THE NEW GLOBAL INFLATION REGIME

Seaford Macro Research Brief

Central banks in advanced economies generally expect inflation to fall back down to about 2-3% in the next couple of years. However, the recent track-record of these forecasts has been spotty at best, and economists have increasingly struggled to account for both its persistence and the resilience of job markets even as economies slow.

We posit that this is because their theories of inflation are flawed. Eschewing conventional demand-focused models of inflation, we propose an alternative approach to the topic which factors in labour costs to produce a different set of projections. We thus forecast that

- Headline inflation will continue falling as the transitory causes of inflation diminish, but core inflation will diminish more slowly
- Therefore, although inflation will eventually return to levels consistent with macroeconomic stability, it will remain elevated much longer than expected, and may not settle below 3-4%
- Employment will remain more robust than during similar phases of previous disinflation; in the North American economy (Canada, US) it may even maintain demand at levels that prevent economies sinking into anything more than shallow recessions
- With demand thus holding up, the decline in consumption necessary to cool inflation will consequently depend more heavily than in past tightening phases on the reverse wealth effect of falling asset values
- Interest rates may therefore have to rise higher than currently projected, so as to continue reducing demand for assets and diminishing multiples, before inflation falls sufficiently for central bank ‘pivots’ to occur
- As a result, asset prices – stocks (especially in the US), bonds and real estate – may fall further than most analysts project as economies transition back to a low-inflation regime; forecasts of future asset prices therefore should lean towards the more bearish projections.

The volatile geopolitical backdrop vastly complicates inflation projections. But the fundamental driver of the inflation we described is not circumstantial but structural, so the fundamental forces driving our projections will remain.

The Current Inflation: Cyclical or Structural?

Conventional inflation models focus on demand and treat people as consumers, and thus look for imbalances between supply and their demand for goods and services. But this overlooks their equally-important role as producers of labour and services. When demand for labour exceeds supply, the bargaining power of workers can rise and they can demand higher compensation. Employers can then cover the added costs by raising output prices, which in a strong labour market workers can meet, thus supporting inflation. If the imbalance is cyclical, fiscal and monetary policies can tame inflation by inducing a recession, raising unemployment and thus weakening the bargaining power of labour. But if the imbalance is structural, the inflation can become stickier. Employers, and governments, may then contain costs by investing in technologies that raise the productivity of their workforce.

To measure labour's bargaining power, we construct a simple index using the ratio of wages to profits. Plotting this index against inflation in the developed economies since World War II, we detect four long waves of inflation and disinflation (see Figure 1). The first of these, a long period of high growth, strongly-rising labour productivity and low inflation lasted until about 1970. At that time, a novel phenomenon emerged which bedevilled the then-dominant Keynesian economic model: stagflation.

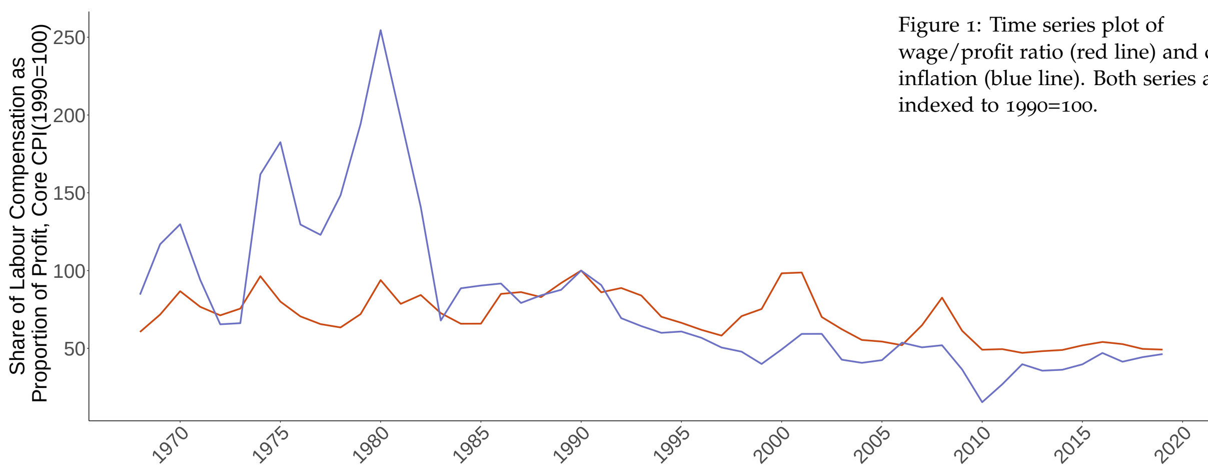

Figure 1: Time series plot of wage/profit ratio (red line) and core inflation (blue line). Both series are indexed to 1990=100.

