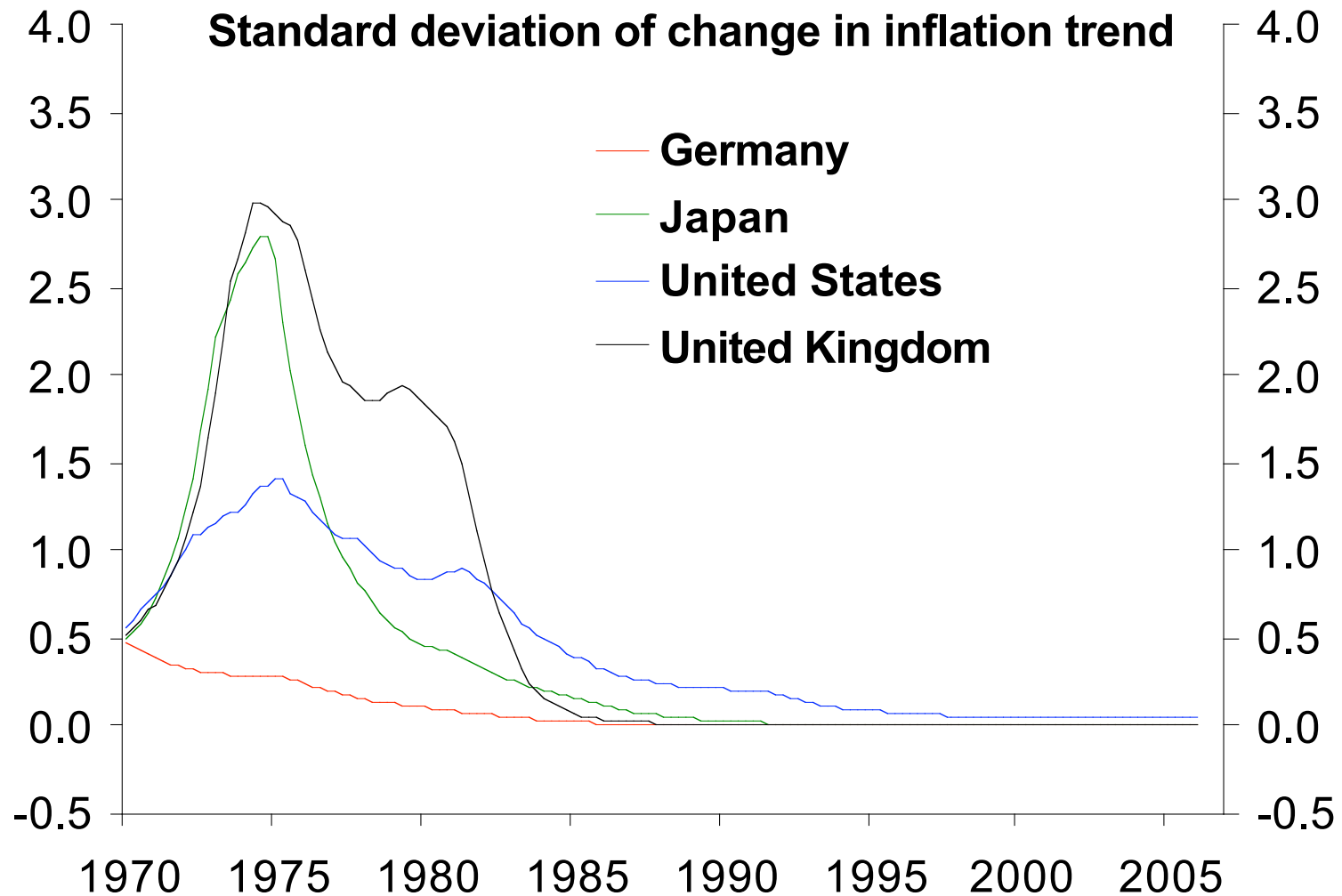
Source: BEA,DB Global Markets Research

Inflation trends have fallen globally



Source: DB Global Markets Research

Inflation volatilities have plunged globally too

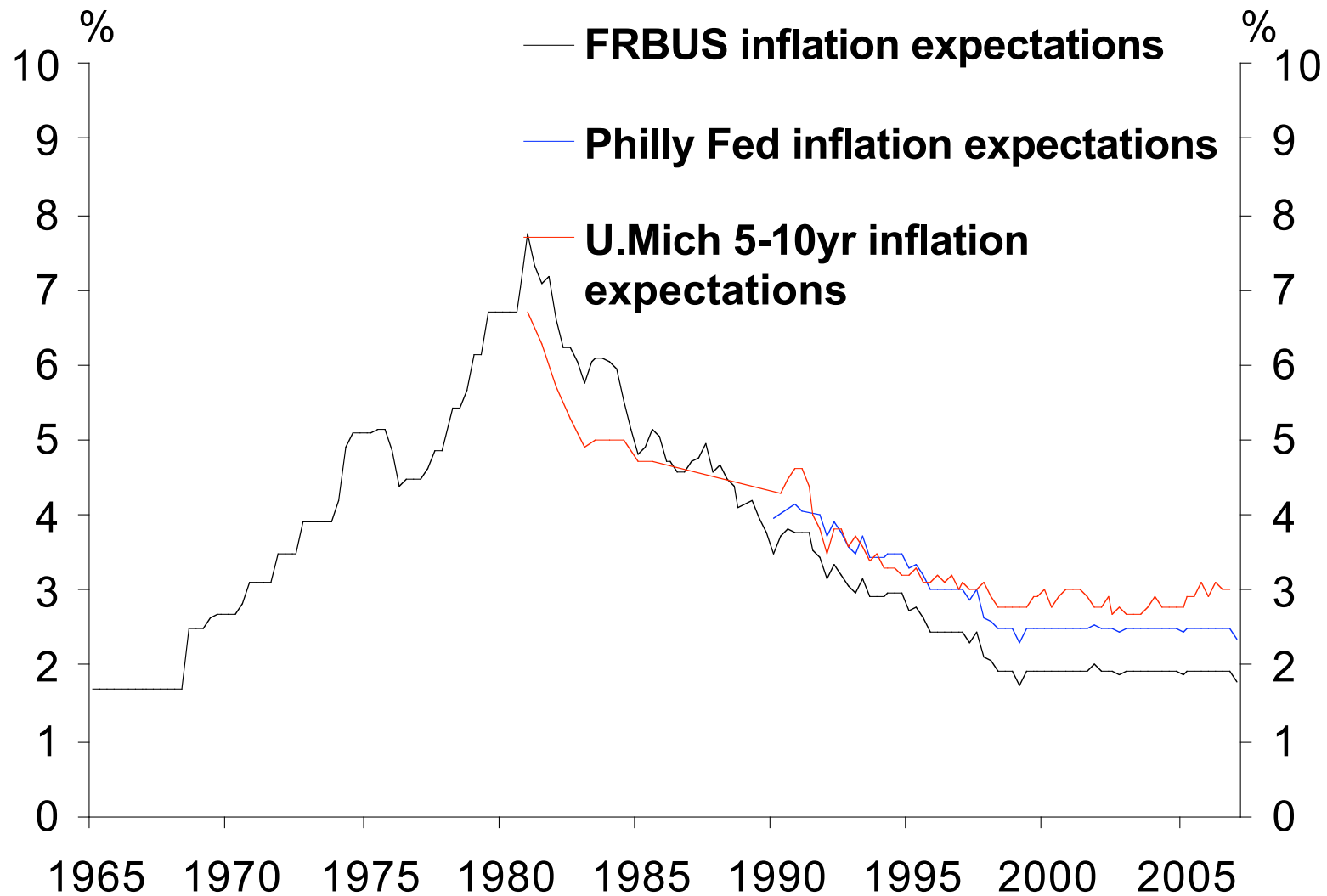


Source: DB Global Markets Research

Why does lower inflation and especially lower volatility of inflation matter?

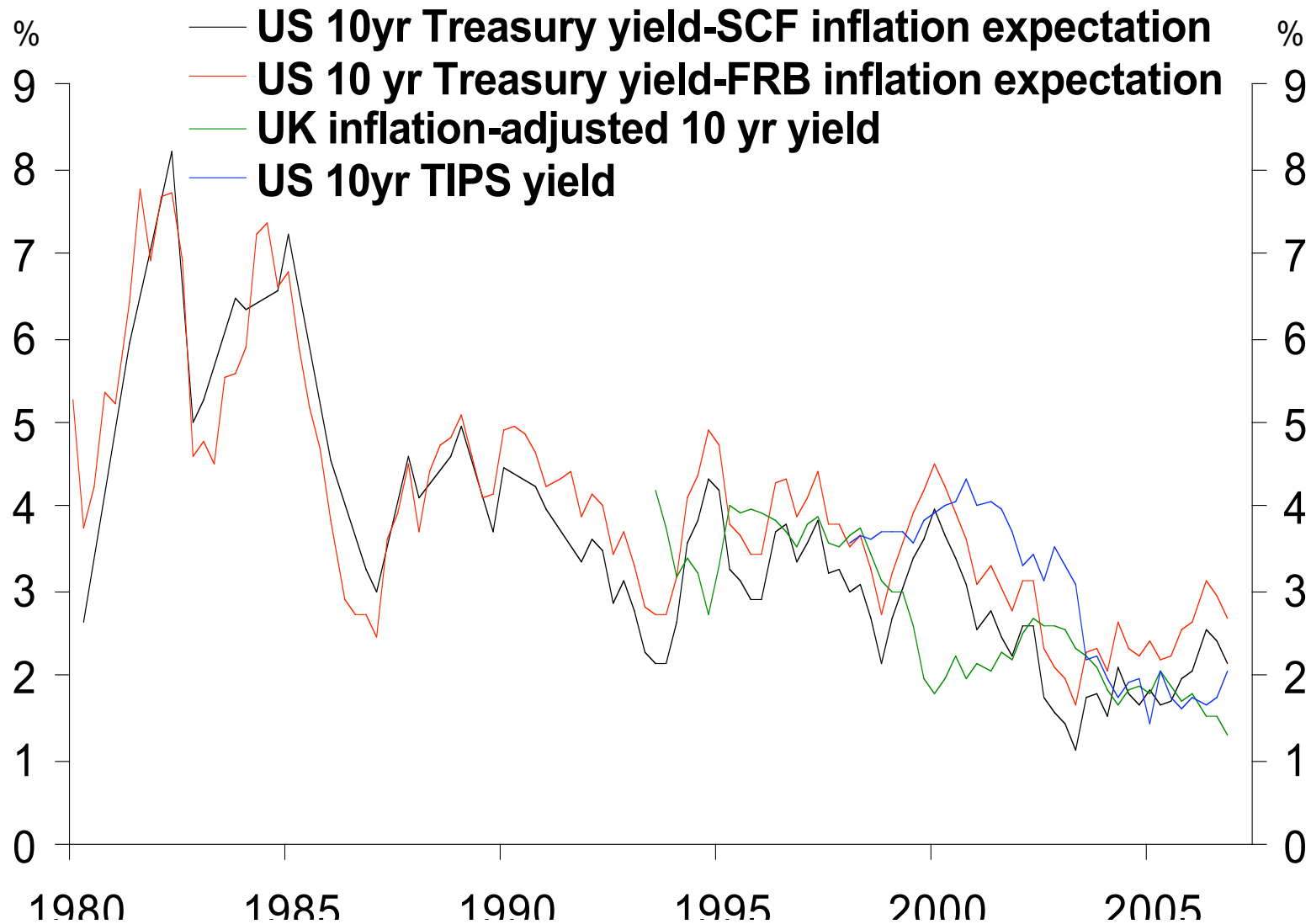
- **Anchoring of expectations**
- **Inflation risk premium and real interest rates**

