



CAPITAL ECONOMICS

The Rebirth of Inflation?

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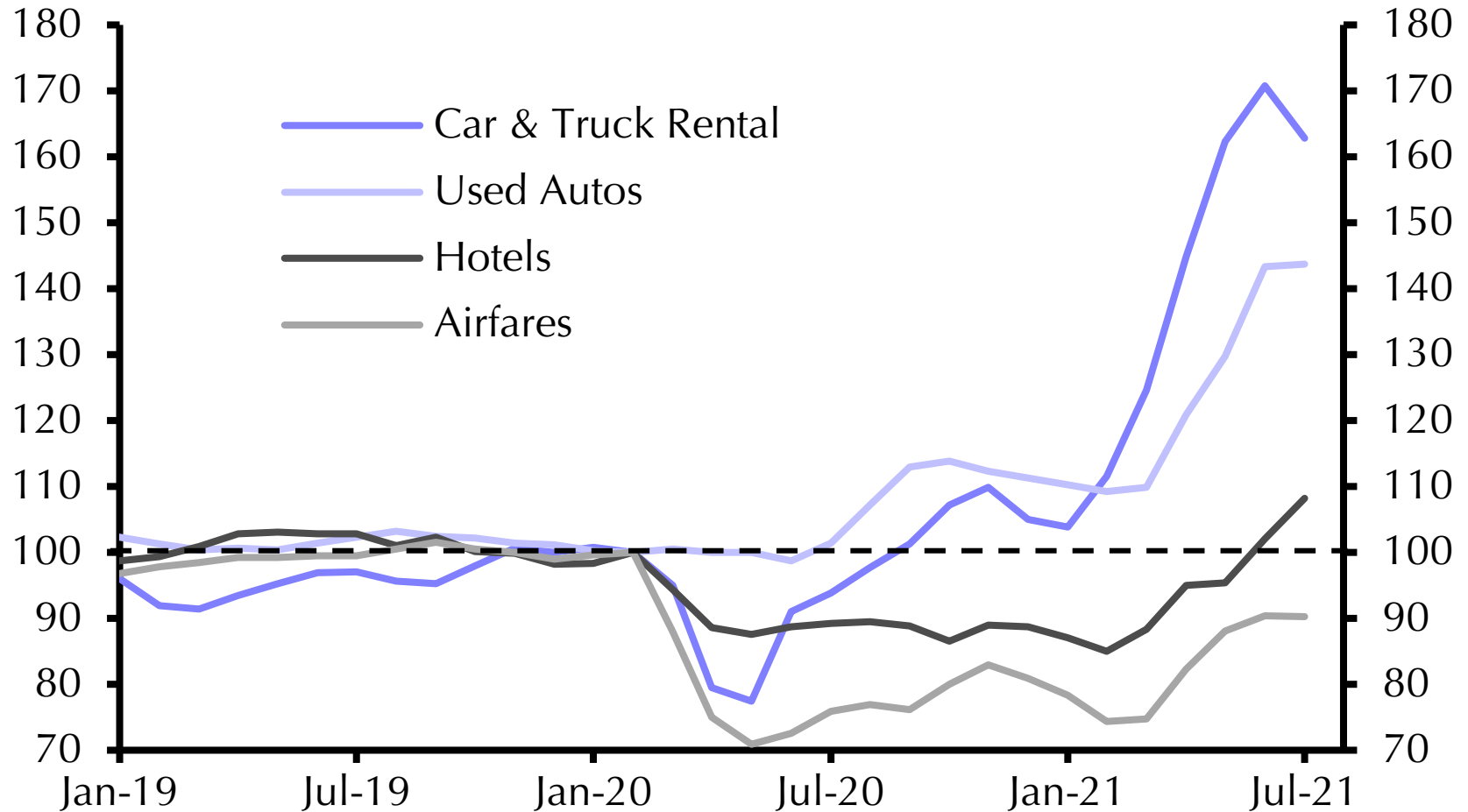
1. Agenda

- Is this year's rise in inflation transitory?
- Will the pandemic lead to a period of much stronger aggregate demand?
- Are the structural factors that underpinned the era of low inflation in the 1990s/2000s starting to weaken?
- How will this play out across different countries and regions?