Stagflation arose when wage-growth overtook the growth of labour productivity. Inflationary pressures, while still muted, had begun building in the late 1960s, such that when the oil shock hit in 1973, prices were poised to soar. Nevertheless central banks, most notably the US Federal Reserve, held that the inflation was due to an exogenous shock, and so persisted in relatively accommodative monetary policies. Amid rising inflation, money supply rose, and workers bargained for pay increases that then kept up with or even surpassed price increases, thereby locking in an inflationary spiral.

This nexus was broken by the 'neoliberal turn' at the end of the decade. Starting with Britain and the US, central banks began to reverse the direction of monetary policy, sharply reducing money supply by raising interest rates. This induced deep recessions and thereby depressed demand, ultimately bringing inflation back to manageable levels. Much has been made by supporters and critics alike of the 1980s political thrust towards deregulation, changing labour laws and the breakup of unions, lower taxes and tighter fiscal policies, all of which are alternatively credited or blamed with initiating the third long wave of the postwar period, one that featured low inflation and stagnant real wages. But in fact throughout the 1980s, changes in both the economy and fiscal policies weren't as great as often supposed. The rollback of the state was usually overstated, fiscal policy often actually loosened, and real wages resumed rising. Rather, the real transformation into a new regime came in the 1990s.

The Great Moderation

Driving the long period of low inflation at the turn of the millennium was the rise of corporate out-sourcing. This, in turn had been facilitated by technological innovations and changes to policy. In advanced economies, governments liberalised trade and capital markets, enabling firms to import and export more freely while moving capital abroad with fewer restrictions.

Importantly, they were pushing on open doors. Governments across the developing world had largely moved away from the statist and import-substituting policies of the postwar period in favour of liberalisation. China dominated this story. In a process begun in 1978, it gradually abandoned the autarchic and state-controlled model of the Maoist period and allowed private businesses to multiply and expand and foreign firms to set up subsidiaries. But this move was broad-based (see Box 1), with liberalisation opening up previously-closed economies across almost all the developing world.

This released vast new pools of labour to Western firms, which the combination of demography and migration had expanded by many orders of magnitude. After World War II, the great wave of decolonisation that washed over much of the developing world had

Box 1. Globalisation in the developing world

In the final years of the twentieth century, policy changes across the developing world opened vast new pools of skilled labour to Western firms.

- Chinese reform had begun in 1978 – to be followed soon after by Vietnam's Doi Moi reforms - but reached peak speed in the 1990s as the economy was opened to outsourcing firms; rural-urban migration then grew massively
- In 1989, the fall of the Berlin Wall brought an end to socialist central planning in Eastern Europe and opened these economies to foreign trade, giving European firms in particular new access to a comparatively low-cost skilled labour force
- In 1991, a fiscal crisis in India prompted the federal government to intensify the turn away from a statist development model which had begun in the late 1970s
- In 1994, the North American Free Trade Agreement enabled Mexico to greatly ramp up its Maquilador sector
- Broadly, across the developing world, this was the era of the move towards liberalised markets and greater openness in trade, opening the labour reserves of the global periphery to Western firms.

installed new governments keen to bring the benefits of modernity to their people. Spending on public health care and education expanded massively, while infrastructure investment created more integrated economies focused on major coastal and riverine cities – these served as export nodes to the world economy. One effect of this 'urban bias' in development policy had been to encourage a large-scale migration to the cities, since job opportunities in emergent industrial sectors and better amenities offered a brighter future for ordinary people.

As child mortality plunged and nutrition and health improved, the population of the developing world entered a long boom. Adding rural-urban migration to this mix produced a situation in which, in the space of a few decades, some two billion people moved into the cities of the developing world, many of them equipped with the basic skills needed to work in industry. This vast army of labourers expanded the pool of workers available to Western firms at a rate never before seen, eclipsing even the great rural-urban migrations of early industrial Europe.