Inflation expectations anchored at low level



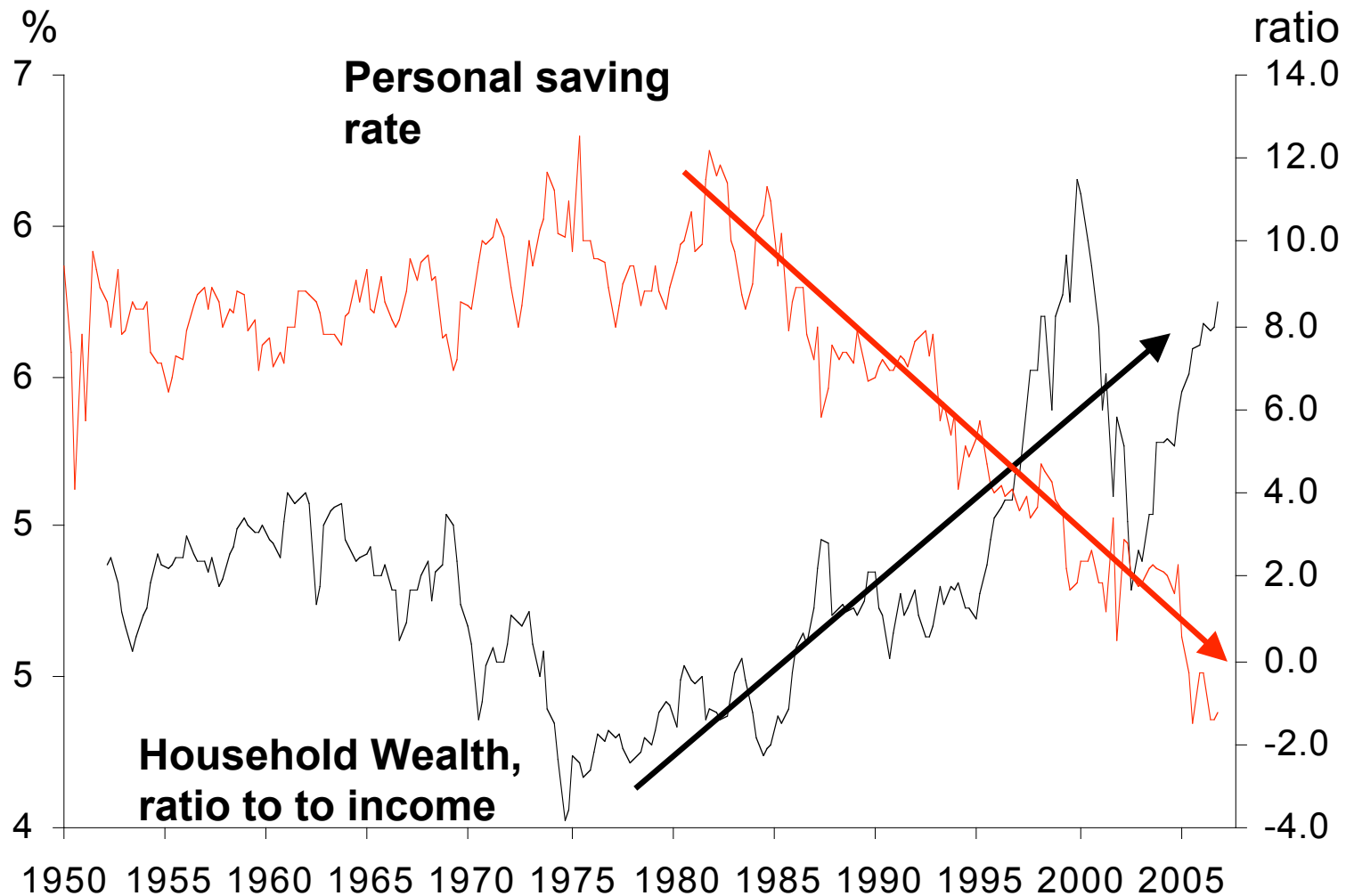
Source: DB Global Markets Research

Real interest rates have trended lower



Source: BEA,,FRB,DB Global Markets Research

Result: Rising asset values, falling saving rate

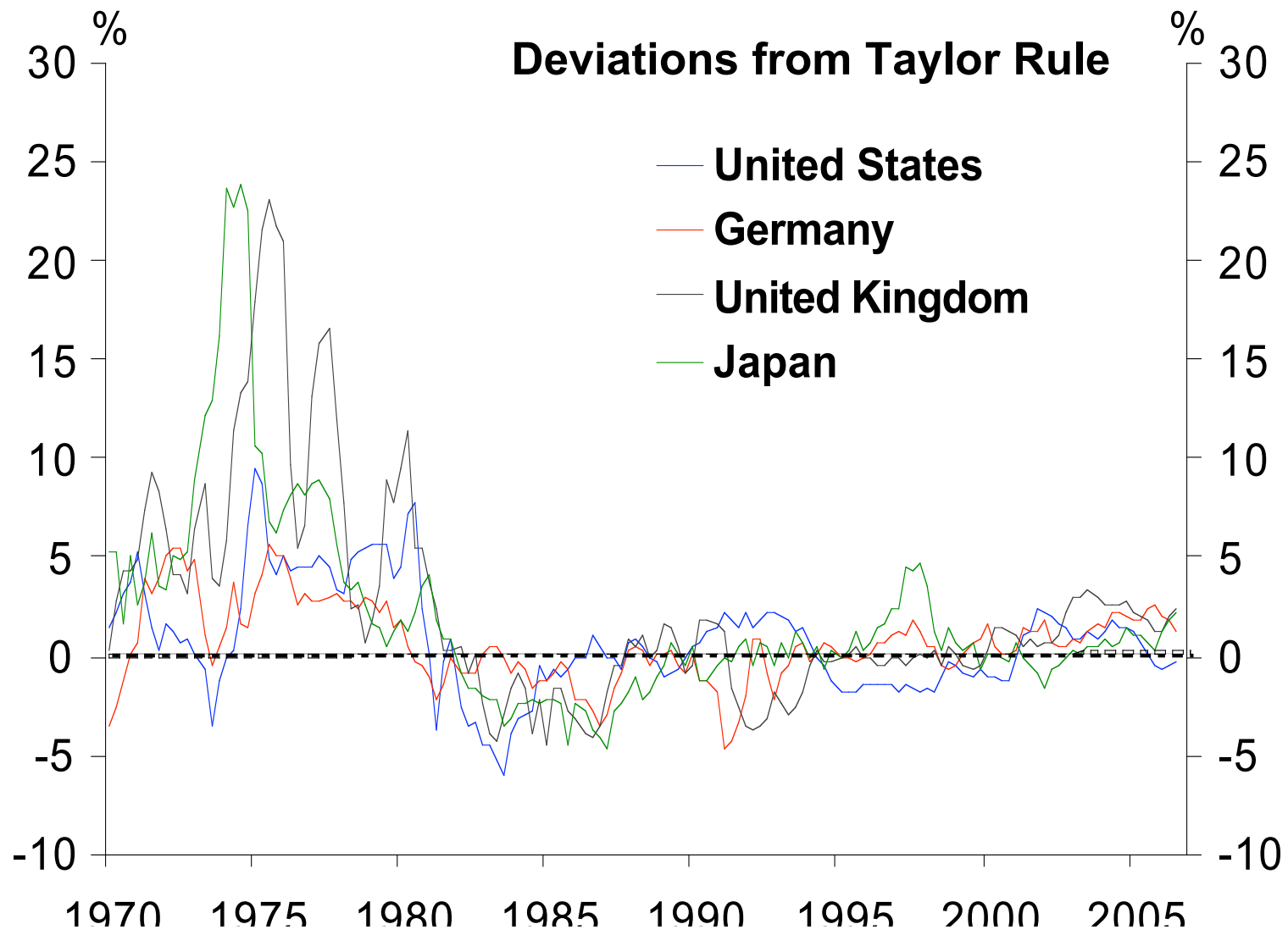


Source: BEA, FRB, DB Global Markets Research

What caused the great inflation and disinflation?

