Mizuho Insights: Output Gap

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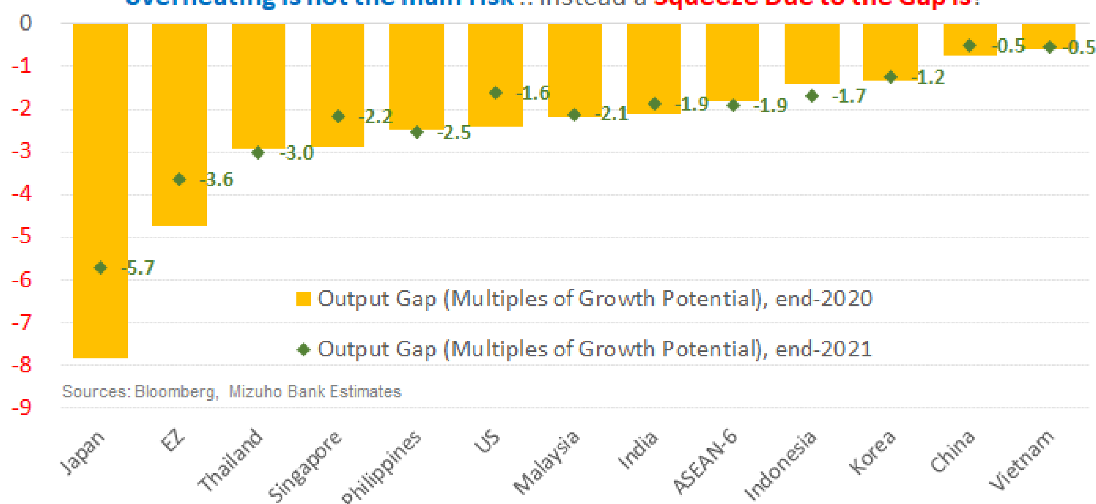
The (Output) Gap Between Reflation & Inflation Risks

"Strong am I with the Force. But not that strong." – **Master Yoda, Star Wars Ep. VI: Return of the Jedi**

In a Nutshell: Fears of untethered inflation down the road from **extraordinary policy stimulus** are **understandable, but nevertheless misguided**. To be sure, **unprecedented policy stimulus** – in particular, the **conspiracy of exceptionally large QE** and **never before seen levels of fiscal stimulus** – will **inevitably unleash cost-push pressures**. **But that is a feature**, albeit by way of by-product, of any effective reflationary policy (monetary/fiscal stimulus). **Whereas, reflation-induced cost-push does not necessarily evolve into an inflationary spiral/overheating requiring policy response**. **Not even if** layers of cost-push are **accentuated by vaccine optimism** and **capacity constraints** colliding with **policy-induced cash deluge**.

Reason being, **record negative output gaps** across the board **negate**, or at least override, **the risk of run-away inflation**. **Crucially**, **gradual rather than robust** pace of **re-narrowing of the output gap is consistent with transitory cost-push** (**from reflation**) **dissipating amid weak wage-price dynamics**. In other words, **negative output gaps serve as a circuit-breaker between transitory cost-push and self-sustaining demand-pull inflation**. The upshot is that monetary and fiscal stimulus need not be hastily yanked given risks of unhinged inflation expectations wreaking havoc are subordinated to the greater danger that too little. Master Yoda's words of *"not that strong"* ring true of inflation with respect to "*the Force*" of reflation.

Figure 1. Even as most global economies rebound to positive growth, ***output gaps remain negative, and in some cases, widen!*** Thus, **overheating is not the main risk** .. instead a **Squeeze Due to the Gap is**!



Reflation & Inflation: What's the Difference?

For the purposes of context and clarity, **reflation refers to policy (monetary/fiscal) initiative aimed at reviving demand**. Whether this is driven by price (interest rate) or quantity (QE) aspects of monetary policy and by tax (cuts) or enlarged fiscal spending are just details. Regardless, **any effective reflationary policy ought to constitute a pick-up in prices**, ***typically led by cost-push pressures on demand recovery expectations.*** Whereas **inflation is defined to be the generalized increase in prices**; **whereby cost-push pressures entrench as demand-pull pressures**.