2. What has caused inflation to rise in 2021?

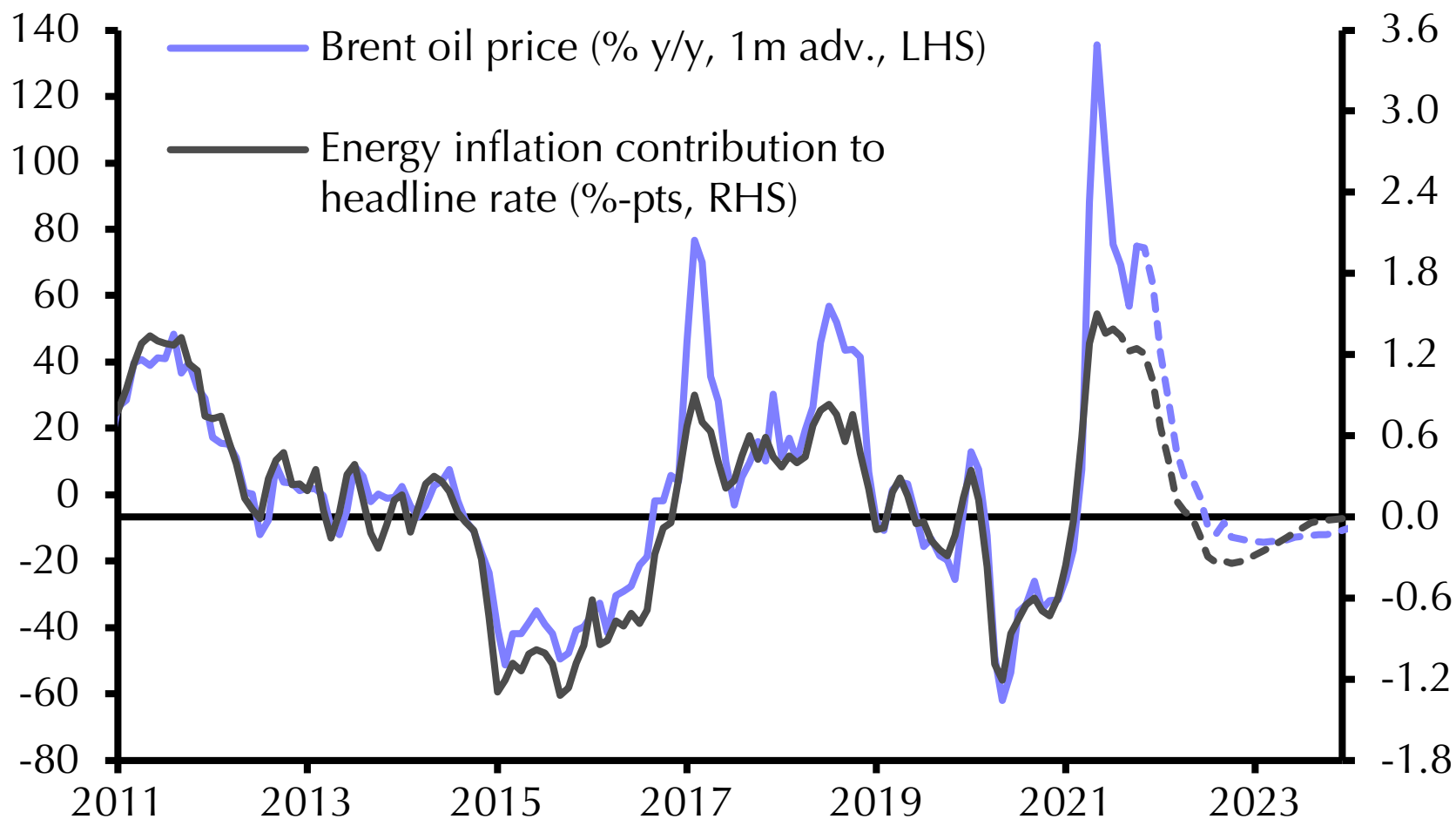
- A rebound in global energy prices
 - *Six-tenths of the rise in OECD inflation*
- Supply shortages (e.g. used cars)
 - *Two-tenths of the rise in OECD inflation*
- Re-opening inflation (e.g. restaurants, airfares)
 - *One-tenth of the rise in OECD inflation*
- Cyclical factors (e.g. housing)
 - *One-tenth of rise in OECD inflation*