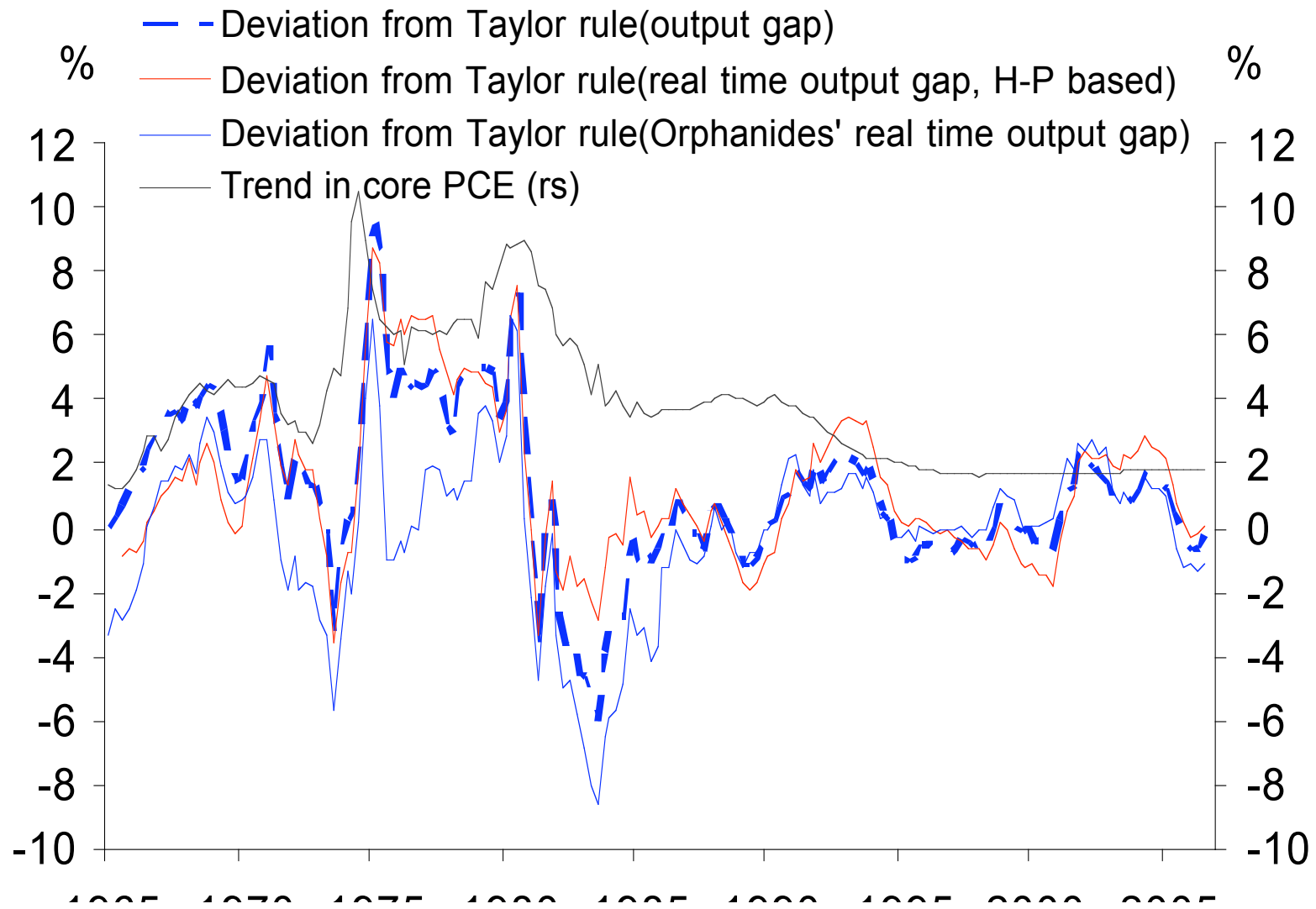
- **Accommodative monetary policy in the face of inflationary demand and supply shocks**
- **Monetary tightening and behavior consistent with a rules based policy**

Monetary policy consistency



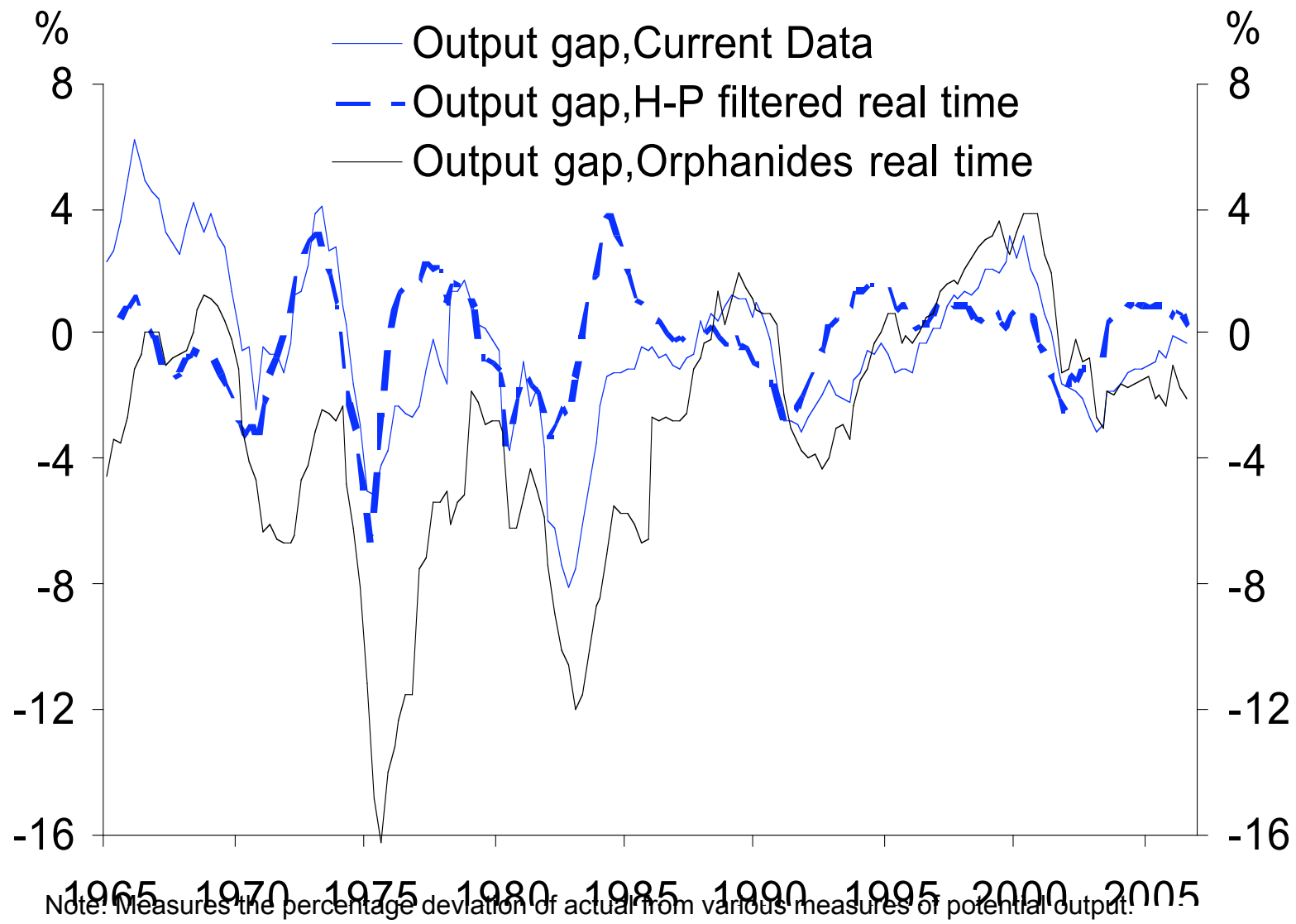
Source: DB Global Markets Research

Trend core PCE inflation and policy rate deviations from Taylor rule



Source: BEA ,DB Global Markets Research

Output gap measures



Source: CBO, Phil fed, Orphanides (2003), DB Global Markets Research

What could cause inflation trend and volatility to rise again?

- **Politics**
- **Demographics**
- **Global factors**

Politics

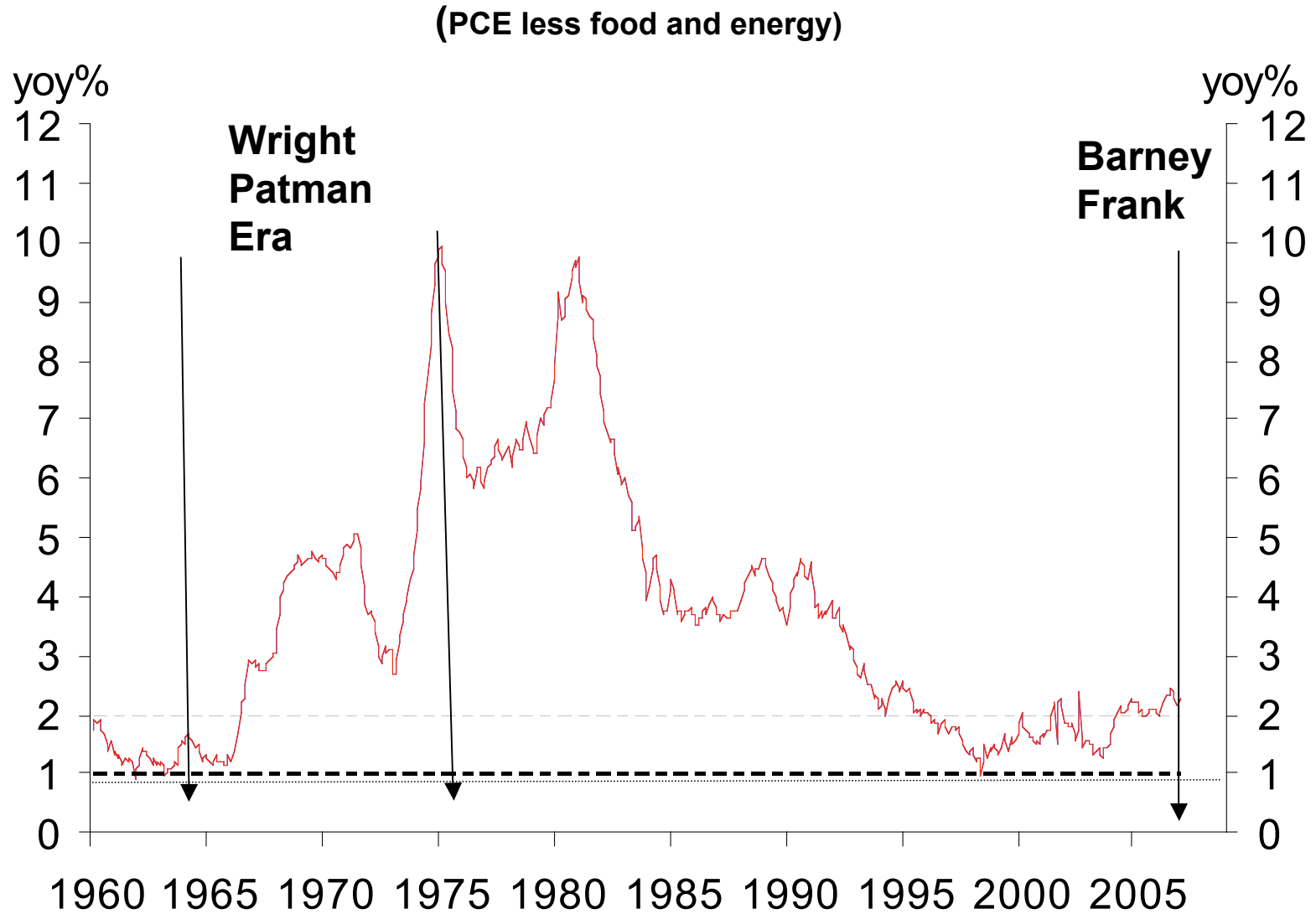


Barney Frank

January 2007:

- **Fed policy is fair game again in Congress**
- **No inflation targeting on my watch.**
- **Fed needs to hold interest rates down to allow wages to rise.**

Inflation: a Political Influence



Source: BEA, DB Global Markets Research

Politics contd.

