

The Economic Aftermath of the War Against the Pandemic: Inflation, Recession, Deflation, Stagflation or Secular Stagnation?

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“The best way to destroy the capitalist system is to debauch the currency. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens.” – John Maynard Keynes (1883-1946), British economist, 1936.

“All crises have involved debt that, in one fashion or another, has become dangerously out of scale in relation to the underlying means of payment.” – John K. Galbraith (1908-2006), in 1994.

“Sooner or later a crash is coming and it may be terrific. The vicious circle will get in full swing and the result will be a serious business depression. There may be a stampede for selling which will exceed anything that the Stock Exchange has ever witnessed. Wise are those investors who now get out of debt.” – Roger Babson (1875-1967), American entrepreneur, economist, and business theorist, on September 5, 1929.

After forty some years of disinflation and declining interest rates, there is some confusion about whether or not this long disinflationary decline is about to end, to be replaced with a creeping up of real wages, prices and interest rates.

This could certainly be the case in the wake of the current post-pandemic economic recovery. In the longer term, we can foresee a context of significant [demographic](#) changes, while economic and financial [globalization](#) will continue to show signs of abating, and could even be reversed in the years to come.

These changes will produce negative shocks on labor supply and be accompanied by upward price pressures. All of this, of course, in the context of significant climate change and rising adjustment costs.

Similarly, it is also possible that major economies will experience creeping inflation, at least in the coming few years, as this has happened after the economic dislocations of a war.

After World War II, for instance, the six-year period of reconstruction, from 1946 to 1951, was characterized by an average inflation rate of 6.4% in the U.S. This was the result of a combination of both [demand-pulled inflation](#) and [cost-pushed inflation](#).

Many governments and central banks had injected a lot of money in the economy during the war, but because of [rationing](#), people were allowed to spend only part of their incomes and were forced to save a higher proportion of their incomes than they otherwise would. Inevitably, saving rates were very high. Consequently, after the war, there was a lot of [pent-up demand](#), and increased spending pushed prices up.

Also, industrial plants had to be refitted to produce private goods, and those costs also pushed up prices. Moreover, the real estate market was especially propelled by the demographic factor of the post-war [baby-boom](#) surge and by more accessible mortgages.

Today, in the wake of the war against the 2020-2021 [global pandemic](#), the real estate market is also [very hot](#), again propelled by a demographic phenomenon, this time by record immigration levels, accompanied by generous public emergency income support programs and by super low mortgage rates.

Larger public deficits and growing public debts, and ultra-lax monetary policies by central banks

In order to fight the economic damage brought about by the 2020-2021 pandemic and the subsequent economic lockdowns, governments and central banks in major economies embarked upon aggressive income support programs, larger deficits and higher public debts, combined with important measures of money printing by central banks.

In the U.S., for example, the [national debt](#) (excluding total unfunded Social Security and Medicare promises) of the federal government ballooned from \$22.7 trillion in 2019, to \$28.2 trillion in May 2021, a 24% increase and a level that has pushed the U.S. national debt above 100% of yearly GDP.

Also in the U.S., the Fed purchased massive amounts of Treasury and mortgage-backed securities with newly printed money, as it did during the Great recession of 2008-2009. Indeed, on March 15, 2020, the Fed announced that it would be buying at least \$500 billion in Treasury securities and \$200 billion in government-guaranteed mortgage-backed securities over “the coming months”.

And, in December 2020, the Fed reiterated its policy of buying monthly ‘at least’ [\\$120 billion](#) of Treasury bonds and mortgage-backed securities (\$80 billion of government debt and \$40 billion of mortgage-backed securities), and this “until the economy recovers to ‘full employment’”.

However, there could be a problem in defining ‘full employment’, because millions of workers have decided to exit the labor force or to [retire for good](#) during the pandemic and the economic downturn.

Thus, the labor force could be smaller today than before the pandemic, resulting in a tight labor market and labor shortages in some trades, because, according to employers, some workers simply [do not want to work](#), unless it is from home. Therefore, no matter how long the Fed keeps interest rates to the floor, it’s dubious that all jobs lost during the pandemic

recession will come back.

The risk of financial bubbles

However, the massive purchases of securities by the Fed have pushed short-term interest rates to close to zero, while keeping longer-term interest rates artificially low. In so doing, the Fed (and other central banks) has created [bubbles](#) in bond prices, in stock prices and in real estate prices. And when such bubbles burst, a severe recession could logically follow.

The Fed's ultra loose monetary policy of excess liquidity has also resulted in the unusual situation of [banks being awash with excess cash](#) that they couldn't lend profitably, leaving them no other choice but to deposit most of it at the Fed, in the form of excess reserves. As of June 2, 2021, American banks' deposits totaled \$15,802.6 billion (not seasonally adjusted), as compared to only \$13,912.2 billion in March 2020, a 12% increase.