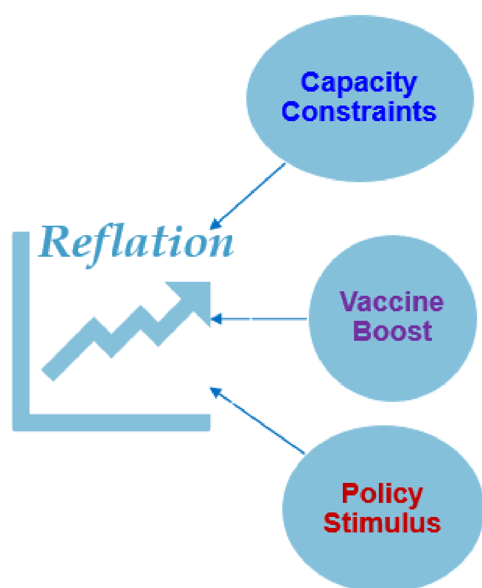
More specifically, the "inflation" **that central bankers are committed to guard against**, entails a **more aggressive iteration of this brand of demand-pull inflation**; which exceed policy threshold and threaten to impair future growth

prospects. And so, the wider point is **while (transitory) cost-push being a feature of effective reflationary policies**, **run-away inflation is not an unavoidable outcome**. In other words, **reflation need not always be a victim of its own success**; ending up **hijacked by risks of inflationary spirals**.

The Inflation Debate …

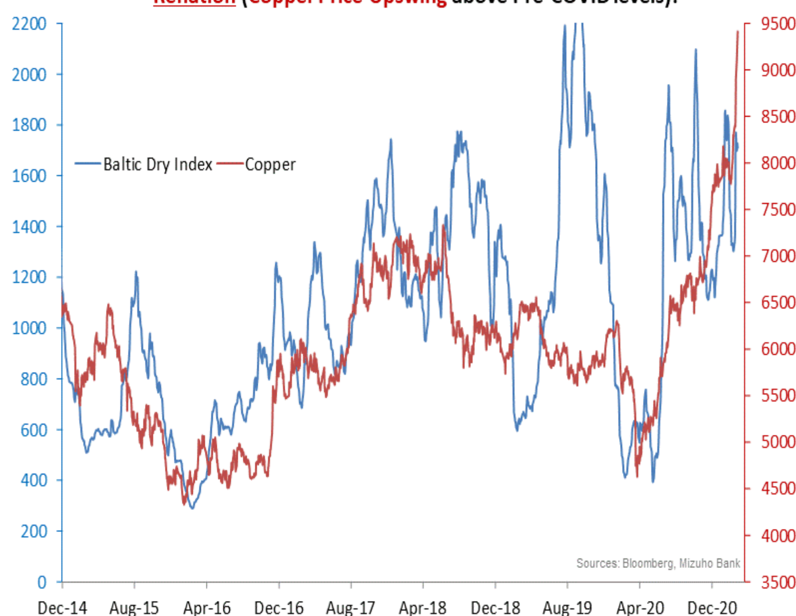
The argument rests on inflation beyond base effects and the notion that cost-push pressures will not be transitory; and the concerns are not without bases. Admittedly, **unprecedented policy stimulus** constituting lower for longer rates, record quantitative easing and exceptional fiscal spending, **push the envelope on pump-priming**; thereby setting the stage for a **sharp jump in inflationary pressures**.

Figure 2. Reflation from Policy Stimulus Accentuated by Capacity Constraints & Vaccine Boost to (Pent-up) Demand.



Source: Mizuho Bank

Figure 3. Confluence of; i) early-Recovery Capacity Constraints; ii) Vaccine Catalyst-Type Impact &; iii) Unprecedented Stimulus; Drive Reflation (Copper Price Upswing above Pre-COVID levels)!



Especially as **demand recovery from "the other side" of the pandemic conspires with** a steep step-up in **(pent-up) on "herd immunity"** and **capacity constraints to accentuate inflationary pressures** (Figure 2); and aspects of this are already observed in the sharp surges in commodity price and shipping cost related to production and logistics capacity constraints respectively (Figure 3).

… Dampened by the (Missing) Wage-Price Link

However, a key **link between cost-push inflation**, which is typically transitory in isolation, **and entrenched inflation risks** is the **demand-pull mechanics that are predominantly driven by wage-price spiral**. Simply put, self-sustaining inflationary expectations require a **feedback loop of rising prices and wage growth expectations**.

And this is where the **rubber on inflation expectations fails to meet the reflation road**. Fact is, into this **nascent recovery** out of the pandemic, aggregate demand restoration is more likely than not set to be **uneven**, and **tentative**, if not fragile. That is, even if spots of pent-up demand restoration, **a lot of initial demand overshoot may be short-lived** and subject to substitution. Crucially, **as fiscal support fades**, **households and firms may be subject to the double-whammy of higher costs** (eroding discretionary income and margins) **and subdued wage/revenue growth** amid lingering uncertainty and economic restructuring.