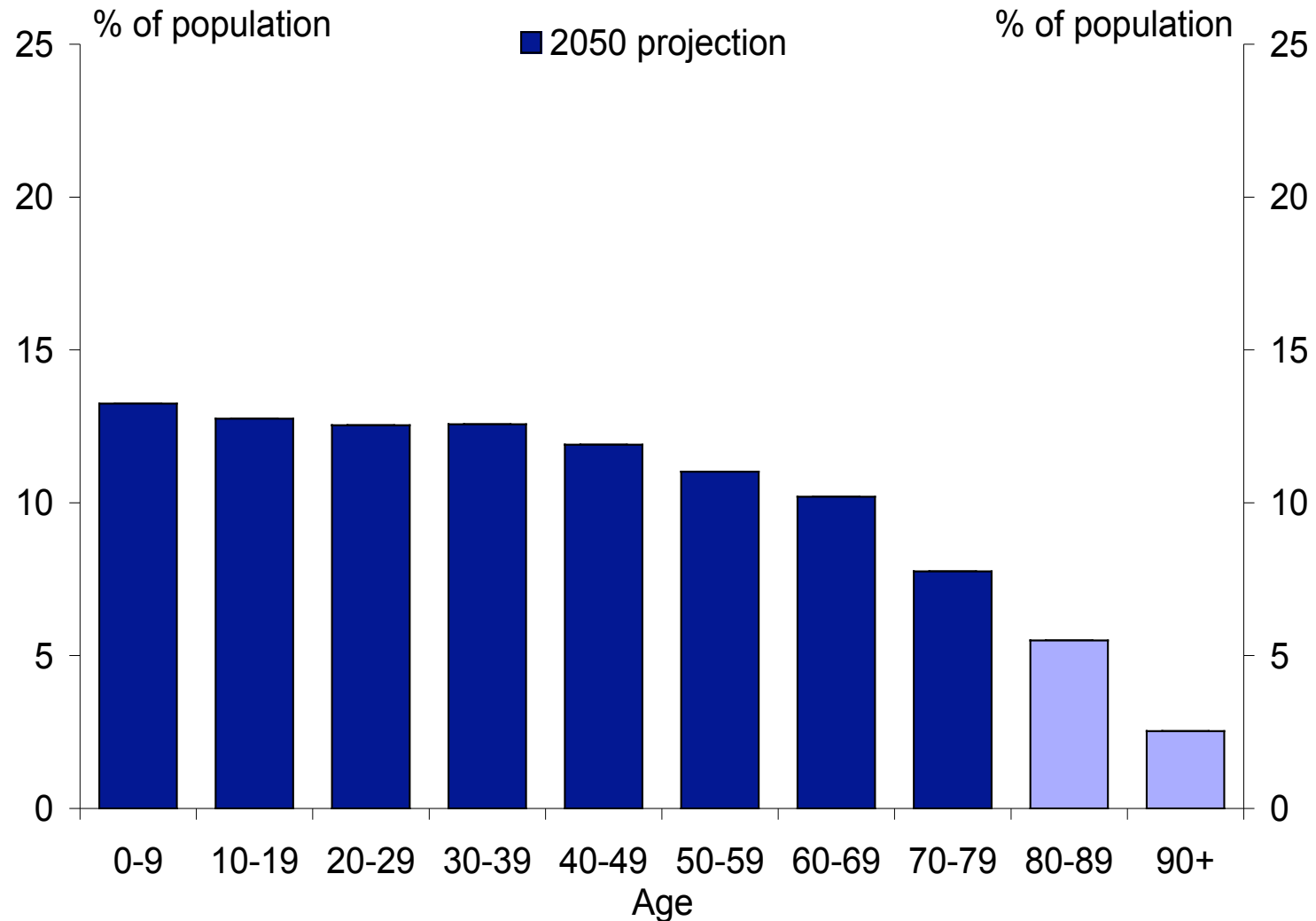


- Fed and markets have learned a lot over the past four decades.
- Has gotten Frank to acknowledge that its real wages that matter, not nominal wages.
- May settle for something less than formal inflation target.

Implications of ageing boomers:

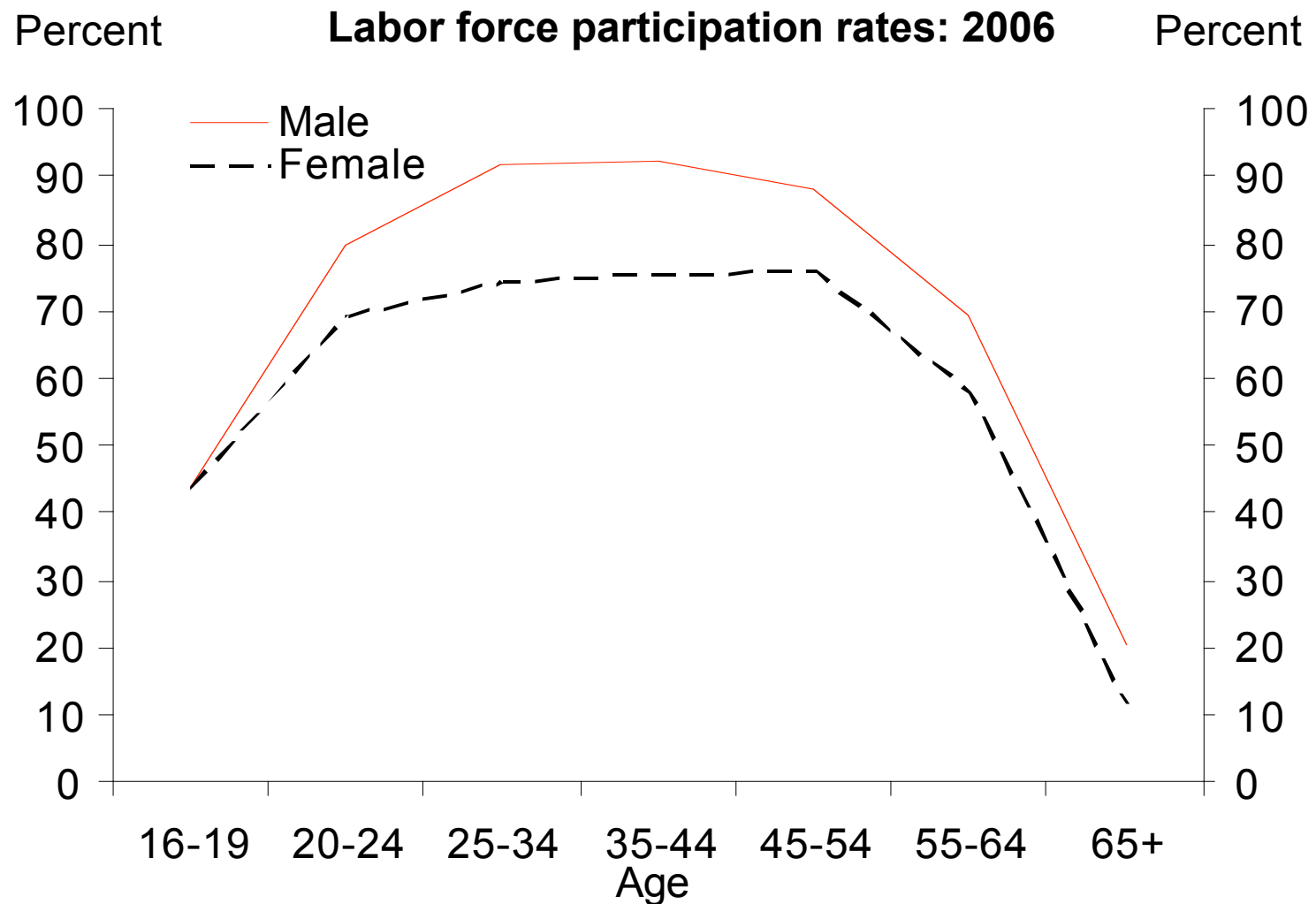
- Slower growth of labor force and potential output**
- Massive increase in social security and health care costs**
- Higher interest rates**