As an indication of such an ultra loose monetary policy, the [Fed's balance sheet](#) ballooned during the pandemic, going from \$4.17 trillion in late December 2019, to \$7.95 trillion in early June 2021, a huge 90% jump.

An extended ultra loose monetary policy can possibly feed inflation, or, if an economy is already in a recession or into an economic downturn, it can produce so much liquidity that the economy becomes mired in a liquidity trap.

A liquidity trap and a debt trap

In my intermediate macroeconomics textbook, here is how I define John Maynard Keynes' [liquidity trap](#):

The monetary situation that prevails when short-term interest rates are way down and everyone anticipates a fall in the price of bonds and an increase in interest rates, so that any further increase in money supply by the central bank is not spent but is hoarded.

To extricate an economy from a liquidity trap, a central bank can gradually end its purchases of securities and let interest rates slowly rise. On the other hand, fiscal policy can become more aggressive in stimulating investments and aggregate demand.

Currently, central banks in the largest economies are at an impasse, as their persistent policy of artificially keeping interest rates close to zero—with even negative interest rates in Europe—has not only created a liquidity trap, it has also encouraged a general increase in debt levels, possibly creating a debt trap when rates are one day allowed to rise.

Debt trap for monetary policy

Indeed, central banks are not immune from a situation of [moral hazard](#) or from a [debt trap](#).

When a central bank pursues an easy money policy and keeps interest rates artificially low (and even pushes them into negative territory) over a long period, it creates an environment that incites not only governments, but also businesses and consumers, to take on heavy or excessive debt loads. This is the well-known case of [Japan](#), where the economy has been bogged down by deflation and economic stagnation for more than a quarter of a century.

Both in Europe and in North America, central banks have been pursuing—since 2008, and even more since March 2020—very aggressive quantitative easing (QE) monetary policies. They have kept interest rates artificially low, a replica of Japanese monetary policy.

For example, in the United States, as in most developed countries such as [Canada](#), total [mortgage debt](#) is presently very high, even as some other categories of debt, such as credit card debt, have slightly declined.

In so doing, central banks may have built for themselves a policy debt trap, because they may have reasons to fear that letting interest rates return to their normal level could trigger a wave of bankruptcies, and this would damage the economy. Central banks may have become prisoners of their own ultra loose monetary policy.

Cycle analysis for the real estate market: The Kuznets' cycle

In the U.S., and especially in Florida and California for obvious demographic reasons, the [18-year Kuznets' cycle](#) is well and alive. Previous tops in this cycle were in 1987 and 2005, while bottoms occurred in 1993 and 2011. If the cycle is as reliable nowadays as in the past, (with 12-year price upswings and 6-year price contractions), the year 2023 could see another major top unfolding in real estate prices in the U.S.

Considering that Fed chairman [Jerome Powell](#) has indicated that it is the Fed's intention to keep interest rates at rock-bottom levels for months to come, possibly until 2023, this would seem to coincide perfectly with the Kuznets' cycle rationale.

What does this entail for future inflation, recession, deflation, stagflation and even 'secular stagnation'?

Let us keep in mind that the 2005 top in real estate prices was followed by the 2007-2008 [subprime mortgage crisis](#) and the [2008-2009 Great recession](#), two crises in which the Fed played a major role.

Now, sixteen years later, it would seem that the Fed is going to keep the bubbles alive until 2023, through its purchases of securities and its ultra loose monetary policy. Therefore, inflation should keep creeping up for some months to come.

When the Fed stops its purchasing program, letting interest rates adjust upwards, this will be the sign that the bond market bubble and the real estate bubble are about to end. The stock market bubble could linger, but not much longer. However, when this happens, a severe economic recession could follow.

Conclusion

The coming years should see major reversals in some important economic trends, especially in demographics and in globalization. The 2023-2025 period, in particular, should be watched closely. It could herald a period of [stagflation](#), that is a period of slower economic growth, rising taxes and creeping cost-push inflation.

Indeed, after that period, the [demographic shift](#) could intensify. The 2023-2029 years will see the last baby-boomers retiring, while governments could be facing a looming post-pandemic budgetary crisis arising from the ballooned public debt and the increased costs of caring for an aging population.

Because of a demographic shock to be experienced in most advanced economies in the coming years, labor shortages are likely to linger on, pushing real wages and prices up. Businesses will have a growing incentive to accelerate the use of computer-assisted automation, [robotization](#) and artificial intelligence. Such a move will reduce the demand for some categories of labor and may keep some wages in check.

A wholesale reliance on mass [immigration](#) cannot solve a labor shortage, except in some well-identified sectors or industries requiring specific skills. The generous refugee and family reunification programs in place in many countries add more to the demand for labor than newly imported workers can do to alleviate the labor supply shortage, besides creating social problems.

Finally, let us also keep in mind that 2029 will mark the 100th anniversary of the beginning of the [Great Depression \(1929-1939\)](#). This could revive talks among economists about a potential era of '[secular stagnation](#)', under the influence of negative structural demographic factors and a slowdown in economic and financial globalization.

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