We were four friends at the bar

Ruminating on the ... inflation

They were not "four friends at the bar who wanted to change the world". Certain illusions belonged to an era that some of them lived through, but did not intend to revisit. The four friends were tempered by the practicality of experience or the comfort of theory. They could only share a few thoughts that had individually helped them take on professional challenges that involved, at the very least, the illusion of understanding the world. For their discussion around a small table in the summer heat of late July, cooled by a light evening breeze, they had naturally chosen to talk about an economic parameter: inflation. Economist talk? Sure, economics had something to do with it. All four of them worked in this field, some as managers, some as journalists, some as professors. But in reality, their thinking went beyond that: inflation is a metaphor for life. Prices go up or down following human impulses, linked to the psychology of the individual, but which, put together, become a collective, sociological phenomenon. And as if that were not enough, everything is complicated by the role of institutions that should simplify what is in itself complex, favoring or restricting the availability of the individual.

"It was very difficult," says the senior manager, "to understand the psychology of people, but basically I did pretty well. The real difficulty is framing collective phenomena because they can lead to distortions in intelligence. Let's take a concrete example. The choice of central banks to set an inflation target (inflation targeting): the more credible they are in predicting interest rates, the less the market will get used to thinking. And if the market were to lose the habit of thinking, imagine the trouble that could arise in the face of what is already happening today that it thinks ... The market would be absolutely unprepared for sudden shocks. It is stability that produces instability, Keynes would perhaps say". Used to managing large companies, the manager relies heavily on method. He recently found part of his thoughts in a book by Anna Carabelli[1], which analyzes Keynes' methodology. For the author of General Theory, the object of economic analysis "is not to provide a machine, or a method of blind manipulation, which will provide an infallible answer, but to give ourselves an organized and orderly method of thinking about particular problems." Thus economics "is a branch of logic, a way of thinking, rather than a pseudo-natural science," an apparatus of probable reasoning.

The reference to probability immediately aroused the sensitivity of the professor who is used to the numbers of statistics, but is ready to complicate his existence by choosing to refer to uncertainty. "When I was younger - he points out - I studied uncertainty for years: not risk, but uncertainty. It was Keynes and Knight who dealt with it about a hundred years ago. In a risk situation, we are able to make statistical inference. With Knight's uncertainty, we are not even able to calculate the probability of events". But despite this clarification, the professor still chooses numbers to answer the journalist who in the meantime had entered the debate stating that "formally rigorous objectives (2% inflation as well as 60% debt of Maastrichtian memory) are arbitrary levels that should be revised almost day by day". The professor then proposes a "numbers joke" that was in vogue among American investment banks in the late 1980s. Considering a GDP growth rate at 5.2%, the deficit-to-GDP ratio at 3% and the debt-to-GDP ratio at 60%, well, once we are given any two of these conditions, the third follows in an economy without crises or recessions. "These thumb rules," the professor continues, "were used to price the debt of South American countries at a time when there was no data science. They are very optimistic estimates. If growth were "zero-point" (not 5.2%), the implications on debt ratios would be catastrophic. It is perhaps the model underlying these calculations that generated the European rules (the idea of the unknown bureaucrat questioned by Mitterand makes no sense)".

[1] Anna Carabelli, *Keynes on Uncertainty and Tragic Happiness*, Palgrave Macmillan, London 2021.

All this theory provoked the reflexive and somewhat disconcerted reaction of a listening journalist, shrewd but not specialized in economic issues: "Like cows - he says - I need to ruminate as much as I hear, because to get rid of the milk produced (twice a day), these animals need a process that must be experienced in calm, rest and silence". But the elderly manager wants to get to the heart of the debate and launches a new provocation: "To make sure we don't miss anything on the subject of inflation: is it possible - he asks - that the countries most affected would be those with the lowest public debt? And that they could then ask the European Central Bank (ECB) to reduce the expansive manoeuvres?". It's months that I follow the positions concerning a probable inflationary flare-up due to the return of the post-pandemic demand. But the feeling is that, despite the enormous liquidity injected into the system, it will return to the 2% target limit. This is because the non-monetary elements that influence inflation, especially new technologies, should regain the upper hand. The real issue is: who will benefit/be affected by the flare-up? Beneficiaries would be those subjects, states in the first row, who are more indebted; those who are less so or not at all would be affected. In Italy, which has a debt/GDP ratio of around 160%, demand is still uncertain and inflation is low (1.3% in May), while in Germany, which is expected to have a debt/GDP ratio of 70% at the end of the year, inflation has risen to 2.4% and the Bundesbank fears it could reach 4%. The United States, with an inflation rate of 4.2%, is one of the few countries that will see its debt, which will still exceed 130% of GDP, erode. The experienced manager has no difficulty in imagining that there will be tensions between the countries of the European Union (EU). Those who, like Italy, have low inflation, will want the ECB to maintain an expansive policy. While those, such as Germany with high inflation, will demand that monetary policy should be turned from expansive to neutral, in order to prepare for the restrictive phase when the pandemic is behind us and economic growth has consolidated. Both the Federal Reserve and the ECB have put their hands on the table, stating that they consider the rise in inflation to be temporary and that they will not start tightening just yet. The markets believed this and for the time being interest rates have moved little. In the U.S. the 10-year bond rate has even dropped. The hammer of the citizens, who will begin to suffer the erosion of their incomes, will begin to fall on the politicians telling them to intervene. And Germany will not remain silent.

