Global Inflation – The End Of An Era

Sharmila Whelan, July 22, 2021

In the post-Covid era, global consumer price inflation will remain higher than pre-pandemic levels even as temporary price increases fade. If inflation is indeed a monetary phenomenon as famously posited, liquidity is abundant among both companies and consumers. Moreover liquidity will remain plentiful, interest rate normalisation slow. Advanced country central bankers are likely to be cautious due to ongoing Covid flare-ups, an uneven economic recovery, high levels of public and corporate debt, and a growing acceptance of higher inflation. There are structural shifts afoot. Going green is going to be costly. The trend towards increased political and fiscal intervention also indicates that Modern Monetary Theory has further to run as well. Additionally, China's readiness to allow the yuan to strengthen suggests it will export inflation rather than deflation to other nations. Moreover, the global market for goods and services is fragmenting, implying that Western consumers may not benefit from historical price advantages.

There is significant divergence in perspectives regarding whether the world is heading towards deflation or inflation, and how this will influence monetary policy in advanced economies. Amidst concerns over a resurgence in global Covid cases and fears of economic slowdown, uncertainty surrounding the inflation outlook is contributing to market volatility. Although central banks like the Fed and ECB have assured markets that current consumer price inflation is transitory and that monetary policy normalization will occur gradually, investors remain apprehensive. The yield on the 10-year US bond reflects this unease, with markets now predicting the first US interest rate hike in March 2023 and the second around September 2024.

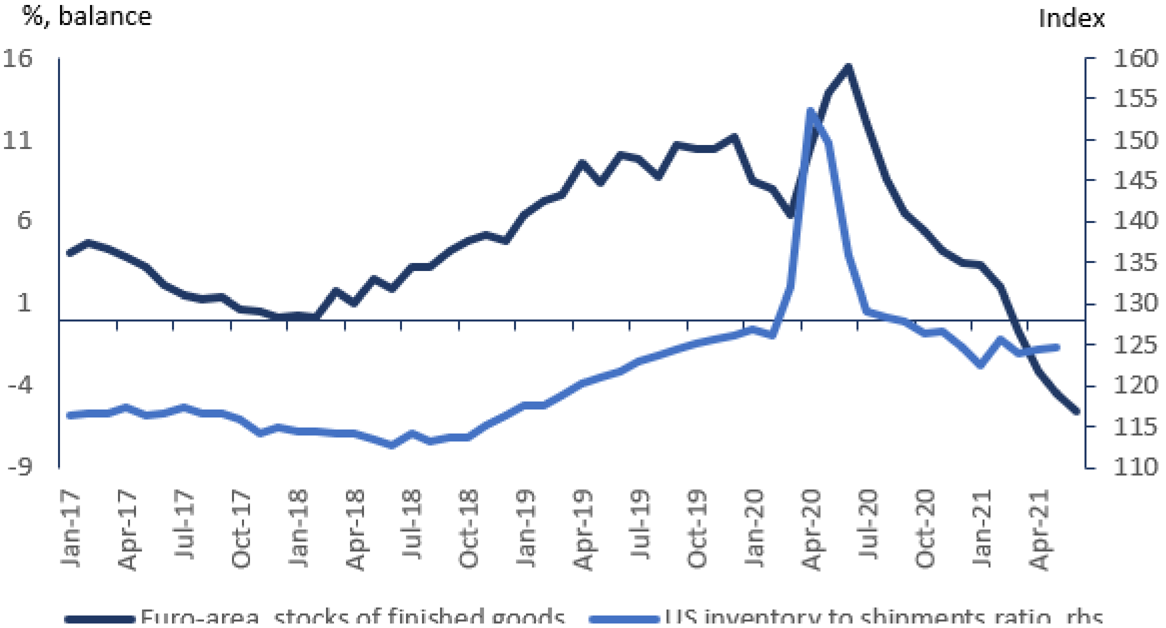
In this report, we first examine the drivers behind the current surge in consumer prices before delving into the critical question of where inflation is headed in the medium term. We explore arguments put forward by proponents of both inflation and deflation, and propose a third perspective.