Demographics: Ageing Baby Boomers



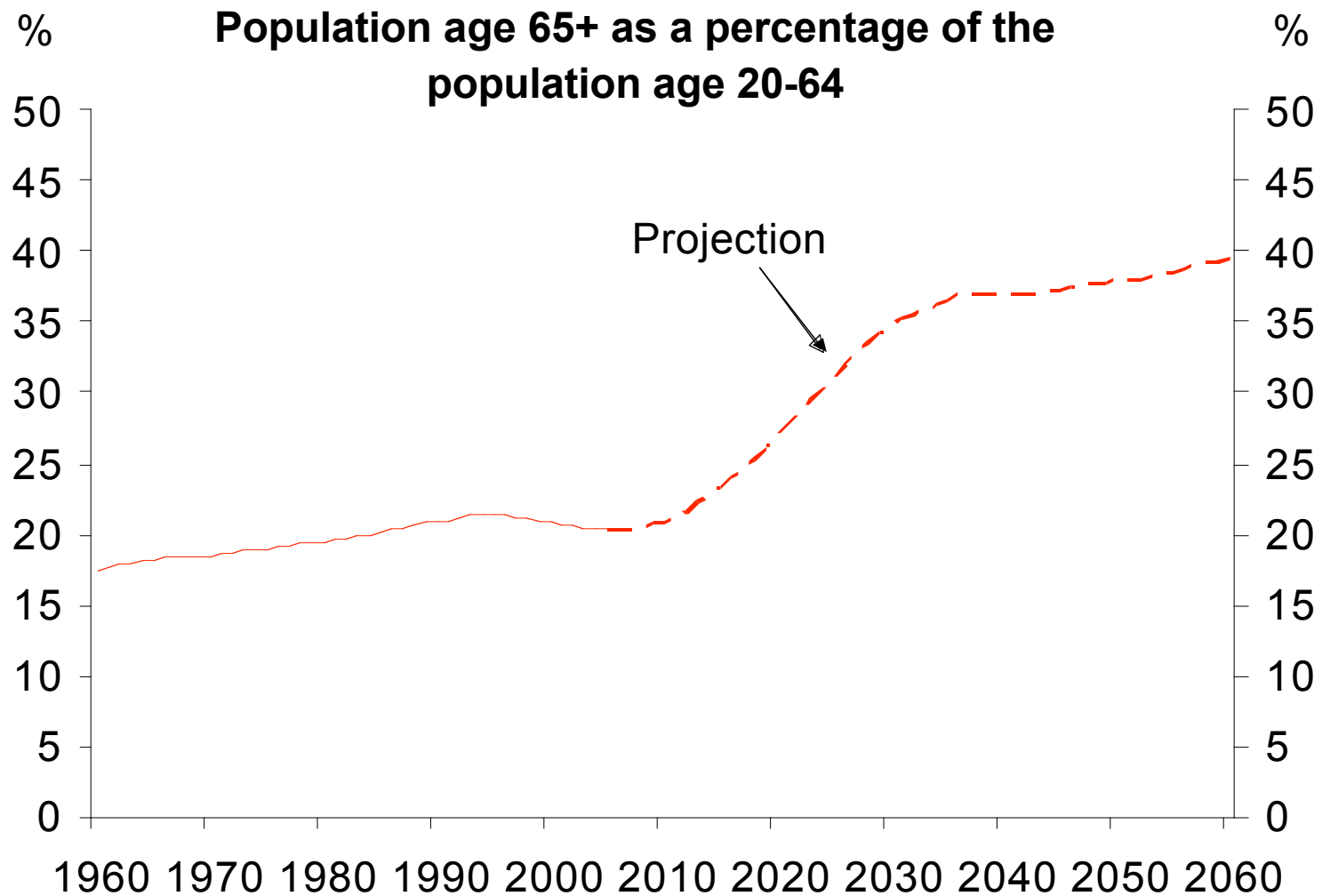
Source: Census, DB US Economics Research

Labor force growth set to drop



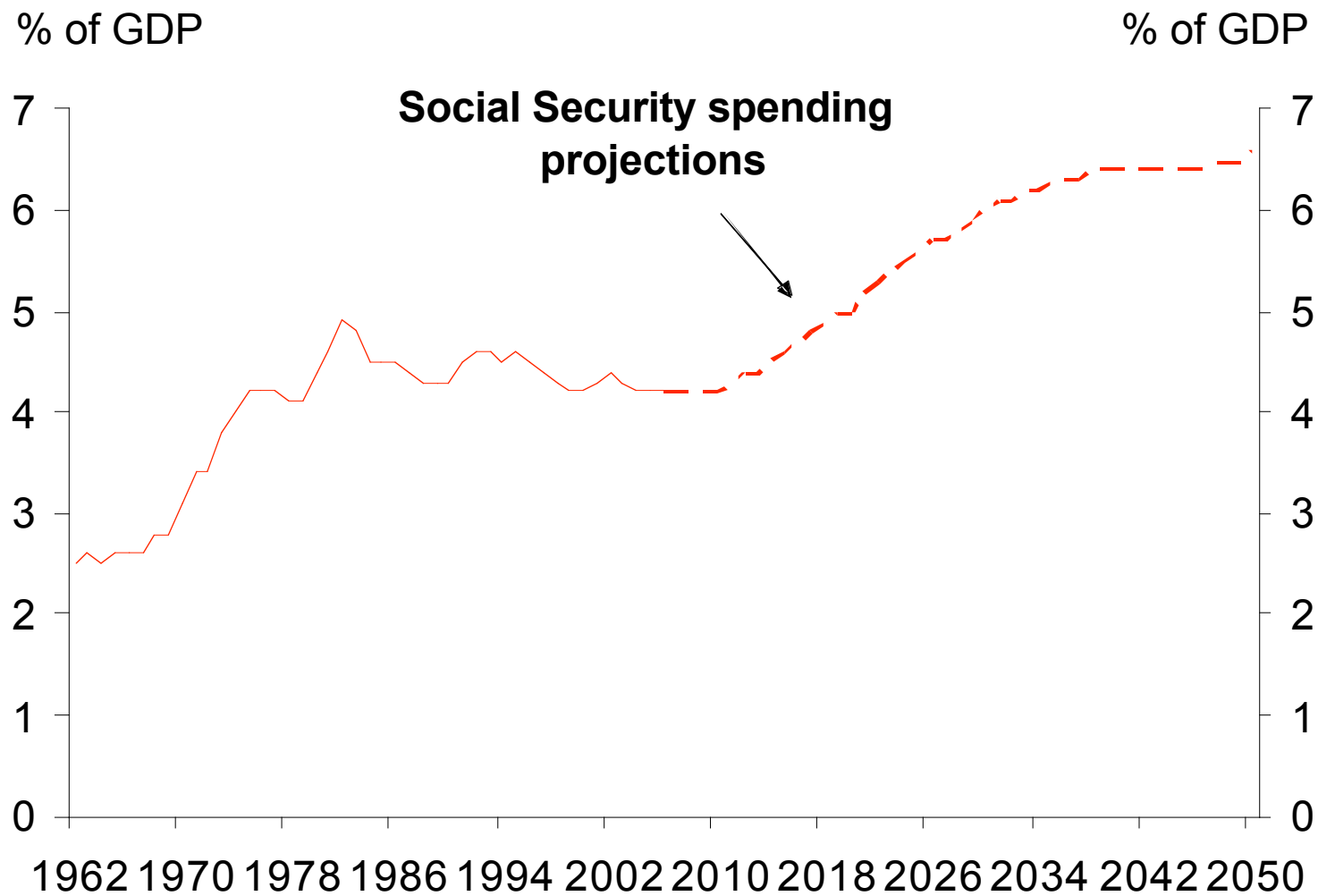
Source: BLS, DB US Economics Research

Dependency ratio age on verge of jumping



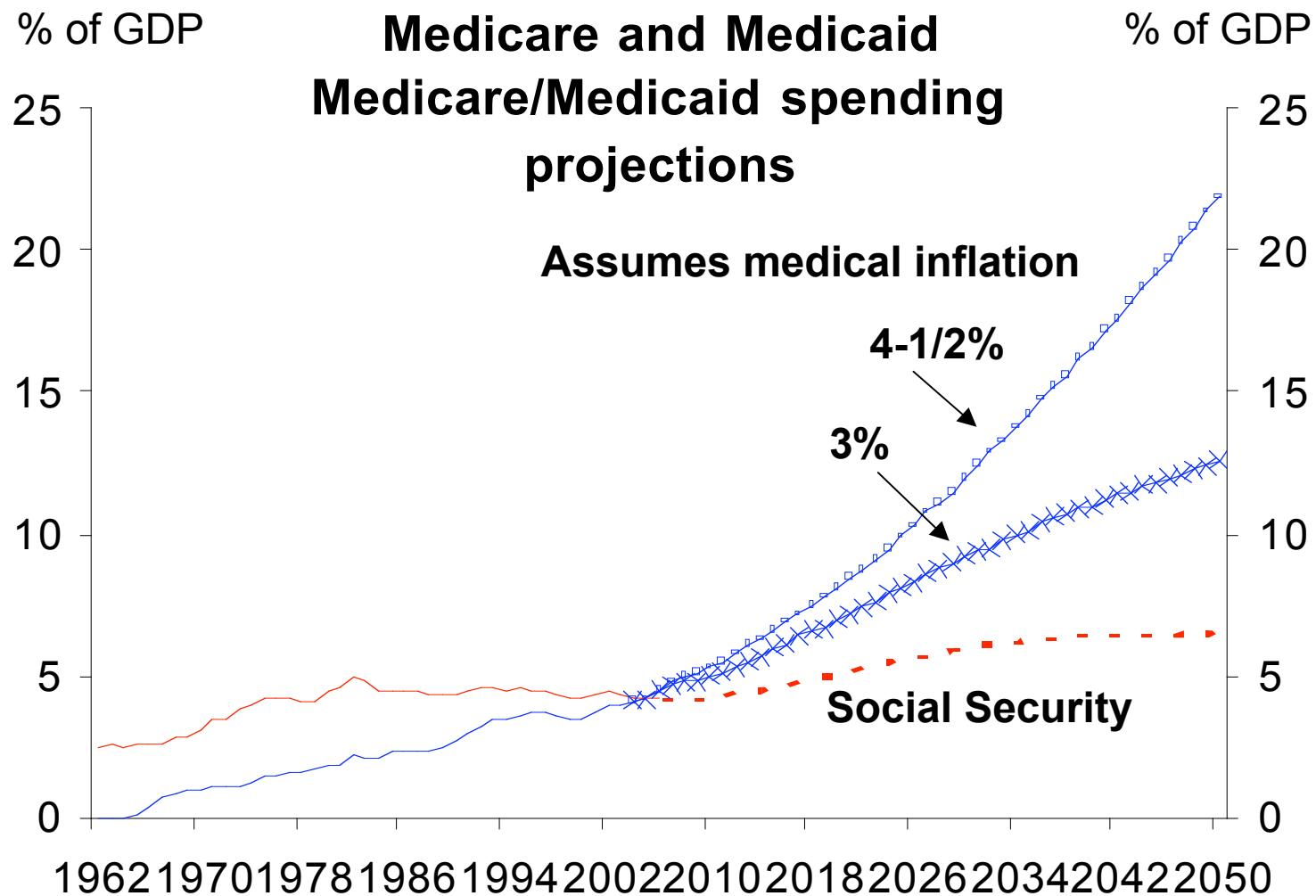
Source: Social Security Administration, DB US Economics Research

