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Inflation, Expectations & Listening to Your Parrot

Agnès Belaisch and Matteo Cominetta, London

"Catch a parrot," goes the old adage, "teach him to say 'supply and demand' and you have an excellent economist." When it comes to tracking inflation, however, most economists would actually teach their parrots how to say 'demand and expectations.'

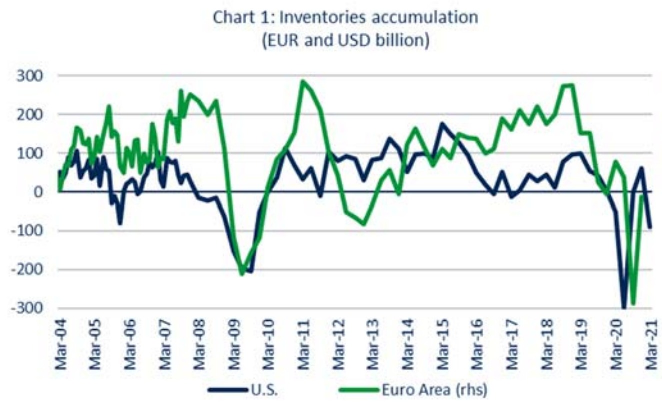
In fact, persistent inflation is driven by two main factors:

- **Excess demand**. The inability of supply to satisfy demand at existing prices results from one of two causes. The first is a persistent increase in demand to which supply cannot easily adjust because all the existing capacity is in full use (think of the time it takes to drill new copper mines). The second is a sudden drop in supply (if a major oil field catches fire). This distinction is crucial because its implications for inflation are very different: demand-driven inflation can be persistent, while supply-driven inflation cannot.

- **Expectations of future inflation**. If people expect prices to grow 10%, they will either immediately demand a 10% raise or they will buy as much as possible now to avoid higher prices later.

The bout of inflation in recent data is driven by supply rather than demand. Factors of production (labor, machinery, energy) are far from being fully utilized. Evidence shows that there is room for employment, capacity utilization and output—all still below pre-COVID levels in most countries—to rise and satisfy demand. If inflation is accelerating, it must be that disruptions are preventing supply from rising back to, or above, pre-crisis levels quickly enough to satisfy pent-up demand.

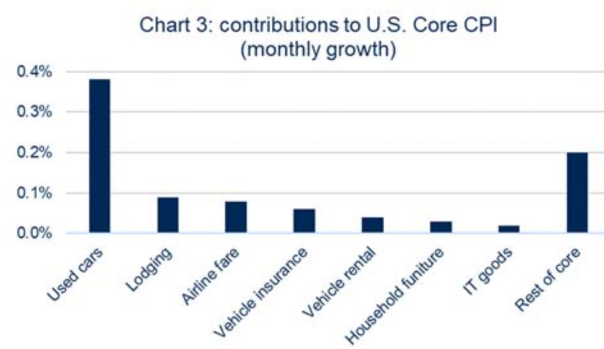
What are these disruptions? The stop-and-go pattern in the reopening of the economy, as control of the virus turned more or less successful, made it impossible for suppliers to predict future demand for their products and submit orders on time to meet the recovery. This has created shortages in some goods and services, including semiconductors, commodities, and home-building materials. Containers and container ships were not made available at the right place or the right time, resulting in the dislocation of global supply chains. To top it off, firms ran down their inventories at a faster pace than during the global financial crisis to preserve liquidity buffers while the global economy was shutting down (Chart 1). With the recovery more advanced in the U.S. than in the euroarea, American firms started destocking again in Q1 2021, this time on rising demand.



Source: U.S. Bureau of Economic Analysis, Eurostat, Haver. As of May 18, 2021.

This has an important implication for inflation. The inflationary effects of supply disruptions are necessarily temporary. If prices start to rise but wages remain mostly the same, people will have the same money to buy more expensive goods, so they will just buy less. Inflation will moderate and the economy will contract, often with lingering effects given collateral damage. Lower purchasing power, higher unemployment, and the lost capacity of production reduce the economy's flexibility. The clearest example of such dynamics is the 1973 oil shock: everything became more expensive in a matter of months and the world economy fell into recession for the next two years, twice as long as it took for inflation to plummet (Chart 2 illustrates the dynamics in the U.S.).

