Inflation

The Inflation Conundrum: Weak Demand or Something Else?

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Despite central banks' best efforts since the global financial crisis to accelerate inflation with low interest rates, inflation continues to remain stubbornly low in most advanced economies.

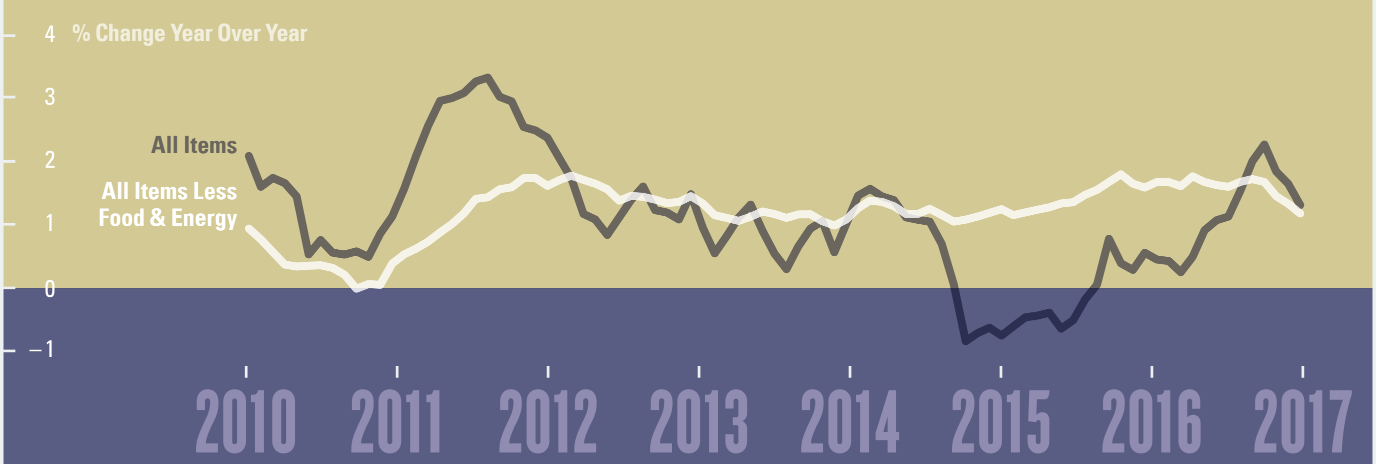
Proponents of secular stagnation attribute slow inflation to weak demand. But as economies have recovered and unemployment continues to fall, there is a nagging question of whether something else might be at play. In a conversation with Deputy Global CIO Lori Heinel, Senior Economist Simona Mocuta suggests technology-driven forces might be keeping inflation more contained than in the past.

HEINEL We started the year worried about a potential spike in inflation in the US, in anticipation of the stimulus policies that President Trump had campaigned on. Instead we see inflation coming down again. What happened?

MOCUTA We did actually get a big step up in headline inflation in 2016 because of higher oil prices. But that has now been exhausted, and with oil prices down more than 20% since February, we've had some inflation weakness recently. Also, political uncertainty has led investors to scale back expectations about Trump's fiscal stimulus, pricing in less inflation.

HEINEL Apart from those cyclical moves in commodity prices, we have noticed for a while now that even as unemployment has fallen across advanced economies, in some cases to multi-decade lows, those tighter labor markets are not feeding through to wage inflation and higher prices. What is driving that disconnect?

Figure 1: United States: Gap Between Headline and Core Inflation Has Closed



Source: Macrobond, SSGA Economics, U.S. Bureau of Labor Statistics (BLS). Updated as of June 13, 2017.

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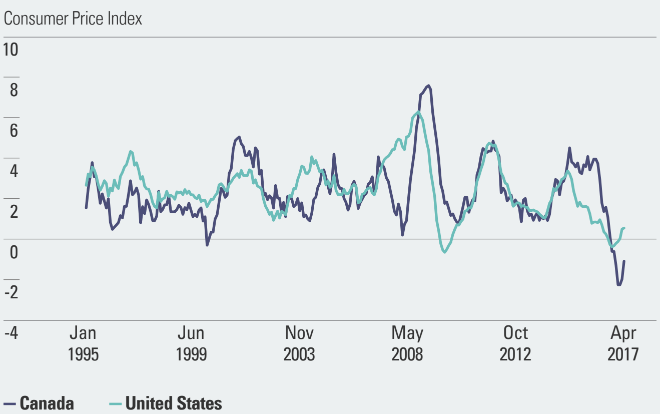
MOCUTA In the earlier stages of the recovery, there was a case to be made that weak wages reflected slack in the labor market and that low inflation reflected generalized weak demand. But now that we have broad improvements in growth and big declines in unemployment, it is increasingly difficult to make this argument. Moreover, in certain areas of the economy, like housing, inflationary pressures are quite strong in spite of these soft wages. That suggests to me that we need to look at supply dynamics as having something to do with low inflation.

Distribution Efficiencies

HEINEL How do you see those dynamics playing out?

MOCUTA Let's take food inflation, which is at historically low levels in a number of countries, including the US, Canada, and, until very recently, the UK. The only other time we had such low food inflation was during the recession. In the UK, food prices have risen lately, mostly as a function of post-Brexit currency weakness. India has also reported that food prices fell 1.0% year over year, the first decline in five years.