Social Security spending nearing take-off



Source: CBO, DB US Economics Research

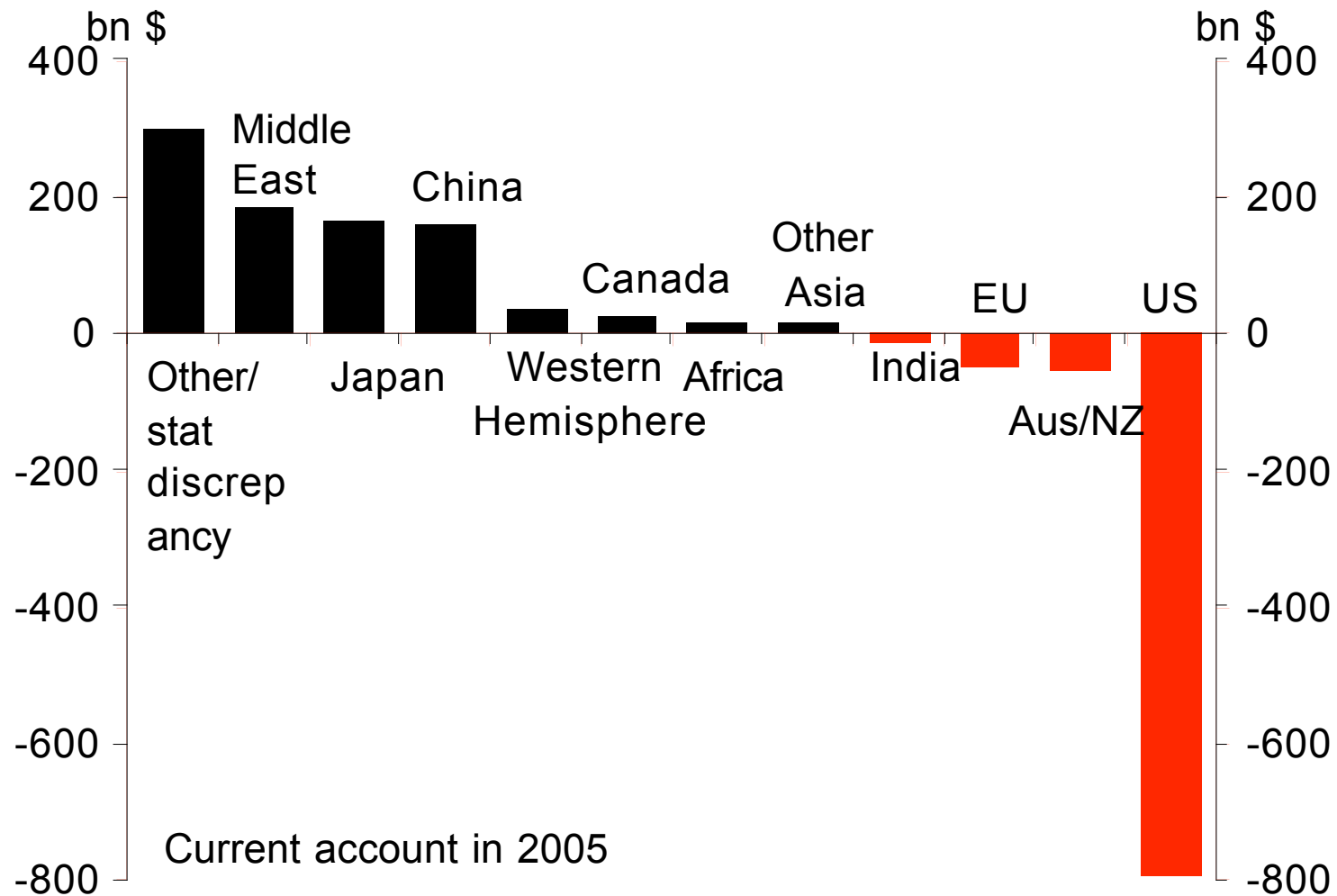
Medical spending set to blast off



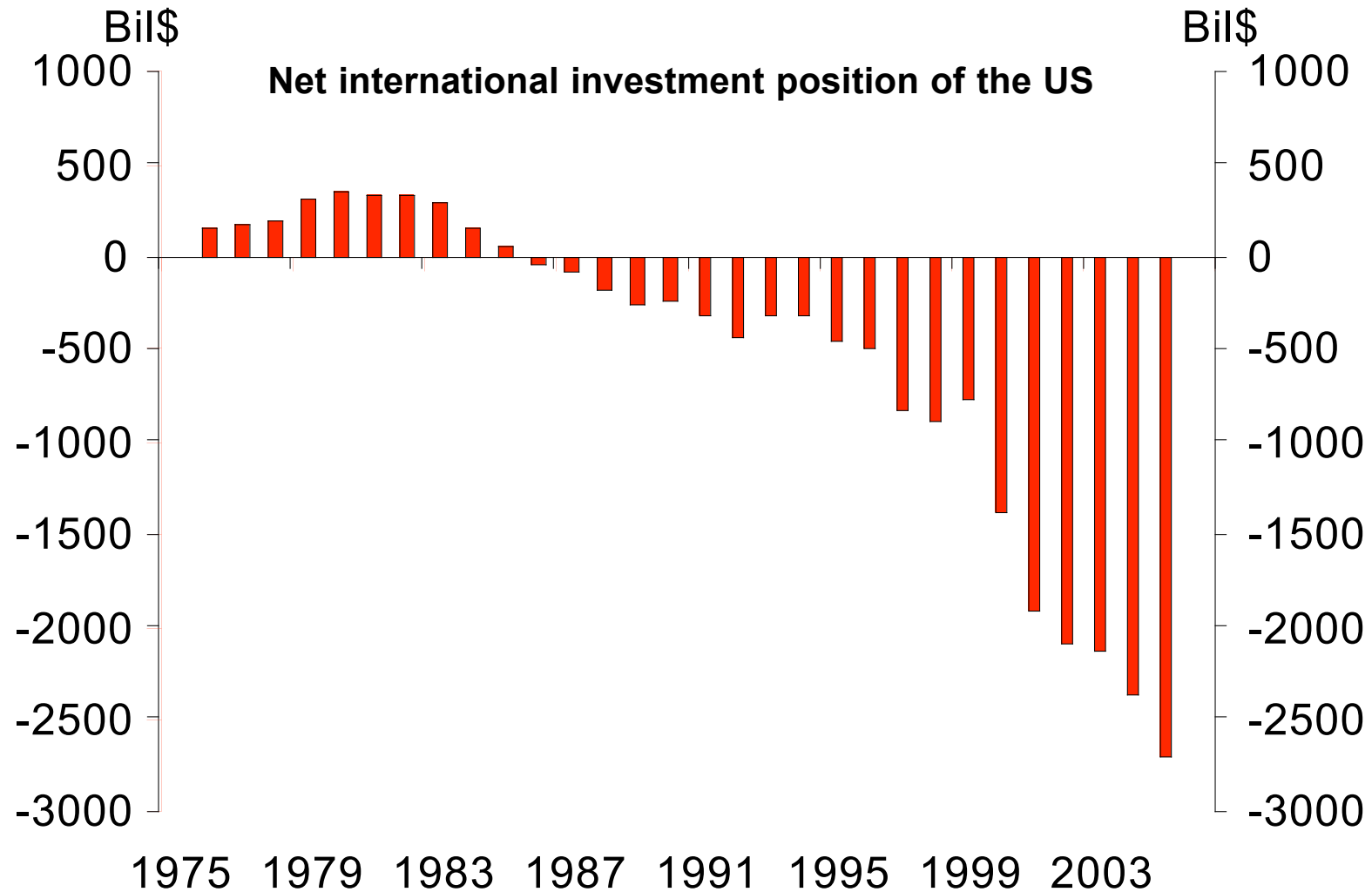
Source: CBO, DB US Economics Research

**Global factors could cause
inflation trend and volatility to rise
again**

Global Dimension: Growing Imbalances