Current Price Spikes

Consumer prices are rising globally. In the US, year-on-year CPI inflation reached 5.3% in June, up from just 0.2% in May the previous year. Similarly, in the euro area, consumer prices, which were in decline until December, are now rising by nearly 2% annually. This inflationary trend extends beyond advanced economies; for instance, India saw a 12% increase in wholesale prices compared to the previous year, while Chinese producer price inflation surpassed 9% year-on-year after a decline from mid-2019 to late 2020.

The primary cause of these price spikes is an imbalance between robust demand and limited supply. Figure 1 illustrates this imbalance, showing tight finished goods inventories among Euro-area manufacturers and a reduced ratio of finished manufactured goods inventory to shipments in the US. Supply bottlenecks are prevalent across the global manufacturing sector, exacerbated by a well-documented shortage of semiconductors impacting industries like automotive and electronics worldwide, and even leading to production cuts back among US and Japanese car manufacturers.

Figure 1: US and Euro-area manufacturing finished goods inventories – Tight



Source: Haver Analytics, Aletheia Capital

Furthermore, commodity prices are escalating due to years of underinvestment and restocking efforts by companies (see Figure 2). Despite recent corrections, the S&P GSCI index, comprising 24 major commodities, has risen by 34% year-to-date. Food prices are also climbing, influenced by factors such as droughts in Brazil and increased Chinese imports. Exporters, like those in Korea, are passing on higher input costs to final consumers through elevated export prices.

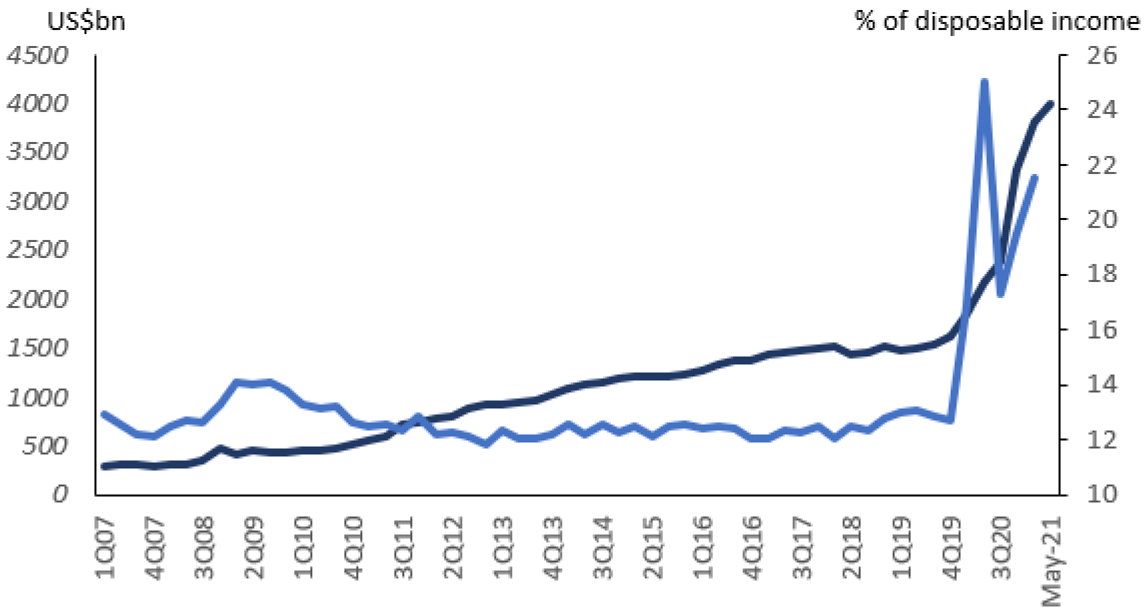
Figure 2: S&P GSCI commodities price index – Spiking up

Source: Trading Economics

Labor markets present another pressure point. Although there is theoretically ample slack, shortages and mismatches in skills are driving up wage costs in sectors, particularly services. Emergency pandemic support measures, initially aimed at protecting employers and businesses, are now artificially tightening labour markets. For example, furlough schemes in Europe and additional unemployment benefits in the US are discouraging workers from returning, particularly in low-paid sectors such as hospitality and entertainment, where demand for labour is highest as economies reopen.

