Inflation

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I had written about inflation in October 2010, cautioning that the output of the central bank's printing presses would inevitable lead to rising prices.

Today, inflation is one of the main concerns in the global economy. Its not ideal but it is far from a catastrophe. Some inflation is healthy and the economy can sustain a higher level of inflation than it thinks it can.

US inflation

US CPI under-measures inflation due to a large weight (25.5%) in housing, owners' equivalent rent.

Housing prices in the US are in a double dip, the Case Shiller 20 is -1.59% YOY for November 2010 (next reading Feb 22, 2011).

Discounting owners' equivalent rent, all other items are rising at about 2.2% for the CPI number to equal the reported 1.3%.

If owners' equivalent rent, which is correlated to house prices and mortgage rates starts rising, and there is evidence of recovery in the US(better GDP, manufacturing and employment numbers) as well as a pickup in mortgage rates, the impact on CPI could be significant. If housing simply flatlines, CPI will jump to 2.6%. If housing costs start to rise inflation will be higher.

Notably, inflation breakevens are around 2.95% so the market is not entirely mispricing inflation.

Is inflation a serious concern?

The source of the current inflation has been rising commodity prices from energy to industrial metals to agricultural products. Food is 13.7% of the CPI and of that 10% is likely raw foodstuffs. Fuel for transportation is 4.5%. In all commodities ex food and beverages is some 25% of CPI. In 2010 the CRB Index rose 16.60%.

Economic theory tells us that in the long run prices will rise to ration scarce resources. Also, sufficiently high prices will drive the search for alternatives.

Hyperinflation of the sort found in failed states tends to be a consequence of a failure of confidence and is discontinuous. This is not a systemic risk in the current inflationary environment. It can arise though if the situation in Egypt should spread into a wider paradigm shift akin to the fall of Communism in the early 1990s.

Wage price spirals tend to be persistent and self reinforcing. Theory does not account for political and social factors that render substitution away from labour infeasible. The current inflationary environment is not driven by wage inflation. In fact the labour market remains slack. US personal income growt peaked in 2006. While it has recovered robustly from the crash in 2009, it appears to have hit a ceiling again in late 2010.

Poorer economies such as China are at risk of wage price spirals. Food represents 34% of CPI in China. Wage growth in China is in the high teens and has been accelerating of late. Whereas India’s RBI has been proactive and hawkish on inflation, China’s PBOC is torn between maintaining some form of export competitiveness, upholding the value of its foreign reserves and tackling inflation.

The probability for runaway inflation to take hold in any of the major economies is non-trivial but the odds are low. The developed world has become accustomed to low inflation rates for too long. In fact a certain level of inflation is desirable, especially given the level of debt still on sovereign and household balance sheets. Higher interest rates too are not entirely undesirable as they represent a hurdle rate for investments and ensure a healthy respect for opportunity costs.

Longer term outlook for inflation:

The reason that developed world inflation has been so benign while interest rates were persistently low and economic growth was surprisingly robust is simple; even if central bankers were slow to realize it. As capacity utilization rates headed in to the 80% – 85% region in the US for example, developed countries began to outsource low value added services such as manufacturing, in effect, off-shoring capacity. This meant that the national, as opposed to domestic capacity limit was actually over 100%. There was slack in the system. The off-shoring of manufacturing also increased domestic productivity as developed economies became more heavily weighted in services.

The success of this strategy necessarily resulted in balance of trade, current and capital account imbalances.

The future will likely see developed economies attempt to rebalance their economies in favor of manufacturing and exports. The consequences are likely to be lower domestic productivity and a higher level of inflation associated with each given level of output growth, assuming that the technology of economy remains constant.

Higher commodity prices and food inflation appears to be fact of life. You can read about this elsewhere.

Higher fuel costs are expected to persist. Apart from the usual inflationary effects higher fuel costs act as a tax on trade. For countries where imports and exports are a significant portion of GDP, higher fuel costs can drive inflation indirectly.

While inflation is expected to be structurally higher going forward it is unlikely to be debilitating. As developing countries evolve towards better technology and innovation their productivity will rise to ease some of inflationary pressures. At higher frequencies, however, markets are driven by psychology and misunderstanding and a good deal of overshooting and cyclicality can be expected.