The professor listens. According to him, inflation targeting works very well, at least in theory. "By adopting it," he says, "central banks manage to drive inflation to the target within a few months. But in the European system things get complicated because inflation targeting requires different historical paths from the one expressed by Frankfurt. "Here," the academic continues, "it is not just a matter of explaining that the ECB is trying to support public debt in common (and beyond). If that were the case, it would be a real violation of the EU's functioning treaty. The reason is deflation aversion. If, as scientists tell us about coronavirus, we are about to enter a fourth wave, it is very likely that the economies will suffer a contraction to which create opposition. The inflation of these months is temporary in nature. A fourth wave of similar size to the third would lead us (on average) to less than 1% in less than a year. The fears are that should economies spiral into a prolonged slump, that 1% could touch zero. Deflation (from demand, the one I am obviously considering) triggers those vicious circles we want to avoid: deflation implies higher debt in real terms and, therefore, higher impaired loans and, therefore, greater difficulties in the credit system and, therefore, lower loans and, therefore, further deterioration of aggregate demand and, therefore, more deflation. The central bank exists to avert this diabolical chain."

This reasoning, however, annoys the other journalist who, comforted by his certainties hardened in the houses of the greatest European austerity (the Swiss and the German) wants to immediately bring the bell back to the center of the village. On the subject of inflation, there are two central points. The first - he says - concerns the basic objectives of the institutions we are talking about. States must (should) aim at containing public debt in the long run, not increasing it, and this in the interest of all taxpayers and the economy as a whole. Central banks must (should) aim for price stability, aiming for zero inflation without going into negative territory. But, according to him, it is not reasonable "for central banks to set targets for increasing inflation, even when there is no deflation." The second point, of which we are losing memory, is that "inflation erodes purchasing power, in this sense it is negative, especially for wages and pensions; it is also negative for creditors, whose money lent loses real value, and on the other hand it is partly positive for debtors (who benefit from the loss of value of the debt, while suffering an almost certain increase in interest rates), with a mechanism then of incentive for further debt (he who thinks wrong is wrong, but maybe he gets it right)". From all this it follows that inflation should be accepted only for the part that is inevitable in market economies (movement of goods and services and reflections of these in prices) but should be avoided for everything else. "If global trade," he concludes, "technologies and other factors allow developed economies to have less than 2 percent annual inflation, what's wrong with that? Indeed, I would say it is an achievement." It would therefore be desirable for central banks to shelve their inflation hike targets sooner or later.

The elderly manager, with his strong-willed character, is beginning to lose patience: "I believe it is time to address 'inflation', as well as GDP, with new criteria and a broader, less academic and less 'accountant-like' vision, even a hint of a tax increase should be considered in this context: if the amount collected is correctly allocated by the state, the country is strengthened and confidence is not lost in those who want to undertake and take risks. It must also be considered that the public debt may never be repaid: it must therefore be examined from the perspective of its sustainability because interest must be paid and it cannot be expected, except in the case of natural disasters, that certain countries pay the costs to ensure the welfare of others and that Southern Europe continues to condition, with its deficits, the interventions of the ECB to the point of undermining its independence".

The issue of inflation is closely linked to that of commodities and oil in particular. The producing countries, such as Saudi Arabia, and the producers themselves, such as Aramco, ENI, BP, Shell are very happy for the price to go up. But, acknowledges the former business executive who knows the sector well from experience, "at the same time they are careful not to stimulate too much the restart of supply from non-OPEC countries and the increase of investments in renewable energies". In this tension are the uncertainties about future investments, which have horizons of 20-30 years, given the difficulty of predicting long-term demand. "With the uncertainty - says the manager - it is therefore conceivable a scenario of the oil market (but also applies to other commodities) with prolonged swings in excess demand and, therefore, high prices that would jeopardize the forecasts of central banks that today see increases in oil prices and commodities as a temporary phenomenon." The senior manager's conclusion is clear and unquestionable: "Inflation is bound to rise because it is an announced objective of the central banks and will not be a passing phenomenon. The real question is: how quickly? And at what levels will it be? And this will depend a lot on the annual growth of the economy which, if it is between 3% or 4%, will make it easier to finance the deficits of individual states. But I agree that deflation is much more dangerous than inflation".

Fascinated by the debate, another manager, an asset manager, decides to intervene, even though the hour is late and many things have already been said. Theory, for him, is important but also dangerous: a choice motivated by a wrong view quickly translates into painful losses. "Markets," he says, "are by essence reflexive and ideological. Two terms that awaken colleagues from their late-night torpor. What does "reflective" and "ideological" mean, we are certainly not here to talk about "anarchy and freedom", they think in unison, remembering the song by Gino Paoli.