There are two possible outcomes to the situation today: either we live something akin to the 1973 shock, with supply chain disruptions lasting for years; or production manages to adapt while disruptions are eliminated and supply increases fast, closing the gap with demand. Crucially, inflation slows down in both cases.



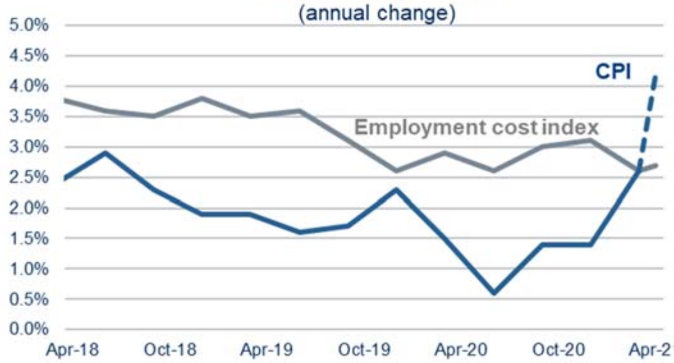
Source: U.S. Bureau of Economic Analysis, Haver. As of May 18, 2021. Source: U.S. Bureau of Labor Statistics, Haver. As of May 18, 2021.

Higher inflation could last into 2022, which may not be as temporary a shock as desired. Yet, there is no reason today why supply should not adjust quickly. Only three components (used cars, lodging and airline tickets), representing less than 5% of the core inflation basket, accounted for two-thirds of the rise in U.S. core inflation for April that stunned the market (Chart 3). As backlogs are worked out, disruptions are likely to correct and higher prices adjust down. Crucially, data show that manufacturing inventories relevant to these specific sectors (transportation vehicles, machinery and construction machinery, and primary metals) returned to pre-COVID levels by the end of Q1. Easing of supply-side pressures should be in the making.

Where could we be wrong? The only way inflation can accelerate persistently is via demand outpacing supply and moving the world to a demand-driven inflation regime. For that to happen, labor markets must fully recover and wages rise at least at the same pace as inflation. Workers could also demand higher wages to offset expected inflation, even with persistent unemployment. Government stimulus checks in the U.S. provide some workers with an incentive to stay home, thus reducing labor supply—but these are due to stop in September. Mismatched skills, particularly after a long period of unemployment, could magnify shortages and prove more persistently inflationary. We stand at a crossroad, and the next few months will indicate whether we are shifting into a more demand-driven inflation regime. Even then, if productivity growth materializes, supply will catch up with demand and demand-driven inflation will not happen.

So far, wage dynamics in the U.S. are not showing any broad-based sign of acceleration (Chart 4), which alleviates fears of demand-driven inflation. Wage growth has been moderate, consistent with labor market slack. In addition, inflation expectations remain in line with historical averages according to surveys (Chart 5). Europe lags behind in the recovery and inflation remains low, at 1.6% Y/Y in April. With furlough schemes still in place, there is no pressure on wages.

Chart 4: Price pressures
(annual change)



Note: Quarterly data. The last CPI figure is only for April.

Source: U.S. Bureau of Labor Statistics, Haver. As of May 18, 2021.

Source: U.S. Bureau of Economic Analysis, Eurostat, Bloomberg, Haver. As of May 18, 2021.

The demand-driven inflation scenario could play out if policymakers keep monetary and fiscal policy extremely accommodative after supply disruptions have dissipated and GDP, employment, and wages have fully recovered. Such a big policy mistake is unlikely, but we will watch key indicators of this scenario playing out. These are:

- real wages
- labor participation and employment rates
- productivity
- manufacturing capacity utilization and industrial production levels
- broadening inflation (more good and service categories showing rising inflation)
- inflation expectations measures (e.g., University of Michigan and ECB surveys)

In the longer run, demographics and inequality, which played a major disinflationary role the last three decades, must also somehow invert to make this inflation bout last. So it is worth keeping an eye on these dimensions, too.

Markets may prove volatile as messy data continues to try and measure the strength of an unprecedented recovery. So far, central banks are well aware of all this and are happy to ride it out. They need to gather more evidence, rather than risk removing accommodation too quickly and threaten the recovery. Our parrot will be watching, too.

IMPORTANT INFORMATION

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