Demand-driven price pressures are also significant. Figure 3 illustrates the high levels of household demand deposits in the US and the savings rate in Europe, indicating substantial consumer spending power and pent-up demand. A significant portion of the rise in savings is precautionary, resulting from restricted spending opportunities during lockdowns and substantial government transfers. For instance, US households received $1.9 trillion more in transfer payments than pre-Covid levels, while experiencing a $366 billion loss in personal income over the past 14 months due to pandemic-related lockdowns (according to the Bureau of Economic Analysis).

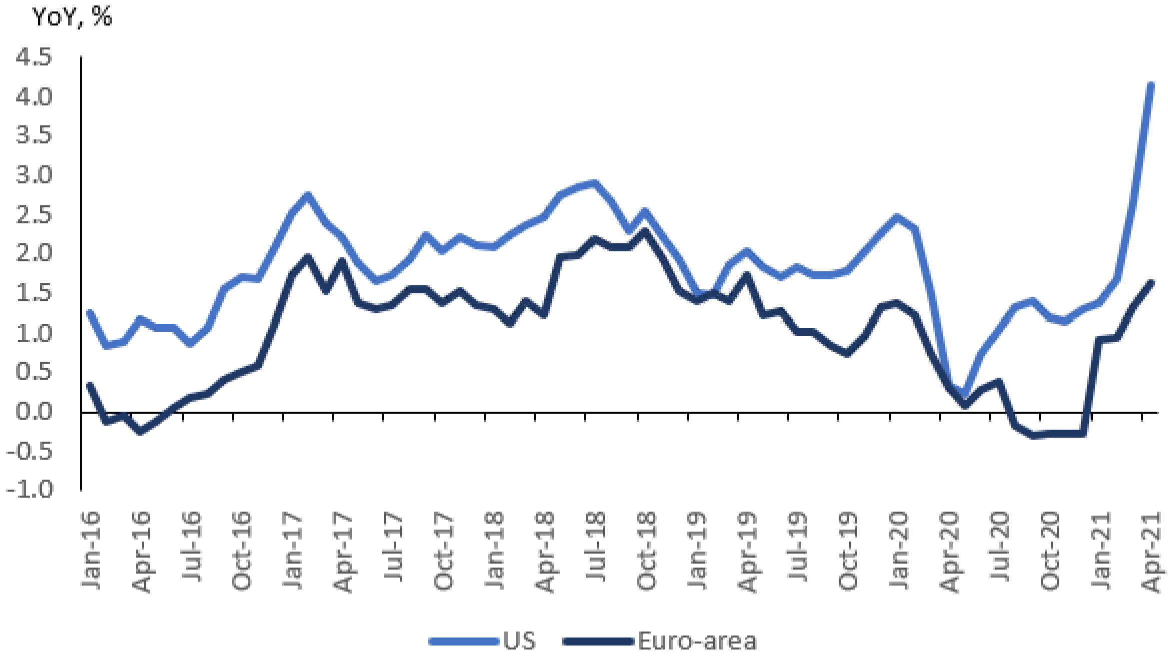
Figure 3: US demand deposits and European household savings – Money in pockets



Source: Haver Analytics

With excessive demand chasing scarce supply, consumer price inflation rates are inevitably accelerating (see Figure 4).