Figure 2: Food Inflation at Historic Low in US and Canada



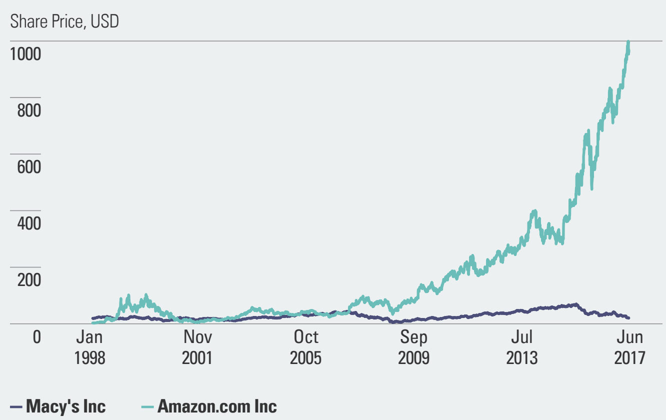
Source: SSGA Economics, Statistics Canada, U.S. Bureau of Labor Statistics (BLS), U.K. Office for National (ONS), Japanese Statistics Bureau, Indian Ministry of Statistics & Programme Implementation as of May 31, 2017. .

Some of this reflects higher output — particularly in India, where two years of drought have now come to an end. But I also suspect we are benefiting from efficiencies within the distribution channels. With the likes of Amazon and Walmart entering the online food market, distribution efficiencies that initially centered around books, music, and clothing, are now broadening to include food. Think of Amazon's decision to buy US organic food giant Whole Foods.

These efficiencies are partly passed on to the consumers in the shape of lower prices. And that also means that a consumer can buy more with the same salary, reducing the urgency to bargain for higher wages. And that might help explain why we continue to see unemployment go lower without a corresponding rise in wages or inflation—which is the flattening of the Phillips Curve so many economists have alluded to.

This dynamic is not well captured by traditional measures of productivity or GDP. We are not simply talking about higher productivity in the traditional sense of higher output per worker. Productivity enhancements to distribution as opposed to production partly manifest themselves via lower prices. It is more a phenomenon of consumer surplus—a kind of economic betterment or wellness. When we look at how online outlets continue to vastly outperform bricks-and-mortar stores, we think this is a trend whose effects will continue to be felt throughout the economy.

Figure 3: Old vs New: Battle of Titans in Retail



Source: Macrobond, SSGA Economics. Updated as of May 17, 2017.

HEINEL Are there other examples of technology-driven changes that are containing inflation in a similar way?

MOCUTA I think the rise of the data economy exerts a similar effect, as data becomes cheaper. For instance, another reason behind the decline in core US inflation over the past couple of months was a precipitous drop in the cost of wireless phone services. To the consumer, this has the effect of a supply shock, but it is a different type of supply shock than, say, an OPEC decision to pump more oil out of the ground. This kind is harder to capture in the GDP data — we aren't very good at incorporating these kinds of consumer surpluses or benefits. But this is a perfect example of why I say we cannot automatically associate low inflation with low demand.

Policy and Investment Implications

HEINEL If this is true, what are the implications for policymakers?

MOCUTA The most important implication is that the equilibrium rate of unemployment for the economy may be even lower than we think. Central banks have repeatedly lowered their NAIRU estimates (non-accelerating inflation rate of unemployment); a few months ago the Bank of England slashed its estimate by half a percentage point to 4.5%. I would not be surprised if the Fed lowered its estimate again, too.

I have no doubt that at some point lower unemployment boosts workers' bargaining power so much that they will demand higher wages, not because they have to but because they can. And, to the extent that collective wage bargaining (which is relatively more important in Europe and Japan than in the US) reflects past inflation, the rise in inflation over the past year will similarly drive workers to eventually demand higher wages.

But this can take a while. In the meantime, central bankers can be patient—they can let the economy run a bit hotter to engender some more entrenched inflationary pressures. They have more tools to fight high inflation than low inflation.

As for economists, I think it is up to us to rethink some of the fundamental relationships we have assumed when it comes to understanding growth, productivity and inflation. We need to look at these conundrums from a different perspective, especially as we experience structural changes to the economy that continue to alter those basic dynamics.

HEINEL And finally, for investors, good portfolio practices suggest everyone needs some measure of inflation or purchasing power protection in their portfolios. However, given the muted inflation we expect to see for the remaining half of the year, investors might want to choose real assets that will not only seek to provide protection but also a measure of growth and income, like real estate.

Glossary

Consumer Price Index (CPI) A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them. Changes in the CPI are used to assess price changes associated with the cost of living; the CPI is one of the most frequently used statistics for identifying periods of inflation or deflation.

Headline inflation The raw inflation figure as reported through the Consumer Price Index (CPI) that is released monthly by the US Bureau of Labor Statistics. The CPI calculates the cost to purchase a fixed basket of goods, as a way of determining how much inflation is occurring in the broad economy. The CPI uses a base year and indexes the current year's prices according to the base year's values.

Non-accelerating inflation rate of unemployment (NAIRU) The level of unemployment in an economy that does not cause inflation to rise up.

Phillips curve An economic concept developed by A. W. Phillips showing that inflation and unemployment have a stable and inverse relationship. The theory states that with economic growth comes inflation, which in turn should lead to more jobs and less unemployment. However, the original concept has been somewhat challenged empirically due to the occurrence of stagflation in the 1970s, when there were high levels of both inflation and unemployment.

Secular stagnation A condition of negligible or no economic growth in a market-based economy.

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