Letter 46

Should inflation be apprehended?

"The truth is rarely pure and never simple"

Oscar Wilde

- The inflation hydra peaked with the second oil shock in 1980 before being overcome by Paul Volcker at the head of the Fed. True to monetarist precepts, he increased the key interest rate from 11% to 20% and the other central banks did the same.

- Since then, the world, with rare exceptions in a few emerging countries in crisis, has benefited from a long cycle of disinflation, encouraged by globalization, deindexation and low wage increases.

- Today, price indices are intriguing, alarming, and worrying, but not all countries are affected identically. Inflation, above 20% in some emerging countries such as Turkey, and even higher in Lebanon, Argentina and Venezuela, is undermining these economies which already had to raise interest rates nearly 35 times since the beginning of the year. In the Anglo-Saxon countries, this surge in inflation, 6.8% in the United States in November, 4.7% in Canada in October, raises questions about the stimulus policies pursued. The Fed, in refusing to describe inflation as anything other than "transitory" until last week, was mistaken in its analysis. But it should quickly adjust its policy.
  In the Eurozone, inflation, at 4.9% in November but 2.6% excluding energy, is less worrying. Cumulatively, over the last two years, it does not exceed 2.3% excluding energy.
  In Switzerland, inflation in November was only 1.5%.
  In Asia, with the exception of South Korea facing a record inflation rate of 3.7%, inflation is more modest, 2.3% in China in November and even less so in Japan.

What are the cyclical causes of this resurgence of inflation? Should we fear structural inflation? What will be the inflationary or deflationary forces at work in the coming years? These are all questions to be discussed in this Letter 46.

Causes and figures of inflation:

At the beginning of the crisis, policymakers feared a Japanese-style deflation scenario, feared a recession of a magnitude not seen since 1929, feared social unrest, and feared a populist surge.

As a result, financial support plans for households and businesses were adopted in developed countries on an unprecedented scale.

The inflation currently observed is the conjunction of a less severe crisis than expected and a faster recovery than anticipated in some sectors. A temporary increase in the demand for capital goods, a lack of supply and therefore shortages, price increases; a difficulty in finding workers in certain service sectors and therefore wage increases.

The Anglo-Saxon countries are the most affected because they have spent more to stimulate their economies. In the United States, cumulative inflation has exceeded 8% over the past 24 months. It is at its highest since 1982 and on a "core" basis, excluding energy, it reached 4.9% over one year. In Britain,

it is 4.2% year-on-year, and will exceed 5% in the coming months, forcing the central bank to raise rates.

In Europe, inflation is perhaps a little underestimated because real estate generally only accounts for 10% of the price indices but it is, excluding energy, half the level in the United States.

In the Eastern European countries, the figures are bad: 7.9% in Romania, 6.5% in Hungary, 6.8% in Poland and even 8.4% in Russia. In these countries, inflation results from the general phenomenon of rising commodity prices and from a specific cause, the decline in the working population caused by ageing and emigration.

Japan is one of the few countries without inflation, +0.1% over 1 year and even -0.7% excluding energy, because companies pass on price increases less and, with an aging population, consumption is less dynamic.

To better understand these figures, we can analyze 6 causes of inflation:

- ***1st cause, the rise in energy prices and the cost of the energy transition:***

It is the 1st cyclical cause, and it will probably be the main, if not the only, structural cause in the coming years.

This is due to the reluctance of OPEC+ (Russia and a few others) to open the floodgates, to put back on the market 4 million barrels/day removed from the market in 2020 i.e., 4% of world consumption. Thus, despite the recent decline, the price of crude oil in the United States has increased by 50% over one year.

As for gas, in Europe, price volatility and the overall high level of prices are the result of a lower-than-normal level of stocks because Russia has delivered less to date.

In China and Japan, countries spared by inflation, the variation in the prices of raw materials, hydrocarbons and metals are the cause of the surge in producer prices, +7% in Japan in October, +12.9% in China in November, after a high of 13.5% in October.

In some Asian countries, despite the high sensitivity to energy and commodity prices, the consumer price index remained moderate as governments either lowered taxes or subsidised petrol prices.

In Europe, half of the price increase is attributable to energy. Nevertheless, in the coming months, price indices will reflect the beneficial effects of a 20% drop in Brent compared to the recent high of $86/barrel.

- ***2nd cause, the excesses of recovery plans and the distributed purchasing power:***

According to the OECD, developed countries spent $10 trillion to protect or revive their economies during the recent crisis.

In the United States, Keynesian voices such as Olivier Blanchard and Larry Summers had already been raised at the beginning of the year to denounce the inflationary dangers of the manna distributed by the Trump administration and then the Biden administration: a budget deficit at 14% of GDP, a deterioration of 9 points compared to 2019, half of which is attributable to the consequences of the recession, half to stimulus measures such as the $1400 cheque offered to the majority of Americans and the $300/week supplementary unemployment benefit.

