SALT INSIGHT

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Inflation and its structural forces

The big debate of 2021 has been the extent to which recently higher inflation would prove transitory or whether we were in for a period of more sustained inflation requiring a monetary policy response. Central banks overall were initially firmly in the transitory camp. Some, like the Reserve Bank of New Zealand, have since shifted stance, but some, like the US Federal Reserve, remain intransigent in the belief that this, too, will pass. This position has been aided and abetted by a now more flexible approach to inflation targeting.

At Salt we have long been of the view that inflation would prove more of a problem this time. To be sure, much of the supply bottleneck pressures would unwind, but the question for us was what else was bubbling under the surface. Once the transitory forces departed, would inflation fall back to the pre-Covid but post-Global Financial Crisis era of being dominated by structural disinflationary forces?

Our view has been no. This view was partly cyclical, particularly that with governments having taken the opportunity of Covid to move to more expansionary fiscal settings, the labour market was likely to tighten beyond the initial supply demand imbalance of the Covid recovery. Fiscal policy is far more effective at achieving labour market outcomes than monetary policy ever will be.

Our expectation of sustained higher inflation was also based on a view that some of the structural forces at play since the GFC had changed, while others had been over-egged in the first place.

Globalisation

Globalisation has been unambiguously disinflationary. The rapid rise in global trade that began in the 1980s allowed firms to source lowest cost goods, be that final product or inputs into production, and even shift production to other locations.

With the GFC came a change in tune. Globalisation was blamed for much of what was going wrong in the world, particularly job displacement and rising inequality. Globalisation can be blamed for rising inequality within countries but has played a key role in reducing inequality between countries. Globalisation is not the problem – the public policy failure has been the failure to educate and retrain people displaced by globalisation.

Nevertheless, globalisation has been in reverse for much of the last decade and accelerated with the United Kingdom vote for Brexit and the election of now former US President Donald Trump with a mandate to make America great again.

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Trump entered a tit-for-tat process with China of ratcheting up tariffs and other trade barriers with China so that by 2019, the average US tariff was back to a level not seen since the 1990s.

President Biden has taken a similarly hard line with China, as the US voting population demands and expects, and has not reversed these tariffs. Though to be fair he has initiated greater free-trade initiatives with the European Union.

With the onset of Covid, the trend towards lower trade flows has gone beyond the realm of the anti-free trade nationalistic tendencies of some politicians. The pandemic and the resulting disruption to trade flows has many firms around the world rethinking supply chain management and risk mitigation.

The disruption to trade flows and normal business operations is expected to see many firms looking to bring production back home, or at least closer to home. While this will help build resiliency in their supply chain, it may not be the cheapest options and prices will rise as a result so that not necessarily all the recent supply chain-related price increases will reverse.

Looking further ahead, with the trend now towards more restrictive trade practices and with firms looking to build more resilient supply chains, the era of globalisation as a structural disinflationary force is at an end.

Demographics

There is more conjecture over the role of demographics, and particularly the ageing of populations, as an inflationary or disinflationary force.

The disinflationary argument typically cites the Japan experience of the past few decades. Japan has been at the forefront of ageing population profiles which has coincided with a period of entrenched deflation.

There have clear structural forces at play in Japan and the labour market is at the heart of many of them, including the inflexibility of the labour market combined with wage setting behaviours that are disinflationary. However, the ageing of the population is not one of them.

The early stages of the decline in Japan working age population coincided with a significant increase in the global working age population, primarily in China. That story has now changed as the working age population in China is now in decline.

We think of ageing populations as inflationary rather than disinflationary. As dependency ratios rise and growth in working age populations slows, labour markets will tighten, and wages will rise.

The offsets to this are immigration or increases in the labour participation rate - the ratio of the working age population that chooses to participate in the labour market. Immigration is likely to be more constrained in a Covid world and, in some countries, political challenging.

That leaves engineering increases in the participation rate which is equally challenging. Some countries are better placed that others. In the United States the participation rate is in long term structural decline given the ageing profile of the population base. Any reversal of that relies on increasing the participation of women, which is not just a US issue.

Here in New Zealand our participation rate is already high by OECD standards. But you must be careful what you wish for. On the one hand it is a sign of a well-functioning labour market. On the other hand, it reflects the challenge of housing affordability and of families meeting mortgage commitments in a single-income household.

On balance we believe demographic changes are inflationary, though there are offsets that will limit its potency. As life expectancy increases, so too does the impetus to save more while working, reducing pressure on the supply of goods and services. Another factor is the reduced level of unionisation of the workforce over recent years which has reduced wage bargaining power.

Technology

Technology supporting improved productivity is often cited as a disinflationary force. The theory goes that as technological advancement increases productivity, employees can produce more with less so wages can rise without firms having to increase prices.

Technological progress isn't a new thing. It has been with us for a couple of centuries now. Furthermore, the period since the Global Financial Crisis has seen disappointingly low rates of productivity growth, even in countries like the United States which saw much stronger rates of productivity in the late 1990s to the early 2000s as the personal computer was introduced to the workplace.

Since the GFC technology has been transforming our lives in a different way. The rise of E-commerce has changed how we shop, reduced costs for retailers who no longer need to rent or own retail premises and has increased competition through transparency of pricing so that consumers can compare prices across retailers online in a matter of seconds.

A couple of questions arise as to whether we will continue to see a continuation of downward price pressure from E-commerce. Firstly, for this to continue as a disinflationary force, ever more shopping needs to move online. While online shopping will continue to grow a natural saturation

point will eventually be reached. Some countries, like the US, are closer to this point than countries with a low online shopping ratio, such as New Zealand.

Secondly, it appears investors in online platforms are becoming increasingly impatient for a return on investment which seems likely to result in price increases rather than further decreases. Innovations in consumer credit by online entrepreneurs also tend to impose small but material costs on retailers, narrowing their margins or encouraging them to recoup the costs of granting shoppers "afterpay" credit via price stickiness or rises.

However, there is good news on the productivity front. As labour markets become tighter in the post-lockdown recovery, business investment is recovering. This is exactly what we would expect to see as labour becomes hard to find while demand continues to grow – firms looking to boost production in more innovative ways. This will help contain price increases.

Technology is both a plus and a minus for the inflation outlook. The disinflationary forces that have come from online retail platforms could be at their zenith, while the productivity gains that come from continued investment in innovation will continue to contain inflation, so long as it provides the long-awaited shot in the arm for productivity growth.

Higher for longer?

Central banks are gradually coming to realise that while some of the inflation we are witnessing right now will prove transitory, cyclical forces such as tight labour markets mean inflation will not fall back as much as previously expected after those transitory forces have faded.

The Reserve Bank of New Zealand likely understands that and will start a monetary policy tightening cycle in a few days that we expect will see the Official Cash Rate rise to around 2% over the next 18-months.

Looking through those cyclical factors we further believe that those structural disinflationary forces that have prevailed for the 14-years since the Global Financial Crisis will be at least less potent and possibly morph into inflationary forces.

The era of lower-for-longer interest rates is at its end.

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