3. Selected US CPI components (Feb. 2020 = 100)



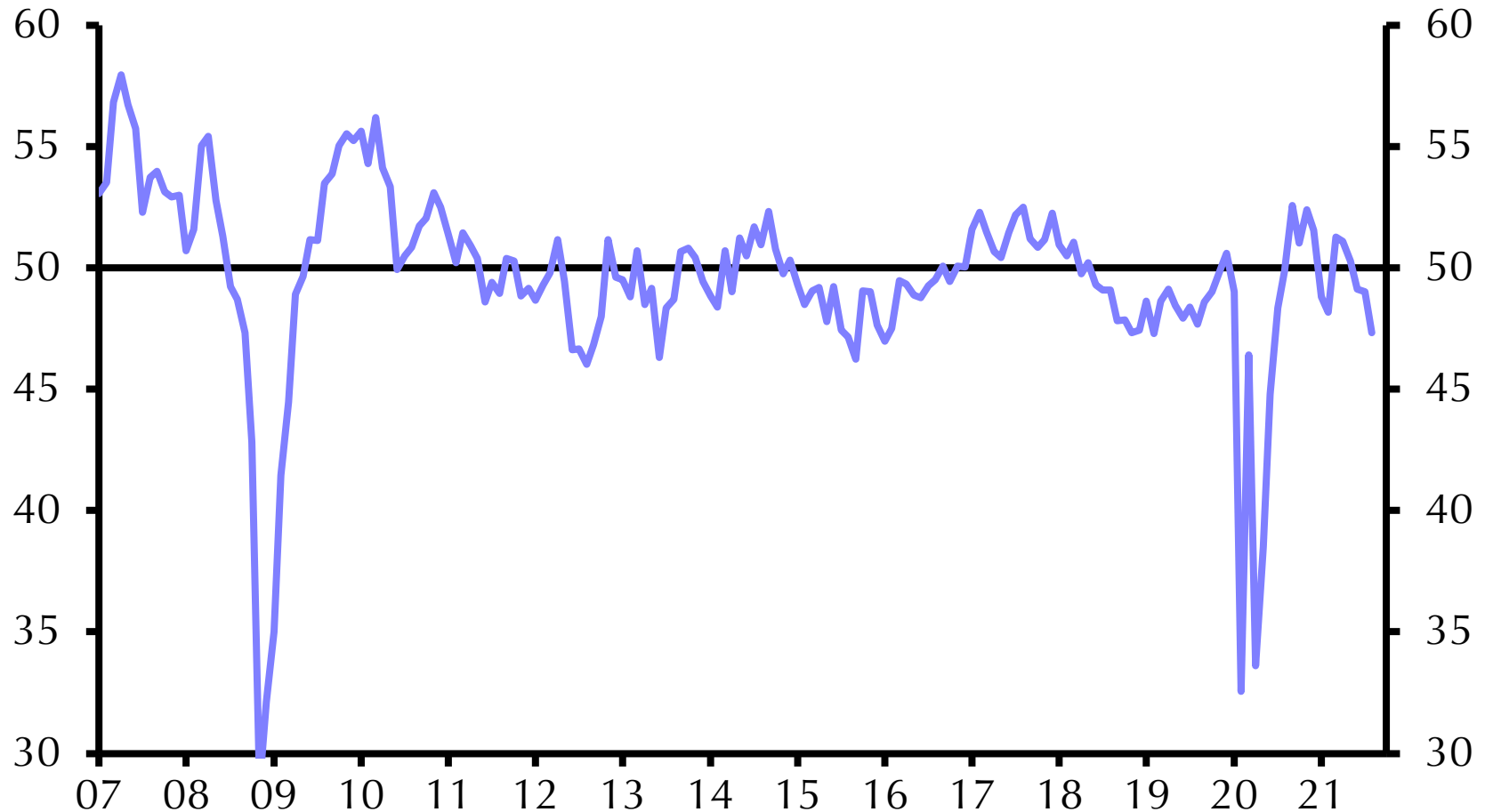
Source: Refinitiv

4. Oil Price & Energy CPI Contribution to Headline Inflation in Advanced Economies



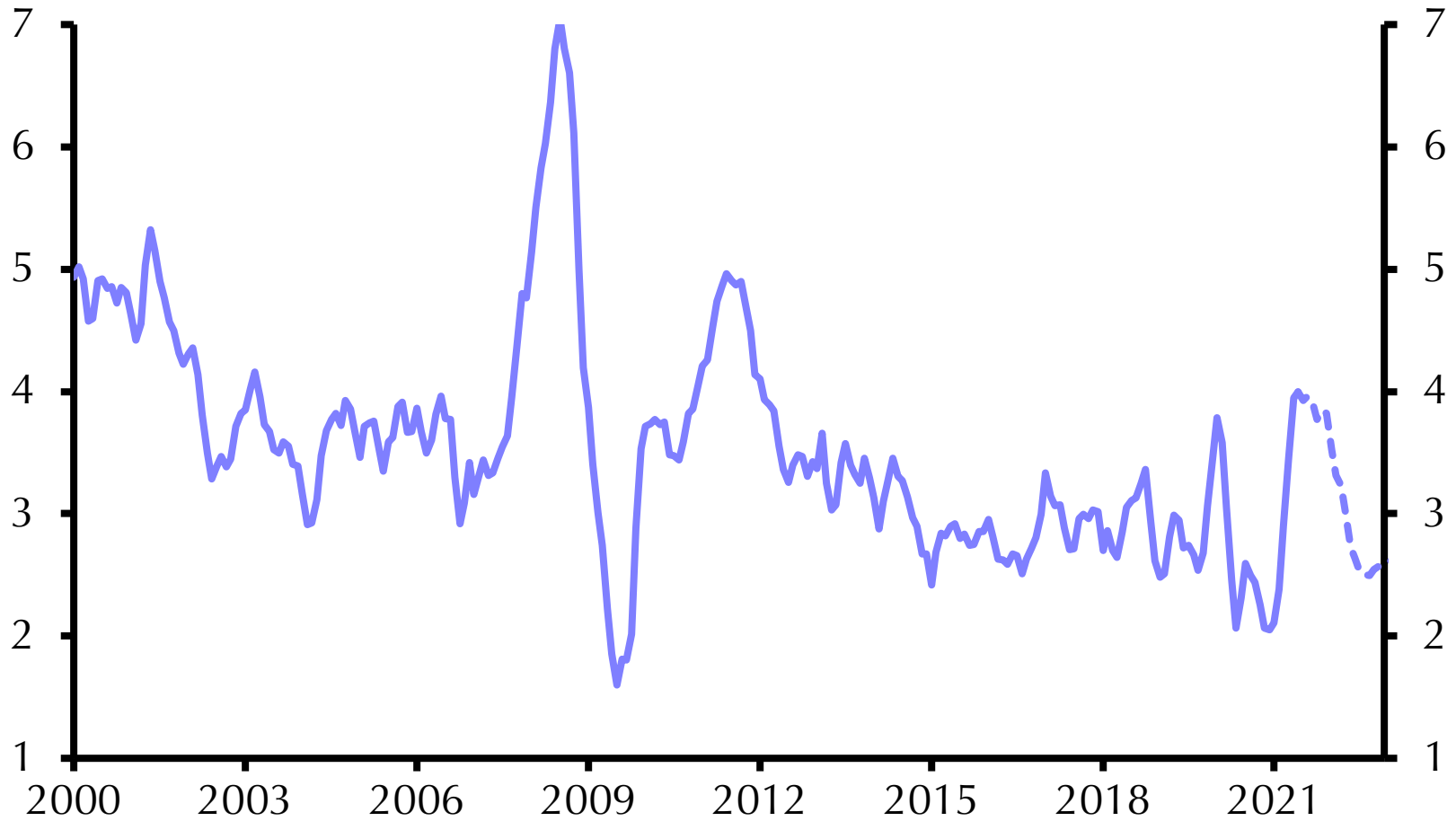
Source: Refinitiv, Capital Economics

5. China Manufacturing PMIs – New Export Orders (average of Official & Caixin, Latest=Aug.)