This hugely expanded labour pool thus diminished the bargaining power of labour in Western countries. Firm managers could now outsource production to suppliers in the developing world and thereby import disinflation. Alternatively, they could cite the possibility of out-sourcing work to extract concessions in negotiations with their workforce, diminishing their costs and thus raising their profits.

Outsourcing helped foster the growth of a large middle class in the developing world at the expense of unskilled workers in Western countries, where there was a wave of deindustrialisation. Figure 1 reveals how, after 1990, the balance of bargaining-power had shifted decisively from workers to managers, keeping a lid on wage demands. In consequence core inflation, dragged down by the constrained spending-power of the workforce, trended steadily downwards.

Falling inflation lowered interest rates and allowed central banks to adopt increasingly accommodative monetary policies. The low cost of credit mitigated the effect of falling real wages, since people were able to borrow affordably both to sustain consumption and buy homes or shares. This supported what would be a forty-year bull market in assets, with bonds in particular rising steadily in value, bringing down yields. The stock of total debt - household, corporate and government – rose to historic highs (see Figure 2). Nevertheless a virtuous cycle operated, with falling interest costs offsetting rising debt burdens to keep the ratio of income-to-debt affordable. And since assets were rising in value so steadily, net debt remained at levels that posed little cause for concern.

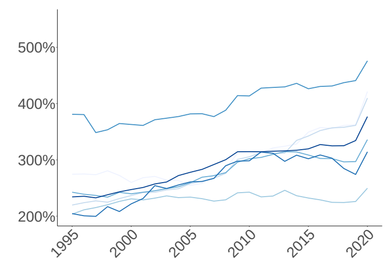

Figure 2: Total public and private debt rose as a percentage of GDP in G7 countries.

All the same, risks were accumulating. In particular, the deregulation of the banking sector in the late twentieth century broke the firewalls that had kept the banks from growing too exposed to the rest of the financial system, raising systemic risk each time asset-prices fell. On one hand, the freedom of manoeuvre of central banks allowed them to continually keep markets liquid anytime asset-prices suffered a deep fall, since the weak bargaining position of workers tempered any inflationary risk that resulted from extraordinary increases in the money supply. On the other hand, in addition to the risk of moral hazard which these central-bank 'puts' introduced, they had an unexpected side effect on investment. With asset values underwritten by loose monetary policies, capital got increasingly drawn into rent-generating fixed assets, like real estate, with less going into raising labour productivity. Moreover, the abundance of cheap labour already diminished the incentive for firm managers to contain costs by improving the efficiency of their workers. In consequence, the long downward trend in the growth of labour productivity continued across developed markets, while rates of new business formation fell.

Figure 3: Productivity growth declined in G7 countries between 1995 and 2020.

The Great Reversal

This long period of steady growth, low inflation, rising profits, quiescent labour costs and central-bank support for asset-values today provides the base-case for most forecasts of future inflation. However, the past thirty years were never going to be the new norm. They were rather an exceptional period which has now come to an end, and will not be repeated. The long wave has crested, and a long reversal has begun, because the growth of the global labour supply has begun to slow beyond the continued rise in demand.

- In all but Africa, the demographic transition which occurred in Western societies in the second half of the twentieth century, has now begun, with fertility falling towards replacement levels
- The great migration of the late twentieth century has peaked, as the developing countries become increasingly urbanised and further movement from the rural hinterlands of the global periphery slows
- In almost all Western societies, the native-born population is declining and the population as a whole is aging, necessitating increased migration to maintain the dependency ratio at manageable levels, but
- After peaking in the middle years of the last decade, net migration into Western societies has begun to slow; it will continue doing so as the rising incomes of the former global periphery, the primary source region for global migration, multiply opportunities at home and raise the opportunity cost of emigration.