Figure 4: US and European consumer price inflation – Demand chases supply



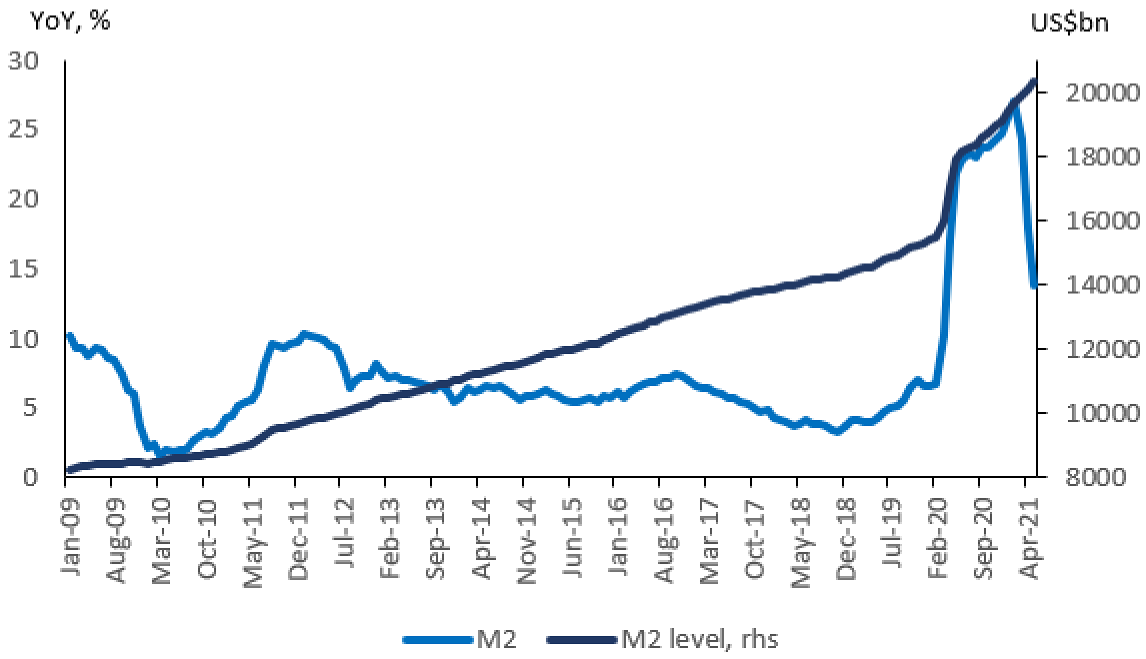
Source: Haver Analytics

Inflationists vs. Deflationists

Inflationists

Advocates of this view argue that the current surge in prices is not transient. They emphasise the relationship between inflation and the growth of money supply, positing that the abundance of liquidity in the financial system—reflected in household demand deposits and commercial bank reserves with the Fed—poses significant inflationary risks. Figure 5 highlights the substantial monetary stimulus injected into the US economy post-GFC, dwarfed by emergency liquidity measures during the pandemic. From February 2020 to May 2021, broad money supply surged by 32%, while the Fed's balance sheet expanded by 94% in just 17 months up to June. Although M2 growth is now decelerating, inflationists contend that existing liquidity, poised to be unleashed, will drive inflation upwards.

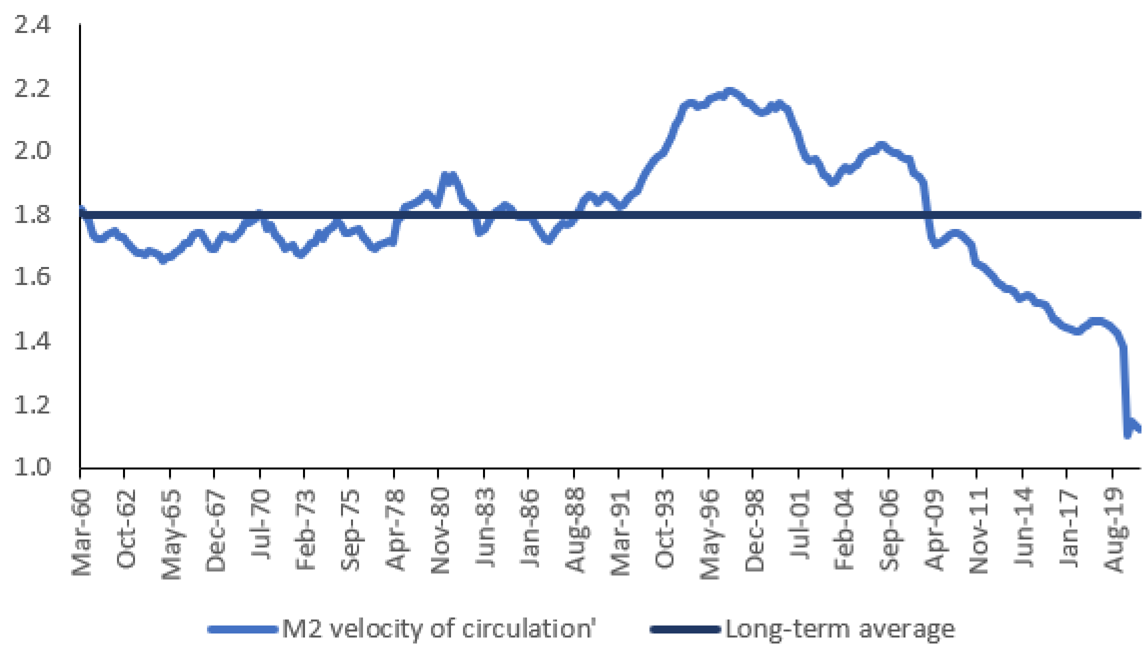
Figure 5: US broad money supply – Growth slows but money is in the system