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The result is a record accumulated savings, an unprecedented level of household wealth. In one year, household wealth in the United States has appreciated by nearly 30% to more than $140 trillion and in the United Kingdom, by 3.3% to £11.2 trillion.

This increase in wealth contrasts with the decline observed in 2007, -10% in Great Britain, and can be explained by more substantial liquidity injections.

The use of these excess savings in the consumption of durable goods is causing temporary supply disruptions, but in the United States, the impact of these stimulus plans on inflation is estimated at only 0.2 points. According to a study by the New York Fed, the Fed's injections only account for a third of the 14% increase in real estate prices in the United States over a year. In Southeast Asia and China, this cause did not come into play because there were no such stimulus packages.

- ***3rd cause, the rise in wages:***

For the past thirty years, there has been a disappearance of wage indexation, a loss of influence of unions deserted by their historical industrial troops, a decrease in the wage/value-added ratio, that is to say an increase in productivity greater than that of wages, but some want to believe in a change.

In support of the thesis of a return to wage inflation, wages in the United States rose by 4.8% in November over one year and significantly more in certain service sectors, +13.7% in hospitality and 8.9% in transport. In England, truck drivers' wages rose by 11% year-on-year, but this is a consequence of the departure of European workers following Brexit.

Notwithstanding these figures, the increase is below the rate of inflation. It is higher in only one or two sectors, with no contagion for the time being, and inflationary pressures seem to be easing.

In the United States, this increase is the result of the decrease in the participation rate to 61.8% in November compared to 63.4% in January 2020, the magnitude of unfulfilled job offers, 11 million compared to the 6.9 million unemployed, the unprecedented number of resignations, 4.2 million in October, almost a record, and the low number of jobless registrations. At 3%, or 4 million people, the country has returned to its pre-crisis employment levels.

Also supporting this thesis of a possible wage inflation is the announcement by the new German coalition of an increase in the minimum wage of more than 20% at the beginning of 2022.

For the time being, wage increases are mainly observed in the United Kingdom, the United States, and Canada. In the latter country, wage increase is reaching 5% because the level of employment is already higher than in February 2020 and inflation was at 4.7% in October.

In the United States, the low participation rate is explained by inadequate training or unattractive salary proposals. Both of these problems that can be solved easily because people who are poor in savings are expected to return to the labour market. According to the Conference Board survey, companies are planning wage increases of 3.9% in 2022, up from 3.3% seen in the 12 months before the Covid crisis, which could further anchor inflation and the risk of a spiral with prices.

Elsewhere, wage increase is less than 3% in Australia, 2% in Europe, zero in Japan. An explanation of this divergence: in Japan and Europe, the preservation of employment during the crisis, thanks to state aid, and in Australia, an increase in unemployment to 5.2% in October against 4.6% in September.

- ***4th cause, the temporary disorganization of production and distribution channels:***

As households were unable to spend on services (restaurants, hotels, leisure) for many months, they have instead bought durable goods (household appliances ...). The structure of demand was temporarily different from that of the last few decades and supply has not been able to adapt immediately.

It is striking to contrast the growth in world trade of goods in the 3rd quarter, +26% compared to the 3rd quarter of 2020, with that in services, only +6%.

Therefore, it is also interesting to observe the exceptional consumption of durable goods, +16% compared to the pre-Covid level in the United States.

However, it is also necessary to stress that this demand is concentrated in a few sectors affected by shortages of labour and/or components. In the United States, price of used vehicles has risen by 31% over 1 year as a result of the insufficient production of new vehicles.

China has benefited from this demand for durable goods, with exports still up 22% year-on-year in November. International carriers were surprised because empty containers were not where they needed to be, ports were quickly saturated, freight rates were multiplied by 4 or 5 from Asia, and there were multiple bottlenecks of components and materials. In the United States, port activity in the 2nd quarter was 14% higher than in the 2nd quarter of 2019 while in Europe, it fell by 1%.

These are all eminently temporary factors and there are already signs of improvement: the easing of freight rates between the US and China, the decongestion of US ports following Biden's decision to open them 24/7, the very large number of ship orders, the drop in the Baltic dry index from 5600 to 2400 following the Chinese slowdown and a decline in the transport of coal, ores and grains, the 50% increase in investment in semiconductors since 2019, the 10% year-on-year increase in semiconductor production, the recovery of US car production in October.

The spread of the new variant could again disrupt international trade and add to inflationary pressures, but it is too early to know.

- ***5th cause, liquidity injections:***

Globally, liquidity injections in major countries since the beginning of this crisis have amounted to some $15 trillion, nearly 20% of global GDP.