Meanwhile the experience of collapsed global supply-chains during the pandemic and the resurgence of geopolitical tensions has capped and possibly reversed the globalisation of labour markets that began in earnest in the 1990s. Now the talk is of de-globalisation, near-shoring and friend-shoring. Just how far this process will go remains very much in question, and some of the death notices for globalisation are likely exaggerated. Nonetheless, it is undeniable that businesses are diversifying their supply-chains while governments are increasingly steering industries they consider strategic back home, as the US is doing with semi-conductors. For its part, China's opening to the world has now gone into reverse as Xi Jinping's 'common prosperity' agenda seeks to reorient more of production to the domestic market. Equally India, while taking the baton of dynamism from China, is also turning more inward in its recent policy orientation. The effect of such recent developments in these two economies is to reduce somewhat the participation of some two-fifths of the planet's population in global markets. In short, just as the growth of the global supply of labour is slowing, its fragmentation into separate markets has reduced what is available to any given firm, all as the continued rise of the developing countries has made them more competitive in the labour markets to which they tradition-

Box 2. Beyond Peak Globalisation

The aggressive globalisation of the 1990s was accompanied by a 'liberal peace' literature that posited a future that would be flattened, homogenised, and harmonious. Authors like Francis Fukuyama and Thomas Friedman predicted that economic integration would reduce conflict and win citizens around the world to democratic values, while improved communication would bring people together in new virtual communities. However, recent years have gone the opposite way, as anti-democratic populists around the world build support with illiberal and nationalist programmes. In developed countries, their appeal to working-class voters in the communities left behind by globalisation is obvious. More puzzling has been the rise of nativist politics in developing societies, where it finds support among the new middle class that has prospered from globalisation. Politicians like Brazil's Jair Bolsonaro, India's Narendra Modi, or Turkey's Recep Erdogan have won appeal among new urban migrants who, while benefiting from broad economic currents, are culturally conservative, parochial and see their own interests as tied up in their local communities, not the global economy. These movements are sinking deep roots. When coupled with the ideological reorientation underway in China, it is safe to assume the turn away from further liberalisation of recent years will continue. Too much is wrapped up in the global economy for full reversal to occur. But we will continue to see less, not more, liberalisation, and a stronger inward bias in most of the world. This will further entrench the fragmentation of labour markets.

ally exported: as wages rise in developing countries, the opportunity cost of leaving home does too. This increased bargaining-power of workers was already emerging as a phenomenon in the middle years of the last decade, and showed up in rising curves for both unit labour costs and the employment cost index in the US. Thus, rather as in the early 1970s inflation was poised to take off if an exogenous shock drove up prices, pushing workers to demand compensatory increases in earnings, Western societies were at risk of an inflationary spiral were any kind of exogenous shock to drive up prices.

The Return of Inflation

The pandemic provided such a shock. Amid lockdowns, shipping and production fell sharply, creating large backlogs, while sudden shifts in demand scrambled the normal inflation measures, with prices on different goods and services varying wildly as demand shifted abruptly. Government stimulus programmes designed to prevent economies collapsing maintained demand amid falling supply, exacerbating inflationary pressures. However, because all these effects were by definition temporary, central banks not unreasonably judged that the inflationary surge would be transitory, and

Box 3. The Role of Central Banks

As the bank to the banks, central banks consult closely with their clients and share a worldview. Even before the 2008 Crash, there was an apparent symmetry of interests between them and the financial sector, and the need to protect against systemic risk solidified the impression that central banks would always defend the interests of their clients. So widespread did this view become that it has become an article of faith among many investors that the central bank will always step in to protect asset values from falling too far. We make a different assumption. Rather as Henry Kissinger said that states had no permanent allies, only permanent interests, we assume that the ultimate interest of any independent central bank will always be the defence of its sine qua non – the currency. When consumer inflation is low, the central bank can manage money supply in a way that is beneficial to the financial sector. But given the choice between underwriting asset values and protecting the value of the currency from erosion by inflation, the central bank will prefer the latter. It will intervene to prevent any systemic risk, and may ultimately set a floor on asset prices. But as the recent actions of the Bank of England in stabilising the bond market revealed, central banks may not so much prevent falls in asset values as ensure the decline is orderly, while the floor they set under prices is likely to be lower than in the past low-inflation period.

persisted with accommodative monetary policies. Only when it became inescapable, late in 2021, that inflation was more tenacious than expected, did central banks adjust policy. In doing so, they moved sharply to raise interest rates, making up for lost time.

