Inflation. Deflation. Two things happening all at once and what a central bank might think of it all.

Two step economy:

Its quite clear anecdotally at least that the bifurcation of the world economy into rich and poor has accelerated in recent years. Wealth creation has accelerated among the rich while the rest of the population has failed to catch up. This has occurred both between countries as well as within countries. Globalisation has played an interesting role. Whereas before, labor prices were a function of local productivity, they are today a function of global productivity. As a result we see wage deflation in manufacturing where capacity has been exported to countries like China and India, while wages accelerate in services which are less portable.

Evidence of a two speed economy can be found across the globe. Aggregate inflation numbers show a fairly benign picture, and it is indeed a benign picture. However, while aggregate numbers cannot represent the extremes of consumers, they fail badly where the distribution tends towards being bimodal. Inflation numbers for the developed world range between 1% – 3% at the aggregate level. Over the last 30 years HNW inflation has risen an average of 5.5% while CPI has risen 2.3%. In the last 10 years HNW inflation has risen by 6.3% while average CPI has risen 2.6%.

Inflation risk:

The key inflation risk is not in rising commodity prices. Fuels and utilities and motor fuel account for only 5.4% and 4.1% of CPI respectively. The key inflation risk arises from the unequal distribution of intellectual capital. The long term growth potential of an economy is heavily influenced by its intellectual capital or technology for a given stock of land, labour and capital. Where inflation comes from commodity prices, human ingenuity is deployed to solve the problem. Where inflation comes from wages, human ingenuity is deployed to exacerbate the problem. And the problem lies in the relatively short supply of high value labour, particularly where the value is derived from intellectual capacity. High income and high wealth individuals are incentivised to protect their industries through high barriers to entry. It is also in their interests for their offspring to inherit their positions on the economic ladder. The high cost of education is a primary barrier in perpetuating the unequal distribution of intellectual capital. I will not discuss welfare economic further except to say that there is good argument for central planning from a general welfare perspective. The unequal distribution of wealth leads, through the education system, to unequal distribution of intellectual capital and on to unequal distribution of income which manifests in inflation data.

Central bank policy:

One suspects that interest rate policy goes beyond fighting inflation. Rates were raised aggressively in the late eighties to tackle inflation. As the economy sank into recession the Fed quickly reacted to create liquidity. In 1994 where there was little sign of inflation rates were put back up. In 2001 when recession struck again rates were aggressively cut. In 2004 rates were put back up again in a fairly benign inflationary environment. It seems that interest rate policy is driven as much by crisis as by inflation. A cynical assessment would be that rates are put back up in times of calm so as to reset the reflationary tool.

Today, as it was 12 years ago, interest rate policy is once again in the spotlight. One could argue that a ‘good’ level for rates would be in the region 6.5%. In the absence of turbulence it affords ample room for rate cuts. One could also argue that this is an acceptable hurdle rate for investment. One of the consequences of too low an interest rate is that it encourages over investment.

From an inflation point of view it looks as if rates are perfectly poised. If there is inflation it is coming from services and housing with some volatility from commodities. Since there are two inflation rates for two segments, rich and poor, each has to be looked at separately. Unfortunately there is but one interest rate that has to be set to a compromise solution.

In the US, a full 42% of CPI is due to housing of which rent is 5.8% and owners' equivalent rent is 23%. Across the globe today we see rising housing costs, particularly in the metropolitan areas. Residential real estate prices are bifurcated along the very lines of rich and poor. Within countries and within cities, price differentials are evident and in many cases are growing. Much of this element of inflation therefore impacts the higher income segment. As prices are being driven up by income and not the other way around, this may be an acceptable situation to a central bank. At lower incomes, house price inflation is less robust and in step with wage growth so there is not an immediate problem.

We can try to generalize this. Rich sector inflation is higher. However, as incomes are higher and wealth creation derives from investments as much as wages, the marginal propensity to consume out of incremental wealth is lower. A central planner may find this acceptable. At lower levels of wealth, inflation is not just lower, its low. Looking at the aggregate economy, there doesn't appear to be any need to raise interest rates.