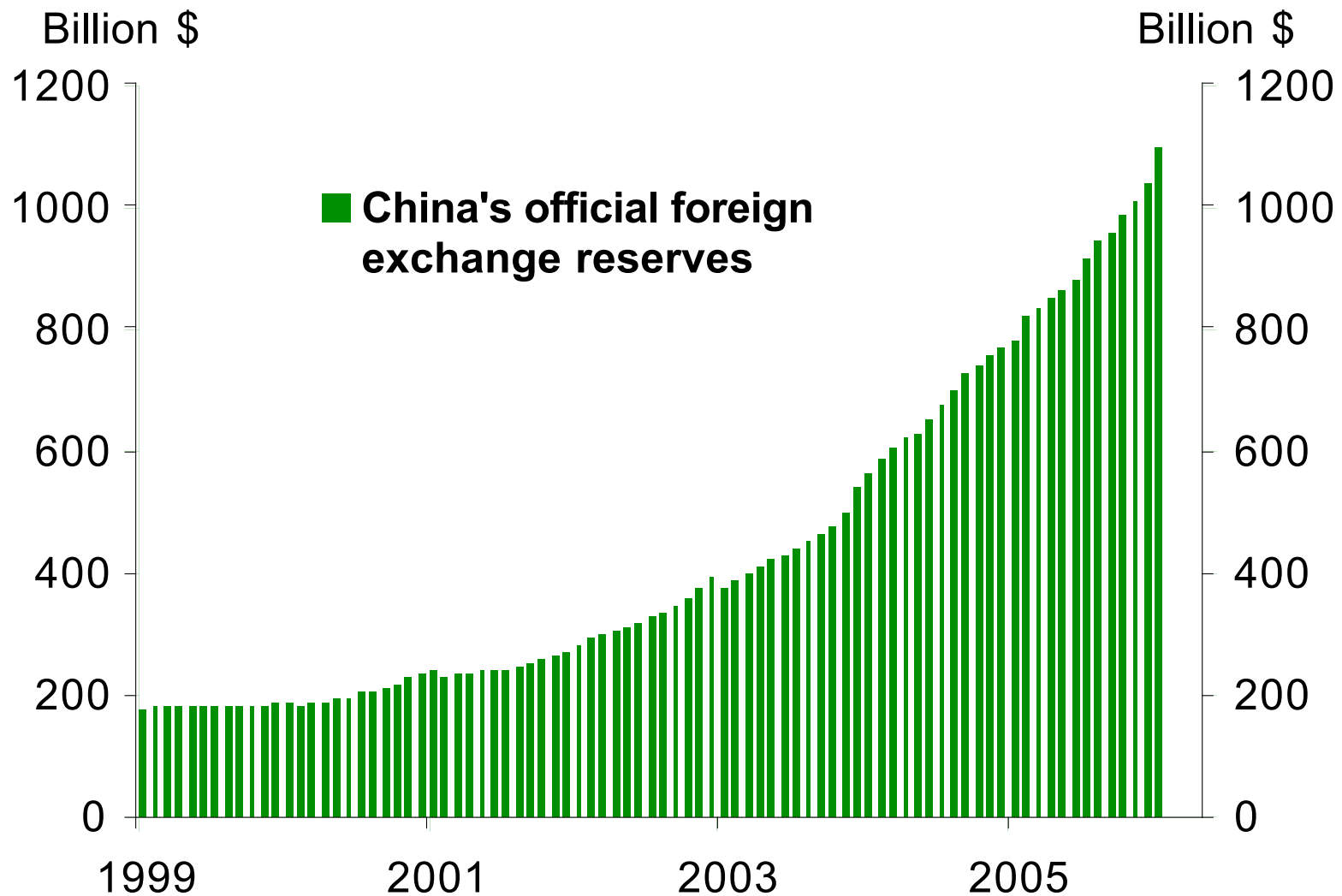


US Net External Debt Growing Rapidly



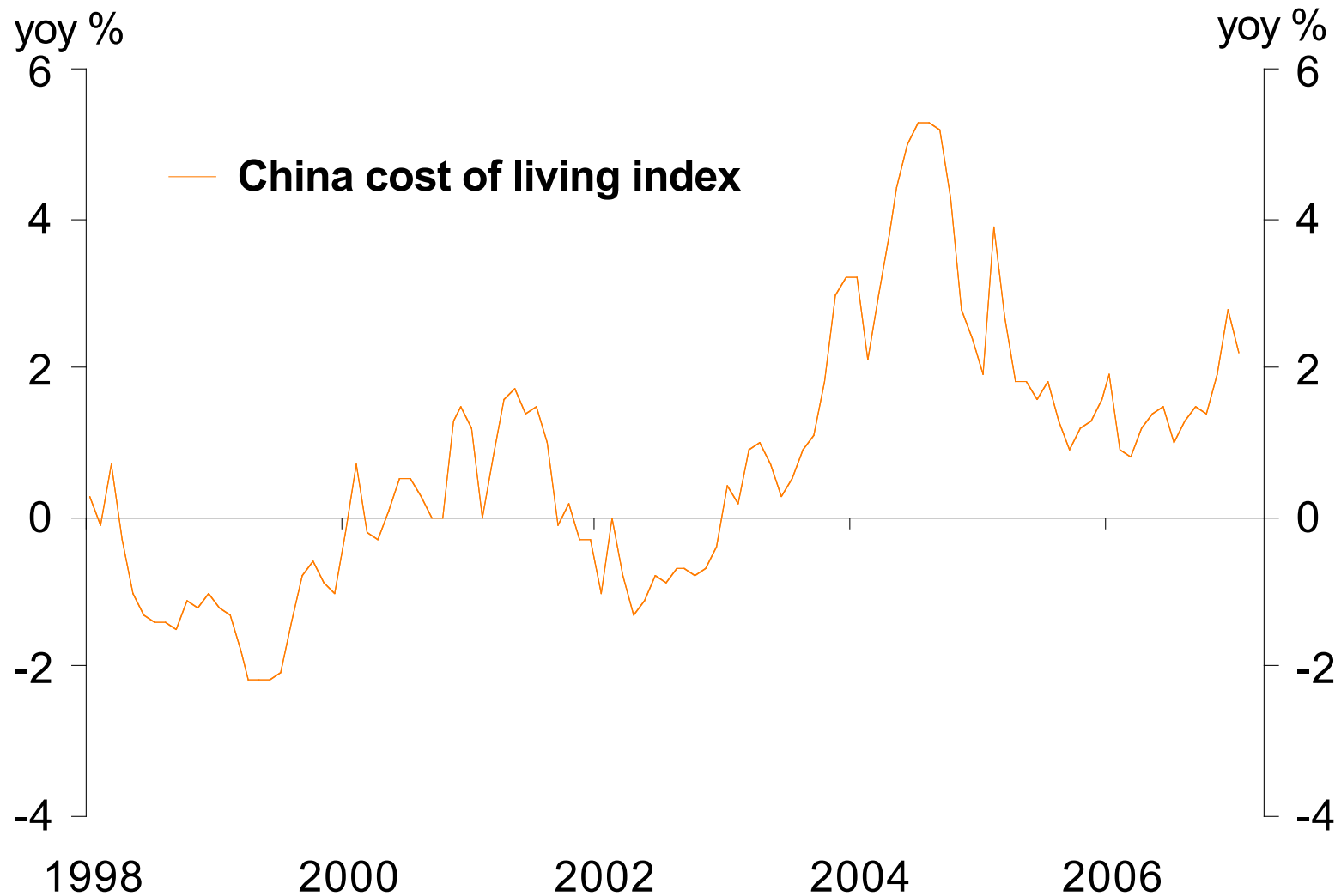
Source: BEA, DB Global Markets Research

China's reserves soaring



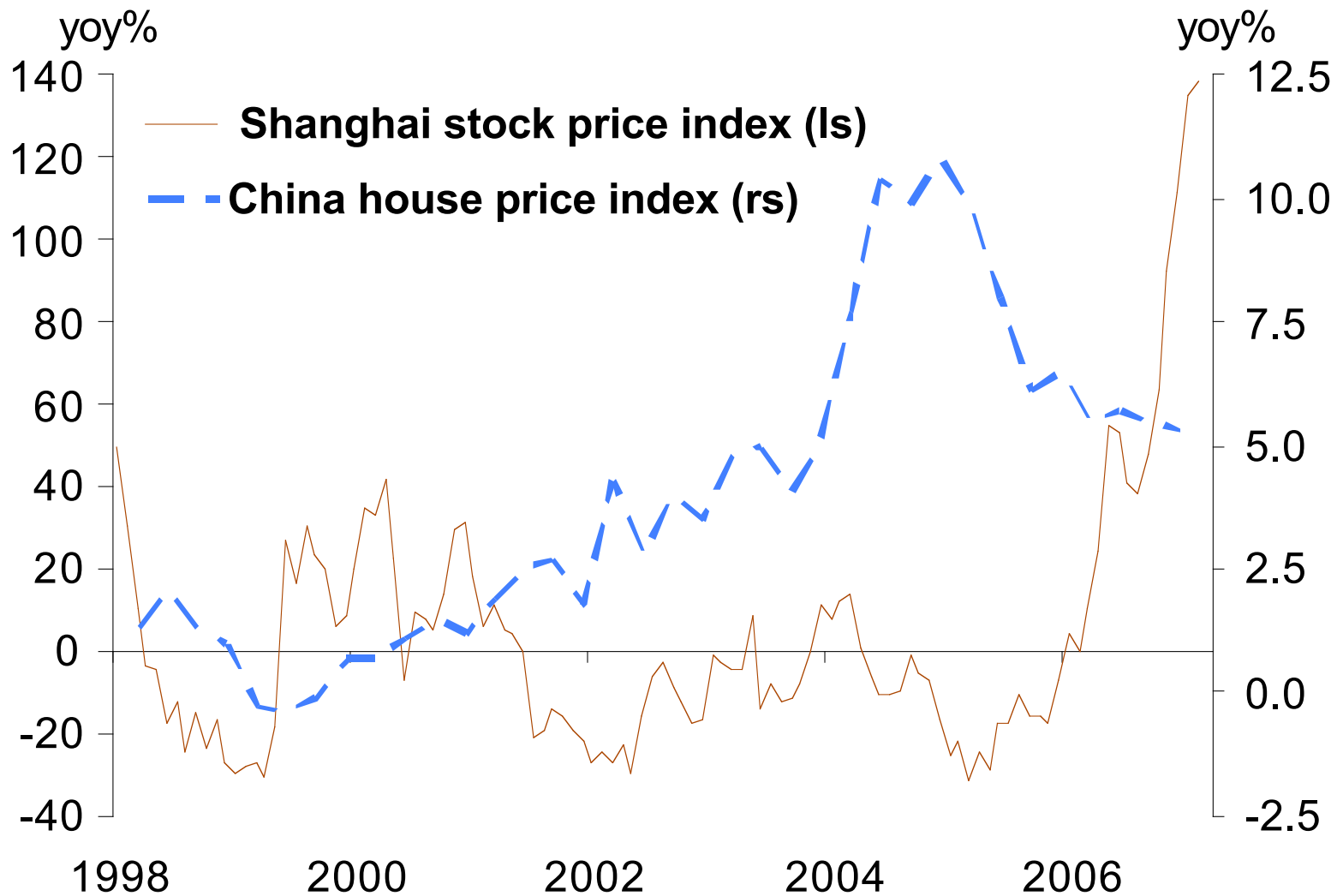
Source: PBC, SAFE, DB Global Markets Research

China's inflation edging up



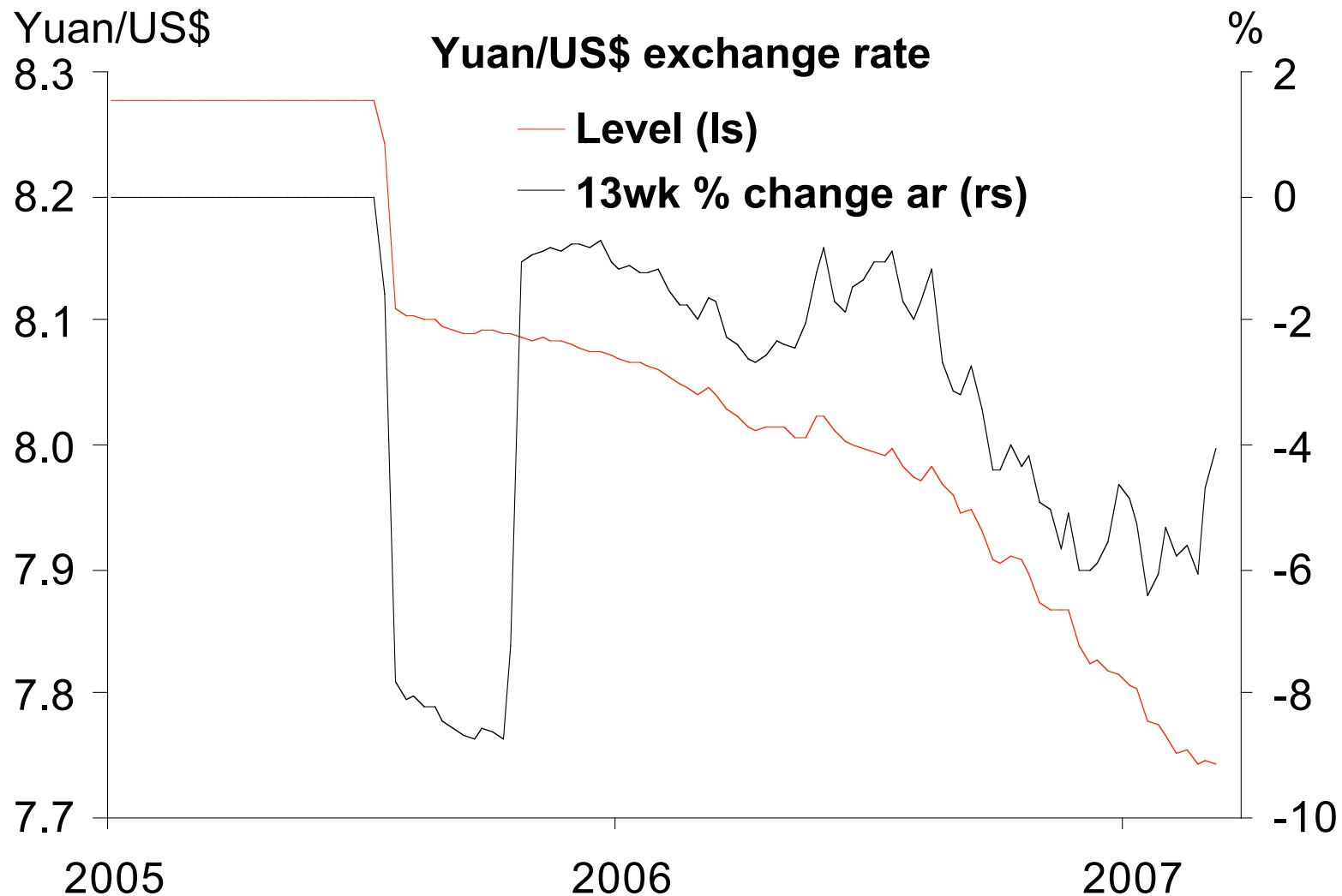
Source: CNBS, DB Global Markets Research

