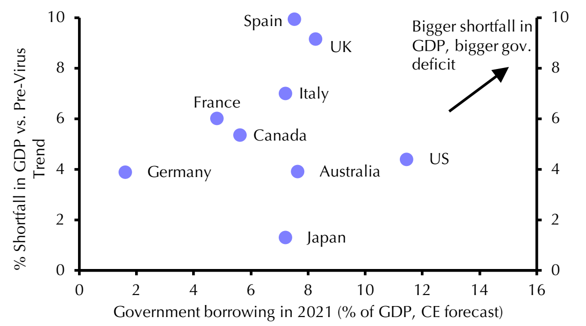
CAPITAL ECONOMICS

GLOBAL ECONOMICS UPDATE

Inflation risks highest in the US

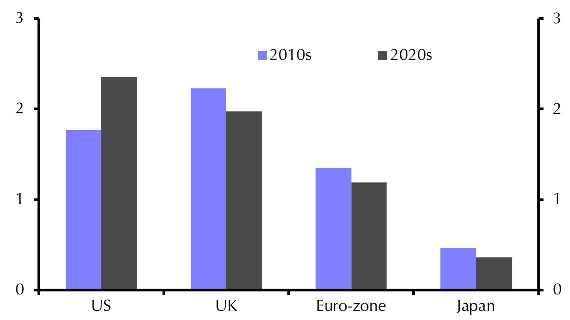
- **While it is still early days, the ingredients for a sustained pick-up in inflation over the next few years seem to be falling into place in the US. It is a different picture in other developed economies; indeed, we still think that medium-term inflation risks are much lower in the euro-zone and Japan.**
- Inflation is set to rise across all developed markets (DMs) over the next few months, reflecting energy effects, rising logistics costs and supply shortages. (See here.) Euro-zone inflation already jumped particularly sharply in January, reflecting these and other factors, such as the reversal of Germany's VAT cut. (See here.)
- But these are temporary influences. In a *Focus* last September, we argued that the inflation outlook further ahead will depend more on policymakers' attitudes towards inflation. We said that higher inflation was most likely to emerge in those DMs which, first, were likely to keep running fiscal deficits after the pandemic and, second, could most easily adapt their monetary policy frameworks to permit higher inflation. **We thought that the US was most likely to fit the bill and recent developments seem to support that view.**
- All countries are still running big fiscal deficits in response to the pandemic and are likely to keep current support programmes in place for as long as economies need them. But its $1.9trn proposed fiscal stimulus means that, even if it is only partially passed, the US will remain well ahead of other countries in terms of the scale of this fiscal support. (See our *US Economics Focus* here.) The contrast is particularly stark with the UK, where the debate has started to shift towards the need for tax *increases* to heal the public finances.
- **Moreover, the extra stimulus in the US does not look particularly warranted by the economic situation; compared to other DMs, the US has a relatively small shortfall in GDP relative to its pre-virus trend, due in part to the generous fiscal measures already introduced**. (See Chart 1.) Remember, too, that the US was running significant fiscal deficits even before the coronavirus hit (with a deficit in 2019 of over 6% of GDP). Indeed, we expect the US still to be running a significant deficit of about 5% of GDP next year.
- **Meanwhile, most central banks have suggested that they will not be as quick to tighten monetary policy as they might have been in the past. But the US still seems to be several steps ahead of the other DMs.** Not only has it gone further than most other countries in explicitly adopting an average inflation target, but it also seems to be taking a particularly flexible approach to its full employment mandate; Jerome Powell recently suggested that the Fed could delay tightening policy if the unemployment rates for minorities and low-wage workers were too high. **While other countries have suggested that inequality might play a bigger role in their monetary policy decisions, none have done so as openly as this.**
- **Accordingly, we continue to think that higher inflation is most likely to emerge in the US over the next few years.** (See here.) Chart 2 shows that, in contrast to the other major DMs, we expect inflation in the US to be higher over this decade, compared to the last. Such a divergence in inflation rates among DMs would be unusual but not unprecedented. And we think that inflation in the US could rise further thereafter – for more detail on our forecasts out to 2050, see our new service The Long Run.

Chart 1: GDP Shortfall & Government Deficit



Source: Capital Economics

Chart 2: CPI Inflation (%)



Source: Capital Economics

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