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The Inflation Wolf at the Door?

For those of us whose formative years encompassed the 70s, the spectre of inflation (or stagflation) always looms large. Indeed, a number of us could (quite rightly) be accused of 'crying wolf' on the inflation threat several times over the last 30 years. However, the thing to remember about the boy who cried wolf is that the wolf turns up in the end.

In the same way, despite serially overblowing inflation concerns over 30 years, the economists who cried inflation might be right in the end and, just as in the parable about the boy who cried wolf, policymakers and markets might be just as ill-prepared as the sheep-owning villagers.

Why that might be the case is outlined in a new book by the highly respected academic economist and former member of the Bank of England Monetary Policy Committee, Charles Goodhart, and former Head of Global Economics at Morgan Stanley, Manoj Pradhan, titled *The Great Demographic Reversal: Ageing Societies, Waning Inequality, and an Inflation Revival*.

The authors theorise that the reversal of the two great structural trends that account for the deflationary tendency of the past three decades viz; globalisation of labour supply (as well as that for goods and services) and baby boomer workforce participation, are on the cusp of reversing.

The fall of the Berlin Wall in 1989, combined with the dramatic increase in prominence of key emerging markets, particularly China, at a time when baby boomer participation in the workforce was at its highest, and female participation was secularly increasing, constituted a massive global labour supply shock. The result was a decline in wage growth and a structural deflationary trend on a global scale.

This phenomenon may partially at least account for rising inequality in the West. The labour share of income in the West declined as much of that income was 'redistributed' to workers in Eastern Europe and China as Western capital shifted production to those locations and / or increasing global labour mobility bid down wages in Western economies. Recently, the primacy of monetary policy as a macro tool appears to have reinforced this trend.

The authors suggest that those structural forces are reversing and that the supply disruptions wrought by the COVID pandemic may well "mark the dividing line between the deflationary forces of the past 30 to 40 years, and the resurgent inflation of the next two decades". Indeed, the authors posit that inflation is "quite likely" to rise above 5 per cent in 2021 and that a return to the double-digit inflation rates that characterised the 1970s are not out of the question.

Interestingly, there may have been some hint of this effect in the recent monthly US CPI figures. The August numbers released last Friday, exceeded consensus forecasts, following on from July numbers that were well ahead of consensus forecasts. This was attributed to supply disruptions, and might be temporary, but might just as well be a harbinger of CPI surprises in the future.

If there is any truth to the Goodhart / Pradhan thesis, then this precisely is how it would look at the start.

Further such 'surprises' may well occasion sharp pricing shifts in financial assets should bond yields rise to reflect a more inflation prone environment.

Potentially exacerbating these emerging structural trends is a process of deglobalisation and re-regulation that has accompanied the rise of left / right populism in the developed world. Meanwhile, as Chairman Powell suggested in his Jackson Hole presentation, central banks maintain a disposition to tolerate temporary overshoots above inflation targets, and should governments be tardy in winding back budget deficits, it may be that the conditions are ripe for a resurgence of inflation.

The good news contained within the Goodhart / Pradhan prognosis is the arresting of growing inequality within Western economies caused by the same structural phenomena that manifest deflation tendencies apparent over the past 3 decades.

The key take-out, however, is the vast magnitude of the challenges ahead for both policymakers and investors as the pandemic collides with tectonic structural shifts in the global economy.

After decades of absence, the inflation wolf may once again be at the door.

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