Source: Haver Analytics

Another argument made by inflationists concerns the velocity of circulation of US broad money supply (Figure 6). This measure, indicative of the frequency with which currency is used for transactions within an economy, plummeted during the pandemic and remains below its long-term average. Historically, such measures tend to revert to the mean, suggesting that as economic activity normalizes and liquidity levels remain high, inflationary pressures will intensify.

Figure 6: US M2 velocity of circulation – Set to mean revert

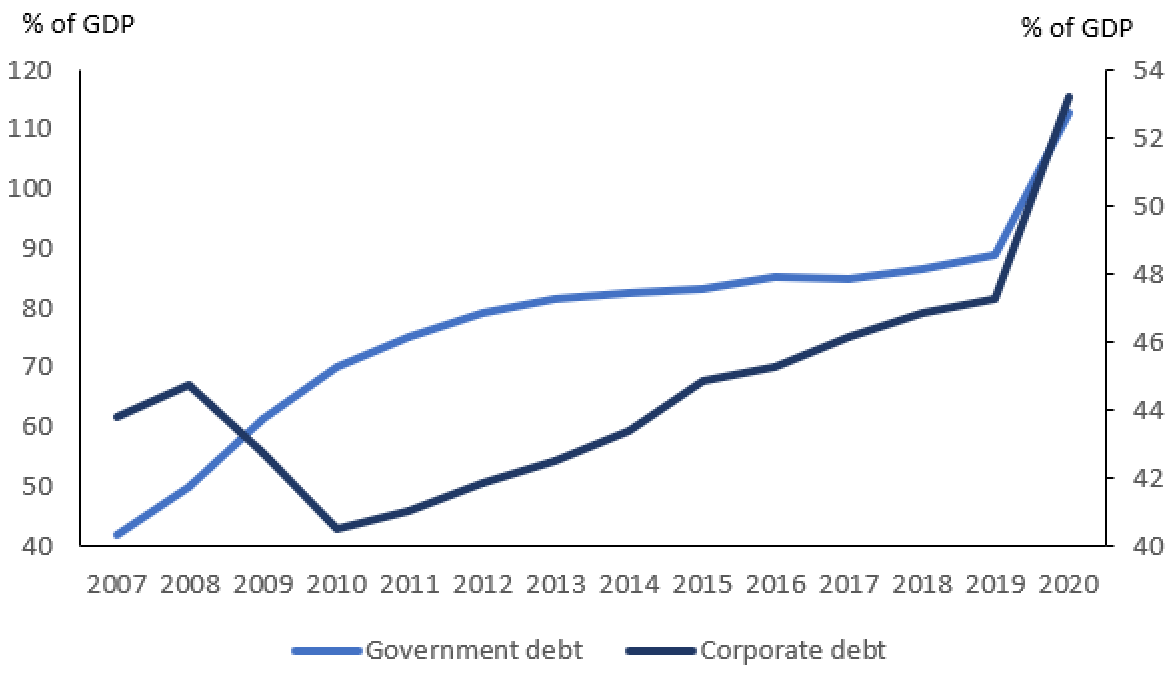


Source: Haver Analytics

Deflationists

Conversely, deflationists anticipate that once supply aligns with demand, consumer price inflation will moderate and decline. They highlight elevated corporate and government debt levels as potential dampeners on economic growth, compounded by tightening fiscal policies in the US. Figure 7 illustrates the substantial increase in US corporate and government debt as percentages of GDP, surpassing peak levels during the GFC. Last year alone, US public debt rose by 24 percentage points, while corporate debt increased by 6 percentage points, supported by fiscal spending increases and emergency credit measures. Deflationists argue that these high debt levels, combined with the presence of numerous unprofitable "zombie" companies surviving on credit, will suppress investment, employment, and wage growth, thereby restraining consumer prices. The lack of demand thereof will translate into lower consumer prices by preventing a sustainable investment led business cycle recovery taking root. On top of that fiscal policy is set to tighten compared with 2020 when US government spending increased by over US$2trn to more than US$3trn. By comparison President Biden's US$2.3trn spending plan is spread over eight years and the plan is to fully finance it through among other things increasing US corporate tax rates.