Source: CEIC, Markit, Capital Economics

6. Global CPI Inflation (%)

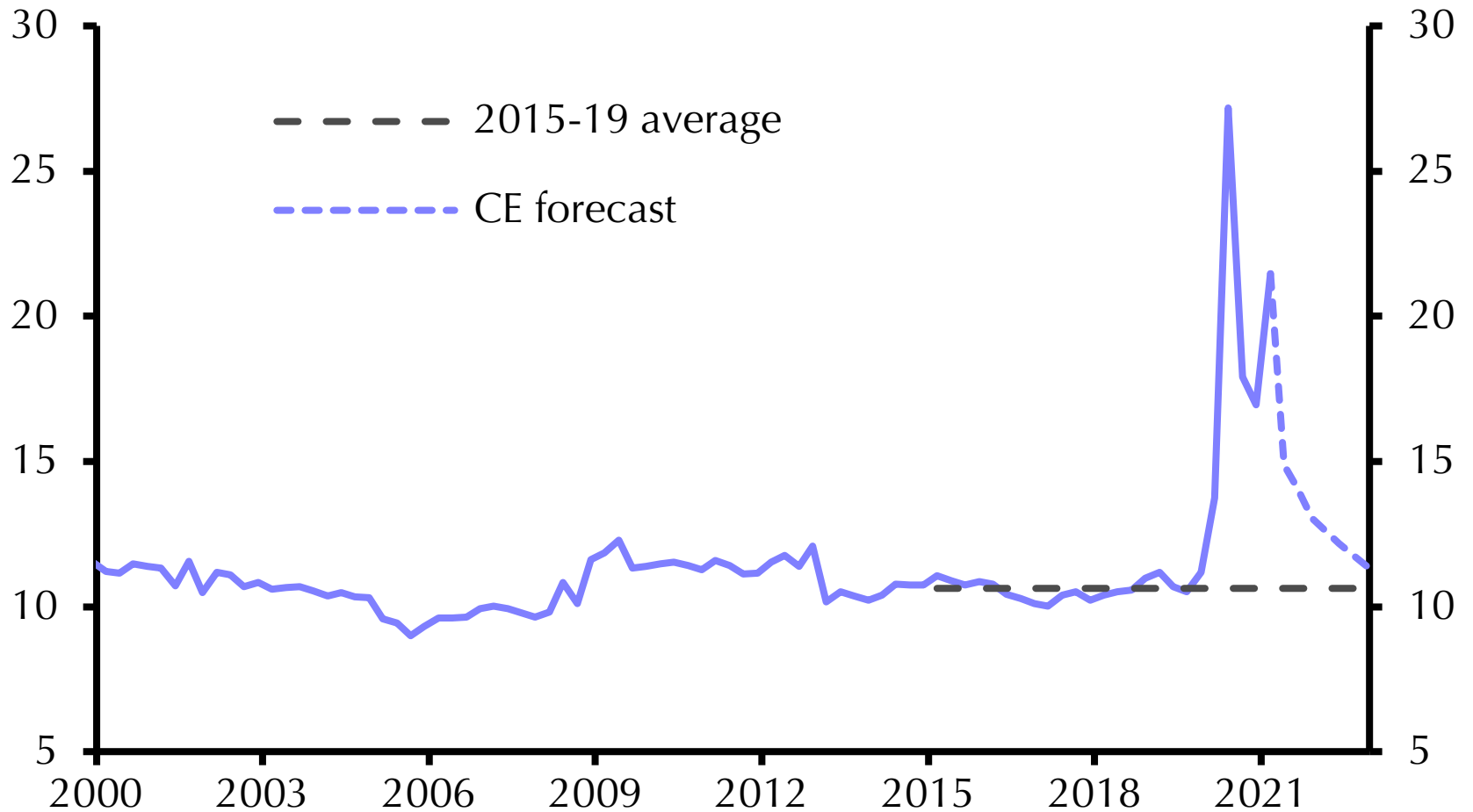


Source: Refinitiv, Capital Economics

7. Is aggregate demand set to surge?

- Unlike in the 2008 crisis, central bank asset purchases have come alongside a loosening of fiscal policy.
- This means that the money created by central banks has made its way into the real economy.
- One way that this has revealed itself has been in much higher household savings.
- These savings have accrued to higher income households, with a lower propensity to consume.
- This reduces the risk of an unanticipated surge in spending.