In the United States, the Fed's balance sheet, $8.5 trillion, has doubled as a percentage of GDP. In Europe, the ECB is injecting €1.85 trillion. More than 50% of companies received aid or guarantees during the crisis, and this explains their resilience and their profitable performance.

These injections contribute to the development of bubbles in the financial and real estate markets. In the United States, over one year, median rental price has risen by nearly 20%. And the rise in rent is expected to persist in 2022. But, apart from this sector, the increase in the supply of money is not a cause of inflation.

- ***6th cause, the rise in food prices:***

The increase is global, but it is primarily affecting emerging and middle-income countries because, given their lower incomes, food accounts for a larger share of price indices.

For example, food is one third of the Russian price index, and a quarter in Mexico and Poland.

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The outlook:

In Europe, inflation expectations are just under 2%, which is comforting. But two indicators are to be monitored, the pace of bottleneck reduction and the evolution of wage demands. If the former were to be delayed and the latter be rushed, then inflation could turn from transitory to structural. The probability is low, but vigilance is required.

- ***Short-term actions:***

Government action:

To break the momentum of rising prices at the pump per gallon, $3.40 recently i.e., a 60% increase since the beginning of the year, and so as not to weaken his chances in the mid-term elections in 2022, Joe Biden has taken 60 million barrels from the strategic stocks of the United States and has involved China, India, South Korea, and Great Britain in this approach. The price of WTI fell by nearly 10% before rising again quickly because the effort was symbolic: three days of consumption in the United States and one day worldwide. The impact was more noticeable in the spread of the variant, as the price of crude oil fell by 20%.

In Europe, the Commission has asked Russia to increase Gazprom's supply. Gas prices, which had risen from €20MW/h in January to almost €120/MW/h, fell back to €88/MWh, before rising again with the tensions at the Ukrainian border.

The action of central banks:

If central banks injected some $4 trillion in 2020, and $2.5 trillion in 2021, it will likely be less than $700 billion in 2022. If net government issuance, after central bank buybacks, was negative in 2020, it is positive by about $1.7 trillion in 2021 and could reach $2 trillion in 2022.

In the meantime, such injections explain the record level of negative rate bonds outstanding reached in December 2020, $18.5 trillion, before it fell back to just over $10 trillion in November.

Rising rates cannot be the solution to bottleneck problems.

Nevertheless, it is underway in many emerging countries, such as Brazil which has raised its rates to 9.25%, and in some developed countries. Norway, with little debt, was the 1st OECD country to raise its rates from 0 to 0.25%. South Korea, then, raised its rates from 0.5% to 1%.

The Fed, after the likely end of liquidity injections in March, should immediately start to raise rates, more quickly than expected, but nevertheless more slowly than in the past.

The ECB is expected to maintain negative rates for at least another year. Christine Lagarde rejects the idea of a rate hike before 2023 but the injections should decrease at the end of the €1.85 trillion program in March.

Italy's 10-year debt, at its lowest of 0.45% in February, rose to 0.99% on 10 December and the differential with Germany which had fallen to 0.9% is now back at 1.34%. At issue is the prospect of a reduction in ECB purchases from March 2022 and, at the head of the Italian government, the possible departure of Draghi if he chooses the presidency of the republic.

Overall, according to T.Rowe Price, after more than 200 rate cut decisions worldwide in 2020, there were more than 60 rate hikes at the end of September 2021 and this has accelerated because, in October,

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ten rate hikes were announced around the world.

No one seems to be panicking since the rise in 5-year rates in the United States is less than in 2013 and long rates are hardly increasing.

- ***Long-term trends:***

In the United States, the infrastructure plan and the Build Back Better plan are not necessarily inflationary:

While it is true that they lead to new injections of money, deficits and additional debt, the spending is spread over ten years and is essentially an investment that can increase productivity and reduce structural inflation. This is the meaning of the external savings expected from investments in infrastructure, education…

Conjunctively, the Chinese slowdown has had an impact on commodity prices:

The price of iron ore has fallen by a factor of three since May and the price of copper and other metals has plateaued.

Structurally, Chinese growth is going to slow down:

This point is the subject of our next Letter. There are two opposing aspects: less growth means less monopolization of raw materials and therefore less pressure on prices. At the same time, if for a long time China, the factory of the world, was a disinflationary vector in the world with its low wages, this is no longer the case, as wages in the coastal areas are no longer lower than those in certain Eastern European countries and as producer prices are increasing rapidly, by more than 12% last month over one year.

In addition to political reasons, international companies are finding a second reason to move their production units to Bangladesh, Vietnam or other countries closer to the places of consumption.

The cost of the energy transition: 2 points to remember.