China asset markets: looking bubbly



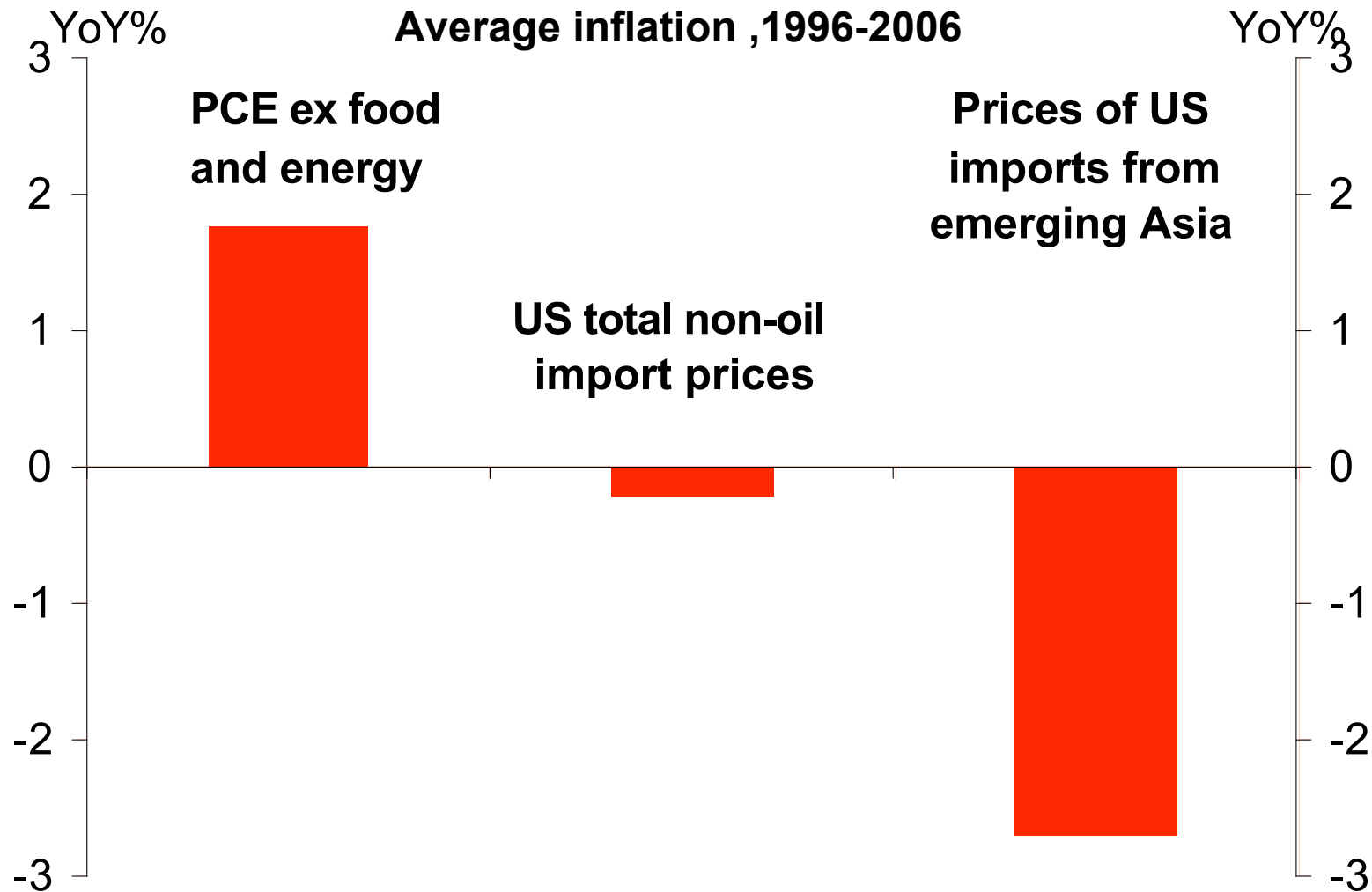
Source: CNBS, Shanghai stock exchange, DB Global Markets Research

China moving toward currency flexibility



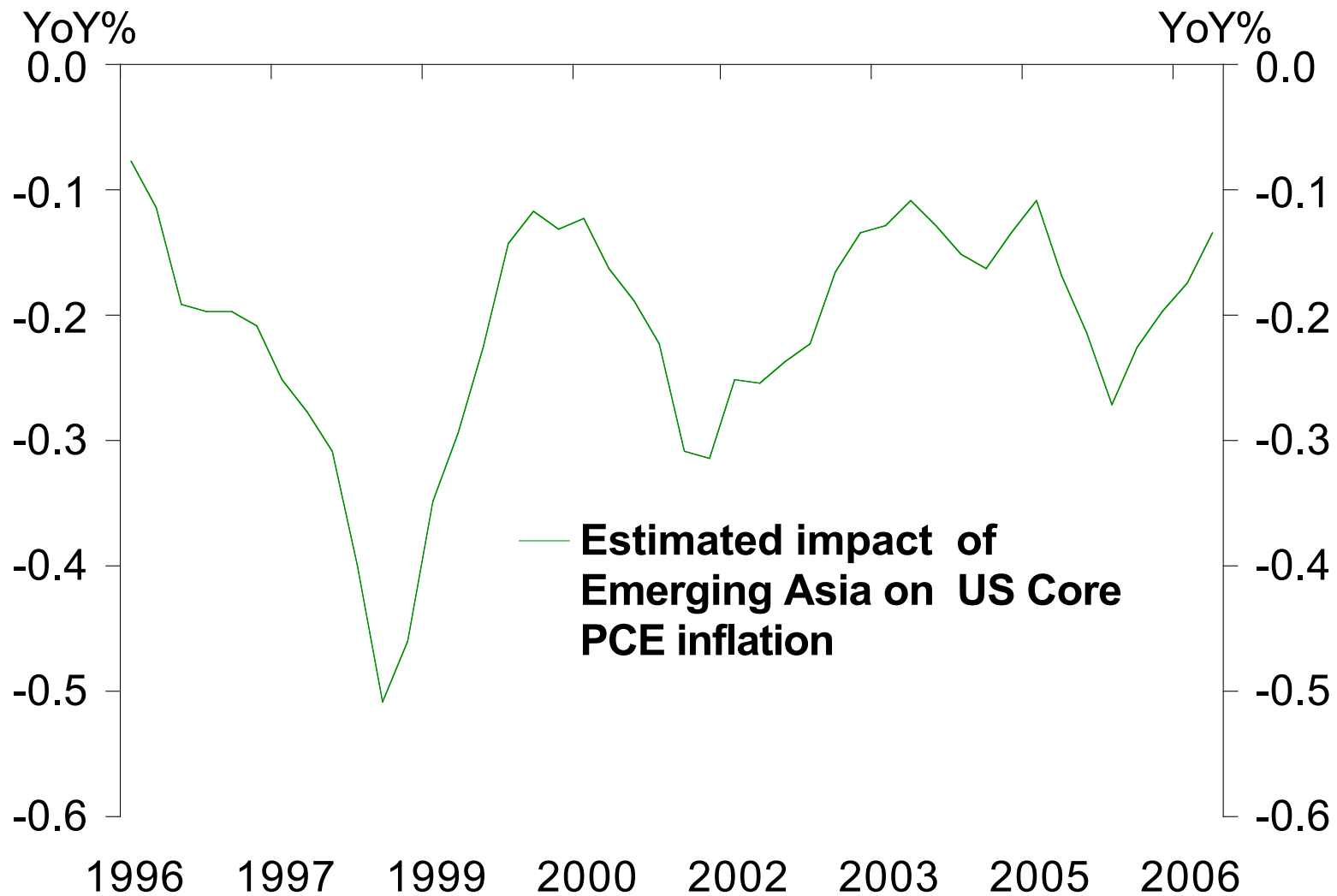
Source: FRB, DB Global Markets Research

China/Asia restraining US inflation



Source :Haver, DB Global Markets Research

But the restraint is small and diminishing



Source :Haver, DB Global Markets Research

Wrap-up

- **Inflation and disinflation are monetary phenomena**
- **Inflation trend and volatility are near a low point.**
- **Longer-term risks to inflation and rates, largely to upside, include political, demographic, and global forces.**
- **Low and stable inflation expectations do not afford complacency at the Fed.**



Torsten Slok, Ph.D.

Director/Senior Economist, US Economics

Deutsche Bank Securities, Inc.

- Torsten Slok joined Deutsche Bank Securities in the fall of 2005 and is a senior member of the US Economics Team.
- Prior to joining the firm, Dr. Slok worked at the OECD in Paris in the Money and Finance Division and the Structural Policy Analysis Division. Before joining the OECD he worked for four years at the IMF in the Division responsible for writing the World Economic Outlook and the Division responsible for China, Hong Kong and Mongolia.
- Dr. Slok studied at Princeton University and University of Copenhagen. He has published numerous journal articles and reviews on economics and policy analysis.

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