8. DM Household Saving Rate (%)



Source: Refinitiv, Capital Economics

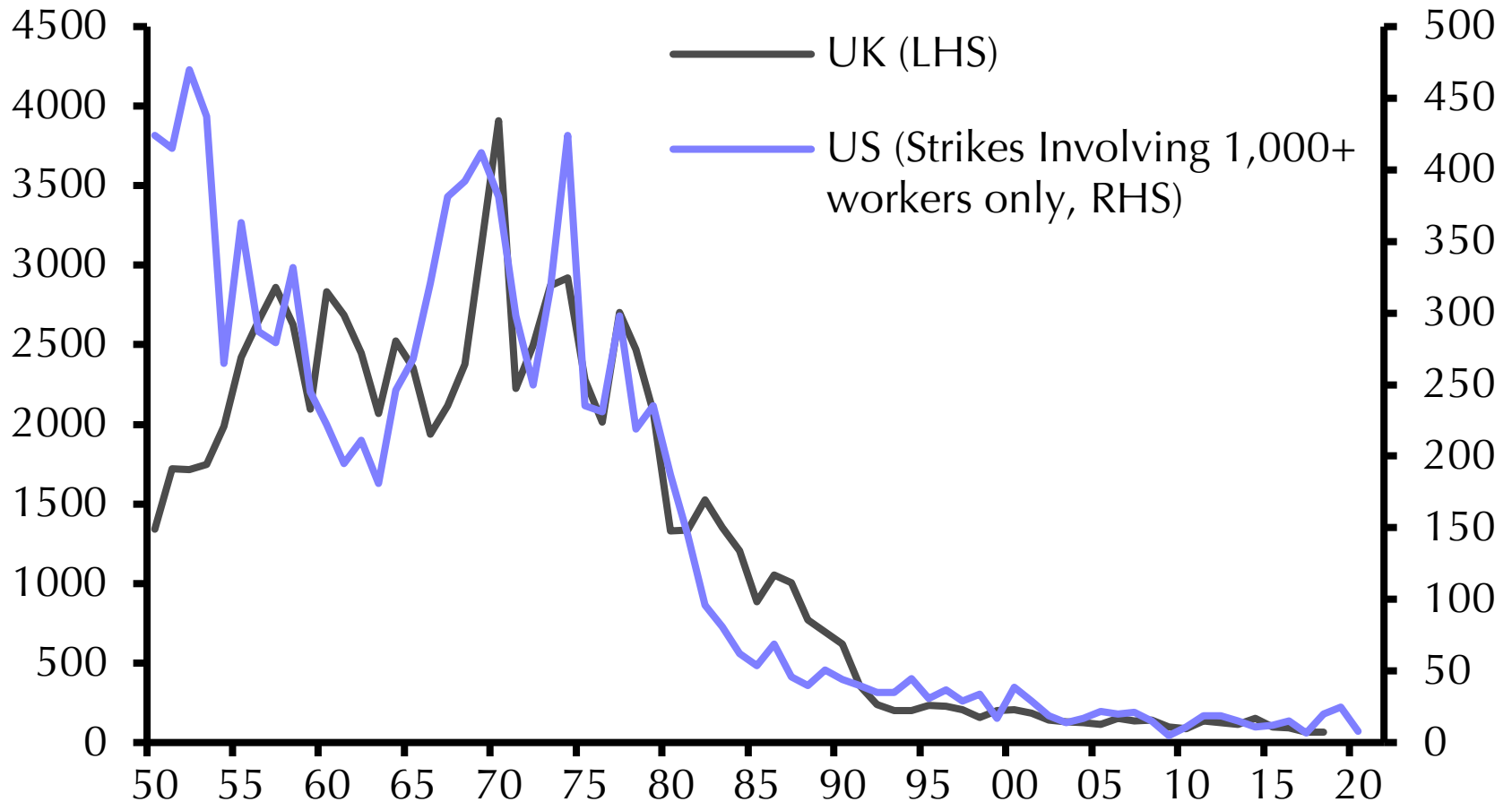
9. Some structural disinflationary forces are fading...

- Globalisation has peaked and US-China decoupling could contribute to a rise in inflation pressures in some sectors.
- Demographics have gone from exerting downward pressure to upward pressure on inflation.
- Firms will face new costs – including those related to green economies.
- Central banks' and governments' attitudes towards inflation are changing (more on this later).

10. ...but some disinflationary forces persist

- Labour markets remain highly flexible and workers' bargaining power remains limited.
- Inflation expectations remain well anchored at low levels.
- New technologies will continue to bear down on capital goods prices, and the development of the gig economy and remote working points to even greater labour market flexibility in some sectors.
- Structural changes in the global economy mean that inflation pressures are now more likely to show up in asset prices (e.g. housing) than consumer prices.