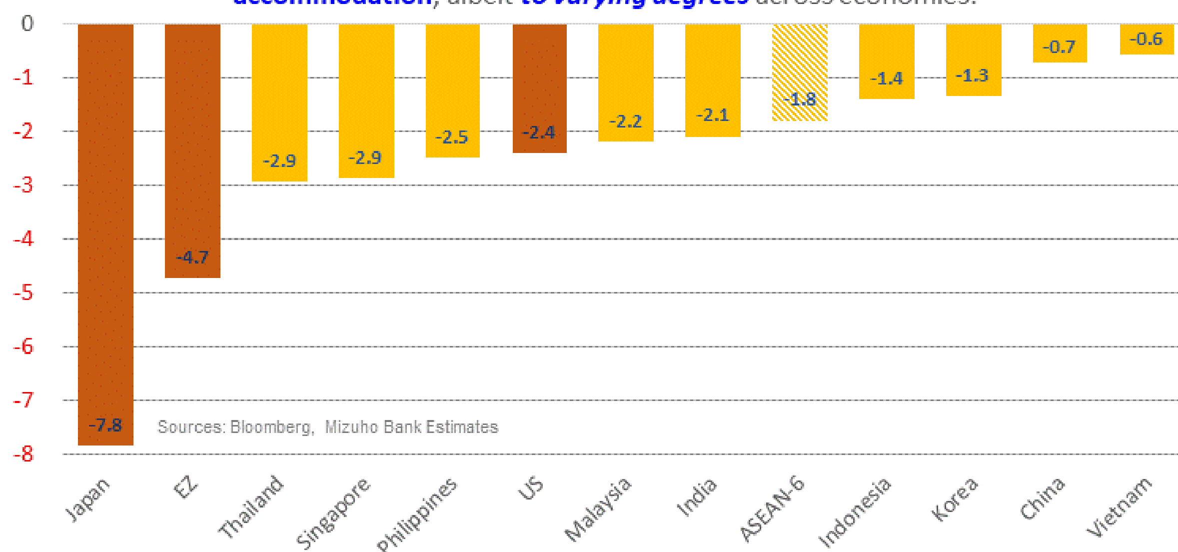
And so, the **conspicuous absence of wage pick-up** in the initial phases of post-pandemic recovery, likely through the first half of 2022 **suggests** that **inflation from cost-push factors may (at least initially) be considered as benign and transitory** with **diminished risks of persistent demand-pull pressures**.

Output Gap Circuit-Breaker

Critically, the **deeply negative "output gap"** (Figure 4) **–** a measure of **how far below output levels otherwise suggested by potential growth an economy is** – **acts as a "circuit-breaker" for potential cost-push inflation pass-through to demand**. Fact is, global economies well below their capacities will have **a lot of "slack" within which cost pick-up may be assumed** (given both weak demand and supply adjustments to response to price increases). In which case, inflationary pressures may be subdued by the dampener effects of spare capacity in firms, if not weak demand.

Typically, **a large, negative output gap** (in multiples of respective GDP) is **inconsistent with wage-price spirals** due to constraints on both firms and households to increase demand and wages correspondingly. Especially if the negative output gap is only expected to close/narrow gradually. And to be clear, **even with stellar-looking headline growth (flattered by base effects) expected in 2021**, **output gaps are expected to only narrow gradually**, if at all (Figure 1); **reinforcing the view that binding inflation risks are some way off**. In turn, this suggest that **policy makers may have some allowance to maintain exceptional policy accommodation** as the **dangers of dropping the baton on a robust recovery override** the risks of inflation usurping the economic agenda.

Figure 4. The **Negative Output Gap*** (expressed as Multiples of Growth Potential**) as a result of the **COVID shock is Severe**, validating the **need for continued policy accommodation**; albeit ***to varying degrees*** across economies.



Growing Out of Risks

In fact, **given that the nature of reflation cost-push tends to be destructive for demand recovery** (through erosion of profits and discretionary income), a **combination of fiscal stimulus to "crowd in" private sector investments** alongside **monetary accommodation** may be one path **to lift growth/production capacity and technological efficiencies to grow out of debt as well as supply-side cost-push risks** more durably.

All said, prioritizing the risks that the global economy is confronted with, we may not only draw some comfort that **inflation risks are kept at bay by negative output gaps** but ***in fact*** that **negative output gaps demand that central banks and governments don't take their foot off the pedal**.

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