The term "reflexivity" comes from George Soros. The famous hedge fund manager developed the application of the reflexivity theory of his master, Karl Popper, to financial markets. According to this approach, market values are often driven by the fallible ideas of participants, not just by economic fundamentals. Based on reflexive feedback loops, ideas influence events and events influence ideas in a dynamic that can even lead to self-fulfilling[2] prophecies. But ideas, free, often

[2] George Soros, *Fallibility, reflexivity, and the human uncertainty principle*, "Journal of Economic Methodology", Vol. 20, N. 4, 2013, pp. 309-329.

in contradiction with each other, clash with the desire for coherence of those who act in society and therefore also in that subset of society represented by financial markets. There is a continuous attempt to organize them in a logical and rational way: ideas structured in this way become ideology. Reflexivity is the engine that constantly modifies ideologies, to the point of determining new paradigms of thought. Marxism has been a powerful instrument of logical organization of ideas that has strongly oriented the thought of the twentieth century. It endured until the fall of the Berlin Wall. Keynes' thought also contributed to its shattering. Perhaps precisely because "giving ourselves an organized and orderly method of thinking about particular problems" triggered feedback mechanisms that over time discredited Marxist ideology.

Milton Friedman's liberalism, which came soon after, expressing that new organization of ideas promoted by Ronald Reagan and Margareth Thatcher, was an equally powerful ideological engine. It was so overwhelming that the political scientist Francis Fukuyama allowed himself to theorize that, with the advent of liberal democracy, ideologies even ended[3]. Liberalist ideology supported the financialization of the economy, globalization and the resurgence of China. But after the 2008 financial crisis, new reflexive feedback effects accelerated that steady movement of rationalizing ideas. Then, in 2020, the COVID-19 pandemic broke out, unleashing another wave of action-reaction that allowed the world's economies to avoid being wiped out by the virus. Central banks, with their ability to decide and act quickly, have been proponents of powerful reflexive feedback loops. They have constructed a "narrative" (narrative is also a rational construction of ideas) that has imposed itself on markets. The various Quantitative Easing (QE), i.e. buying bonds, then injecting liquidity into the system, allowed the financial world to save itself from itself in 2008 and then to withstand the virus. Permeated by *Modern Monetary Theory* (which is also a first rationalization of ideas) central banks have instilled in the market the idea that they can intervene with powerful financial injections until inflation starts. And if

[3] Francis Fukuyama, The End of History and Last Man, Simon & Schuster, New York 2006, 432 p.

inflation doesn't rise, it means that QE is not only the tool to save the system, but also the modern means to finance a new digitized and sustainable economy at virtually zero cost. COVID-19 also forced states to intervene directly with fiscal policies that complemented financial ones. The return of the state and the activism of central banks create reflexive movements that are changing the ideological framework of departure, the liberalist one. A new path of rationalization of ideas is taking shape, but it is not there yet. However, we can identify three characteristics of becoming: the return of the state in the economy, the rescaling of globalization around the values of sustainability (environmental, social and governance), and the power of digitization. While the first two are inherently inflationary, the third, digitization, is deflationary. The new scenarios of rationalizing ideas, so it seems, can only emerge in a context of no excessive inflation: to finance the new, rates must remain low. This is the "macro ideological" scenario that is emerging with the involvement of central banks. But COVID-19 has reshuffled the cards. The virus' inherent deflationary risk (demand paralysis) has been greatly reduced thanks to liquidity injections and fiscal policies. The return to normality is a battle between variants of the virus, vaccines, the population's willingness to be vaccinated and the desire to spend after hoarding savings or putting them at stake in the financial world, perhaps with online trading or cryptocurrencies. Inflation is a response to the feedbacks that flow from the normalization path. The central bank narrative is to convince the market that it is only dealing with temporary flare-ups due to bottlenecks that have been created on the supply side. And the markets seem to believe it. For this reason, for the time being, they are not too concerned about the 6.1% inflation recorded in the USA in the second quarter (a level that has not been reached since 1980) or the 4.5% growth in core inflation in June (the highest since 1990). In the Eurozone, inflation of over 3% in Germany and 2% overall are also not cause for particular concern. One has to wonder if the bond market has stopped thinking or if it simply believes the Federal Reserve's narrative and the feedback from the delta variant: The 10-year Treasury rate fell to 1.25% in July, losing 23 basis points (bps), the largest drop since April 2020. This context allows central banks not to be in too much of a hurry with tapering (the reduction of bond purchases) and markets are celebrating even though they are hovering at decidedly worrying highs according to some measuring instruments (P/E). China, towards which the attacks of the West are directed, is the deflationary factor (its products have contributed to lowering prices throughout the world). Wanting to reduce its role opens up an inflationary scenario (it will be necessary to produce more at home at higher prices). China's response is underway: it is trying to regain control of the large digitization companies by reintroducing competition in this area. Perhaps it has realized that the digital variable is the key that will allow costs to be contained and thus allow the new economy to be financed through low rates.

After this last intervention, the four friends are tired. They decide that, like cows, it is time to ruminate on these reflections during the summer vacation period that awaits them, at least until the Jackson Hole Symposium on August the 26-28th, when the heads of the world's major central banks will meet to discuss, among other things, inflation and monetary policies.

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