11. Number of Strikes Per Year in US & UK

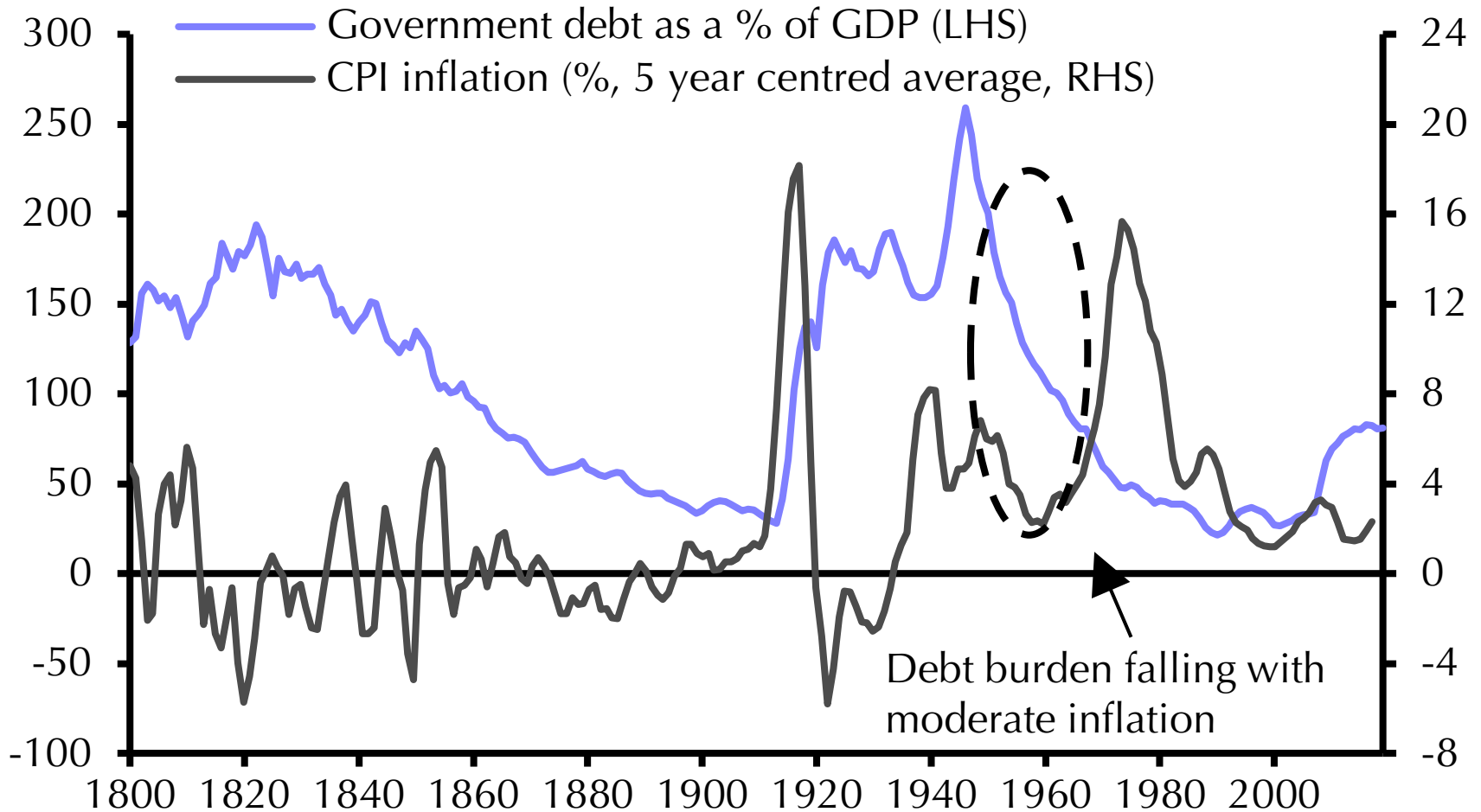


Sources: BLS, ONS

12. Inflation is an institutional phenomenon

- Friedman said inflation is “always and everywhere a monetary phenomenon”.
- In our view, inflation is “always and everywhere an institutional phenomenon”.
- Periods of higher inflation have only emerged when policymakers have allowed them to.
- There are several reasons why governments and central banks might now want a *moderately* higher rate of inflation.