Figure 7: US government and corporate debt – Well above GFC levels



Source: Haver Analytics

A Third View

Looking ahead, while a significant portion of recent price increases are attributable to transitory factors, global consumer price inflation is unlikely to revert to pre-Covid levels. Seven factors suggest that average inflation rates in advanced economies will exceed historical norms:

1. **Monetary Phenomenon**: Inflation is always and everywhere a monetary phenomenon. Now certainly the last decade and more of QE since the GFC has generated very little inflation. Yes, there has been very little consumer price inflation pressures but this is not to say there hasn't been inflation – there has been – massive asset price inflation which has been fuelled and fed by extraordinary monetary accommodation. The difference this

time round – the reason for higher goods and services market inflation – is inflation has broken out from asset price markets to the real economy because the bulk of the Covid emergency monetary stimulus has gone into the real economy to protect firms and consumers from the economic fallout of the pandemic. The huge rise in household savings and the rise in corporate debt speaks to this.

2. **Continued Liquidity**: Significant withdrawal of liquidity appears unlikely in the near term, as demonstrated by ongoing asset purchase programs by central banks like the ECB and BoJ. This accommodative stance is driven by concerns over economic recovery, alongside a tolerance for higher inflation to safeguard businesses and prevent rising non-performing loans in banks. There was little appetite to unleash Schumpeter's forces of creative destruction after the GFC. There is even less appetite now, which also carries the risk that a full-fledged private investment led business cycle upswing is delayed and growth rates in the advanced economies remain low and lacklustre. Advanced world governments also need interest rates to stay low and a cynic would argue would probably like to inflate their way out of their debt mountains.
3. **Cost of Going Green**: The shift towards sustainable green practices, while commendable, comes with substantial economic costs, further inflating economy-wide price pressures. The cost of electric vehicles is falling and so are renewables but it is still going to be hugely expensive for the West to overhaul their industrial structures to meet their carbon emission targets
4. **Political and Fiscal Activism**: The emergence of a new regime of political and fiscal activism in the US and in Europe points to a move towards big government and big spending to address income inequality and ESG challenges. Initiatives like Biden's infrastructure plans and the EU's Next Generation Recovery Fund, are set to continue. This sustained fiscal stimulus is likely to support economic recovery but also add to inflationary pressures.
5. **Chinese Policy Shift**: China's strategy to allow the renminbi to strengthen domestically to curb CPI inflation suggests it may export inflation to other economies, impacting US and European consumers and businesses negatively.
6. **Market Fragmentation**: China containment the lynchpin of US foreign policy and increasingly its allies especially European is resulting in a fragmentation of the global market for goods and services. For decades globalisation underpinned the horizontal integration of the world manufacturing supply chain and consumers globally especially in high production cost mature economies reaped the benefits – by paying lower prices for goods and services. Going forward we are going to see vertical integration of manufacturing supply chains – Tesla's operations in China is a good example of what the future might look like. The implication is that advanced country consumers will not see the same benefit of lower final goods prices, as in the past when multinational companies exploited global comparative advantages to scale up, drive down production costs and final goods prices to consumers..
7. **Persistent Covid Impact**: Ongoing Covid-related disruptions pose ongoing risks to global growth and maintain upward pressure on prices.

The New Normal

While much of the recent price volatility is expected to diminish as supply catches up with demand, the average rate of inflation in advanced economies is likely to remain higher than in previous decades. Unlike the era of prolonged monetary accommodation post-GFC, the recent surge in emergency monetary stimulus has directly impacted the real economy, inflating prices of goods and services. Factors such as environmental costs, expansive fiscal policies, a stronger renminbi, and market fragmentation are driving a structural shift towards higher consumer price inflation.