Economists have attributed the persistence of inflation to a combination of the Russian invasion of Ukraine, central bank complacency and misjudged government policies which maintained loose fiscal policies even after recoveries had begun to take hold, the Biden administration being seen as a particular culprit. However, while all these factors help explain the rise in headline inflation, more puzzling has been the stickiness of core inflation: even when headline inflation began responding to tight monetary policies by cooling, core inflation contracted much more slowly. That's because the persistence of core inflation results not from temporary or otherwise imbalances – temporary or otherwise - between the supply of goods and services, but from structural changes in the labour market.

After inflation surged, wages followed. Because they've risen more slowly than inflation, most observers have paid this development little attention, focusing instead on real wage growth. But this overlooks two significant dynamics. First, while real wages are currently negative, real profits (with the exception of windfall beneficiaries like the oil majors) are even worse, while the real value of asset values is falling in all categories - bonds, stocks, real estate and of course the spectacular collapse of crypto. Second is what might be called the Carl Lewis effect – after the famously slow-starting sprinter who'd however maintain his peak speed for longer, causing his rivals to fall behind: when headline inflation began falling in most G7 economies in the second half of 2022, wages held their rate of increase, the result being a steady improvement in real wages.

This shows up in the right end of the curve in Figure 1. We posit that the reversal in the long fall of wages relative to profits has in fact entered what will likely be a decades-long contraction. Consistent with the relationship we have identified, this will translate into a core inflation that may never return to the ultra-low levels which forecasts currently make, simply because the changes to labour markets are beyond the control of any one government. Consensus forecasts that headline inflation will fall back below 3% by the end of 2023 are thus too optimistic. Indeed, inflation is unlikely to come back down to 3% for the foreseeable future.

Furthermore, the legacy of debts accumulated during the long period of low inflation may further aggravate this upward pressure on inflation. The last time Western societies faced similar levels of debt was after the Second World War, at which time central banks engaged in financial repression to inflate away debt burdens. In time, the temptation of central banks to make a compromise of sorts with inflation, fighting to bring it down but allowing it to run hotter than currently forecast, may become irresistible.

Regardless, investors' hopes of an imminent 'pivot' in central bank tightening will likely be disappointed. Interest rates will continue rising and remain elevated for longer than currently expected. This will further depress asset values, suggesting that it would be better for forecasters to err on the bearish side of their predictions. At the same time, strength in the labour market may well mitigate the recessionary impacts of a rise in unemployment. Europe faces particularly strong headwinds due to its exposure to the Ukraine conflict and dependence on Russian gas, but the North American economy could conceivably stay out of recession altogether, with unemployment rising only modestly. This will further ensure that most demand destruction will have to result from the reverse wealth effect of falling asset values, giving central banks little reason to ease tightening merely in response to market falls.

Adjusting to an Inflationary World

In future research we will explore at length the implications of the shift to a new inflation regime, but already some clear themes emerge.

- Higher inflation will keep interest rates higher for longer
- This could lead to a shake-out of highly-leveraged zombie firms
- Rents will diminish, and fixed assets – including real estate – may offer negative real returns for an extended period of time
- Constrained rents amid rising inflation may produce negative real-rental income gains, which will affect those groups dependent on rents, in particular pensioners; the pension industry may face a long period of fragility
- The rising ratio of wages to profits will squeeze margins and restrain profit growth, which could result in an extended period of low stock-market returns; higher interest rates could further depress multiples
- Faced with higher labour costs, firms will be inclined towards productivity-enhancing investments, ultimately improving growth
- Central banks, under political pressure for their perceived failures of the last decade, will try to preserve their independence by demonstrating an improved responsiveness to societal demands (e.g. the 'Fed Listens' programme)
- One compromise that may result from this pressure will be that central banks maintain financial repression indefinitely, which would help inflate away debt
- Low returns on government paper may then diminish its attraction
- On the other hand, lower total debt stocks in most developing countries (ex China) may make emerging-market bonds long-term attractive propositions
- Faster growth amid relatively sound macroeconomic conditions will further attract capital to developing countries
- Africa merits special attention: while the risk profile of many African countries remains prohibitive, as the only continent whose population will continue growing, its attractiveness as an outsourcing destination may rise; countries which make the social and infrastructure investments needed to facilitate trade and improved access to labour markets are worth monitoring.

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TT Arvind
John Rapley
Lindsay Stirton