13. UK Government Debt as a % of GDP & CPI Inflation

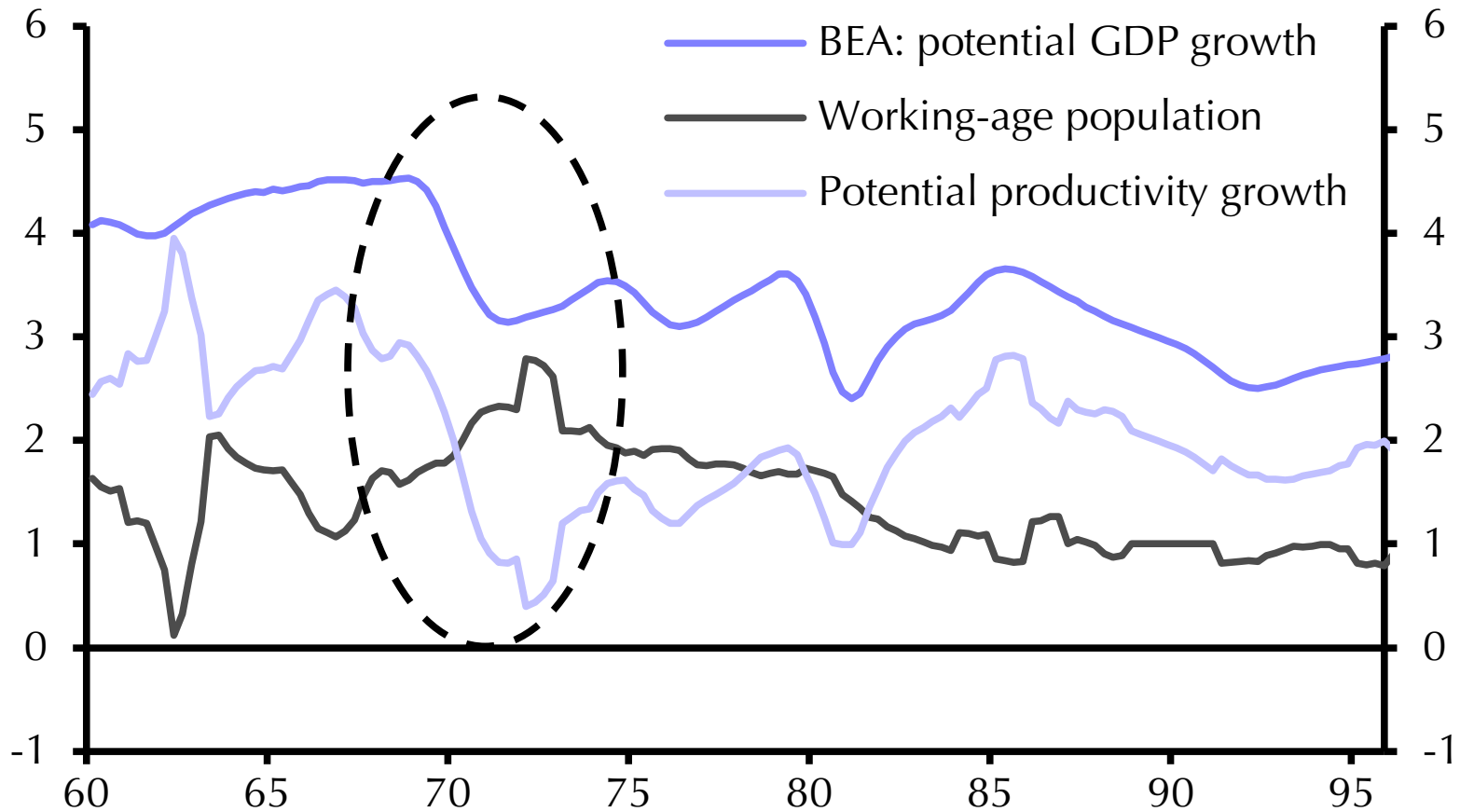


Sources: Bank of England, OBR

14. The costs of higher inflation

- It can cause problems for financial institutions (with short-term liabilities and long-term assets).
- It can restrain savings and investment.
- It distorts the behaviour of businesses and consumers – and therefore the allocation of resources.
- Our analysis suggests that in advanced economies the costs become significant when inflation is 5% or more on a sustained basis.

15. US Potential GDP (% y/y)



Source: Refinitiv

16. What could cause substantially higher inflation?

- An unanticipated surge in aggregate demand – and policymakers falling behind the curve.
- A self-fulfilling cycle in which moderately higher inflation leads to ever higher inflation expectations, and thus ever higher inflation.
- In both cases inflation would arise from policy choices and/or mistakes.

17. An institutional shift has started at the Fed

“The Fed was itself caught up in the philosophic and political currents that were transforming American life and culture”.

From “the anguish of central banking”

Arthur Burns, Fed Chair 1970-78

18. Where are the risks greatest?

- The risks of a period of higher inflation are much greater in the US.
- The size and scale of stimulus has been much larger than other advanced economies.
- “Enforced” savings have been higher in the US than other economies.
- And an institutional shift is underway in the Fed.
- The UK and Canada could follow the US. The risks of higher inflation are lower in the euro-zone and Japan.

19. Conclusions

- The increase in inflation this year is due to factors that will mostly be transitory. Inflation to fall back in every major economy in 2022.
- The risks of a period of higher medium-term inflation are greater now than at any time in the last 30 years.
- But the risks are spread unevenly across countries.
- A period of structurally higher inflation is likely in the US. But the risks are low in the euro-zone and Japan.