On the one hand, there is the consequence of under-investment by oil companies in recent years, $750 billion spent on exploration and production in 2014 while only $350 billion in 2020. According to BP, the group's crude oil production is expected to contract by 40% in the next ten years and, listening to Royal Dutch, crude oil extraction will decrease by 1 to 2%/year. In other words, many listed companies will have to restrict their efforts, and a few states which are not very sensitive to pressure from environmentalists, will acquire an increasing weight in hydrocarbon production. These two factors will push up prices.

On the other hand, renewable energy sources, for example to produce electricity, are significantly more expensive than coal or oil. Investments to produce them will add to these costs and the carbon tax will be reflected in the final prices.

- ***A non-inflationary environment:*** the impact of ageing.

The 2020s differ structurally from the 1970s. At that time, the consequences of the post-war baby boom and a dynamic housing market dominated. At that time, there was strong economic growth and thus rapid growth in oil consumption and OPEC market power.

Today, in aging developed countries, low population growth, energy conservation and efforts to substitute renewable energy for oil explain the stagnation of oil consumption. On the other hand, oil consumption is increasing rapidly in emerging countries in the industrialization process.

Ageing is generally perceived as deflationary because with age, consumption, especially of durable goods, declines and savings are higher.

To temper this view, some economists point to the inflationary nature of an increase in health and pension spending or the wage inflation that may result from a decrease in the working population if there is no immigration.

Nevertheless, Japan has been experiencing this situation for years and, despite the injections of the central bank (annual purchases of public debt to the tune of 13% of GDP), inflation has not taken off because companies are robotizing, increasing their productivity and not increasing wages.

Conclusion: "What we did not say played a greater role than what we said" TAGORE

- ***Central banks and governments cannot be accused of an excess of largesse:*** having kept silent about the risk of inflation, having long said that inflation was transitory, this is the reproach that brings to mind the words of Rabindranath Tagore. It is easy today to accuse central bankers of having deployed too many means to avoid the crisis, it is dishonest to blame them for miscalculations by insisting on the transitory nature of inflation and it is excessive to blame them for the temporary return of inflation.
  Everyone was surprised by the brutality of the crisis, no one could have anticipated how long it would last, and in many countries, there were concerns about the reactions if unemployment had exploded, if business bankruptcies had multiplied, if the financial systems had experienced a systemic crisis. Given the political fragility of a number of countries, the worst could have happened, as in the 1930s.

- ***Inflation is not widespread in the world***: in China, despite a sharp increase in producer prices, at 12.9%, the price index does not exceed 2.3%. In Japan, despite repeated injections by the Central Bank whose balance sheet represents 140% of GDP, the inflation rate does not exceed 1%. In Europe, the OECD expects an inflation rate of 1.8% in 2023, below the 2% target. That leaves the emerging countries, the United States, with an inflation rate still of 2.5% in 2023, and Great Britain.

- ***The new variant could be inflationary***, if it disrupts supply chains or if it slows down the return to the labor market but we do not believe in it.

- ***In the short term, governments are benefiting from this inflationary surge***: VAT revenues and income tax revenues, if tax brackets are not revalued, will increase. But incumbent governments could lose elections because of the loss of purchasing power causing discontent, particularly in the United States.

- ***The stock market is not affected by a temporary rise in inflation***: in an environment disrupted by the exit from Covid, companies have been able to achieve productivity gains and have often been able to pass on the increase in costs. As a result, profits have been better than expected. This could change if wage increases exceed productivity gains and if the Fed raises rates more quickly. Then, growth stocks and indebted companies would be penalized.

- ***Central banks are showing a lot of restraint in raising rates***: real rates have never been so negative. This is necessary because the world (governments, companies and households) is indebted to 3.5x GDP, or nearly $300 trillion, and because the world, plagued by weaker structural growth in recent

years, has less capacity to absorb debts. Central banks are working to contain the rise in long-term rates and prevent higher debt service costs.

- ***The factor of structural inflation could be a return to protectionism***: as much as some relocations or the promotion of investments in sectors of the future could not have an inflationary impact, a protectionist policy would be a seed of inflation because it curbs competition.
  However, according to the Asian Development Bank, while the percentage of foreign components in global industrial production had increased from 17.3% in 1995 to 26.5% in 2011, it had fallen back to 23.5% in 2020. At the same time, according to UNCTAD, the volume of foreign direct investment, after peaking at $2 trillion in 2015, had fallen to $1.5 trillion in 2019, before the crisis. In line with our previous Letter on relocations, vigilance is required. The tariffs imposed by Trump and maintained by Biden on Chinese products, and the national preference are all factors in the price of products as the barriers on immigration can be on wages.

Geneva, 13th December 2021

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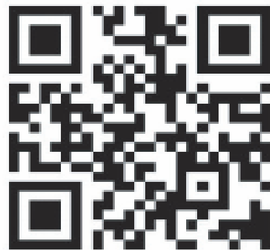

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