

ECONOMIC NOTES

TAPPED BY THE INVISIBLE HAND

After significant CV-19 economic disruption inflation has moved up.

This is largely a relative price phenomenon & not a rise in all prices.

Big relative price swings are there to encourage an increase in supply and restore logistic efficiency.

This is a necessary but not sufficient condition to restore supply.

Central banks stand aside & believe relative price buoyancy is temporary.

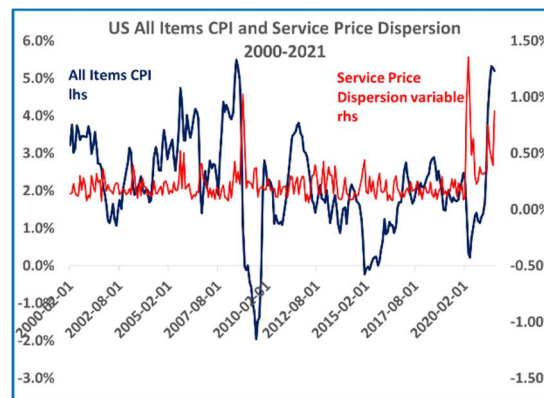
The risk is that we have experienced a permanent supply shock but it is too soon to render this judgement.

INFLATION AND PRICES: TOO SOON TO WORRY

I have been asked many times in the past month for my views on the unexpected jump in inflation, and whether it is temporary or something that we need to protect ourselves against. There is no easy answer to this question, but the key point to make is that the average rate of inflation is moving higher than 2.0% for some time, but not high enough to warrant serious concern *now*.

To understand why we must differentiate between a relative price change and a sustained rise in all prices. In the current context, it is large relative prices that are driving the bulk of the rise in the overall CPI which is why it is too early to discount significantly higher inflation is here to stay.

The price system is Adam Smith's invisible hand tapping producers on the shoulder. A producer facing a higher-than-expected price for their product can increase profits by increasing output, so this is an incentive to get more product to market. Similarly, increases in shipping rates encourage shippers to find more capacity. As an accompanying paper highlights, there is an unusual degree of relative price changes in train, see service price dispersion shown in the chart below.



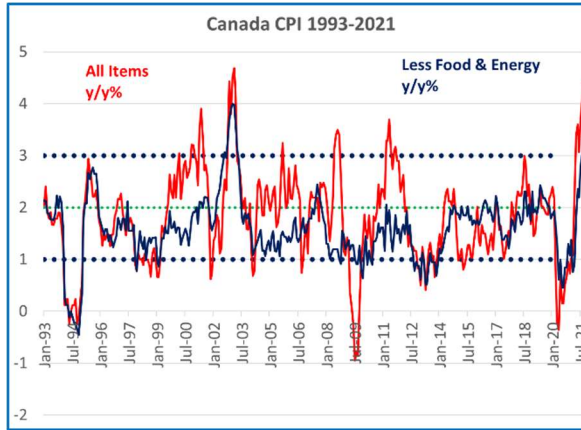
The net effect of sustaining demand and income from extraordinary policy support, and the reduction in supply accompanying stay-at-home orders, has led to significant disruption and disequilibria. On a global scale the resulting supply chain

frictions are well known. Big relative price signals are necessary to reset the system, but it is not clear whether they are sufficient.

When there is a widespread disruption to electricity supply, as there was in Eastern North America in 2003, restoring supply took a weekend to reconnect idling power stations to the distribution grid which remained intact. In the current context, the power stations – factories – are not supplying at full potential, and logistics coordination – the distribution grid – is severely damaged. It is not clear how long repair will take and how long prices must remain high to effect repair.

Expectations that the global supply disruption will persist well into next year and beyond is heightening nervousness that high relative prices changes will be

ineffective in restoring supply. It is possible that the persistence of high *relative* prices into next year will lead *all* prices higher. This is definitely a risk. Central banks are nervous, but remain confident that the relative-price induced inflation is temporary. Their confidence traces to their understanding of the inflation process. Inflation is believed to be the result of the balance of excess demand or supply in the economy. Too much demand relative to supply and all prices are more likely to rise. Too much supply relative to demand and all prices are more likely to decline.



What people expect inflation to be – or inflation expectations -- also matters. If the public feels it needs to shelter from inflation, then inflation is more likely to rise. If the public does not think it needs to shelter from inflation, then

inflation is unlikely to rise. The inflation drizzle is mostly annoying, and we don't need yet to open-up our umbrella unless of course the drizzle turns into a downpour.

Despite recent controversial statements from the Federal Reserve's Jeremy Rudd, inflation expectations do matter. If they are stable, the rise in relative prices that is pushing inflation up can do its job of resource allocation and does not need to be constrained by the central bank. Price rises will eventually recede.

Sizing up the degree of slack and the state of expectations suggests no need to hit the panic button, but the disruption to supply could ultimately determine whether the average rate of inflation moves to a higher level beyond the current 4% we observe. Some history helps us understand why.

The great inflation of the late 1960s and the 1970s can be traced to two drivers. A negative supply shock, or a reduction in supply growth, and expansive fiscal and monetary policy that kept demand growth too high relative to the economy's ability to supply.

The signature of a negative supply shock is falling economic growth relative to expectations and rising inflation relative to expectations. Should the central bank respond to lower growth with stimulus to push it back up, or remove stimulus to constrain the rise in prices? After misreading the signals and stimulating growth, they got even higher inflation. The lesson was learned: the right policy signal was coming from prices.

The supply growth slowdown in the 1960s-70s episode was traced to an unanticipated productivity slowdown. While the drivers today are different, one can argue that the current situation is eerily similar: supply growth has slowed and prices are rising. Moreover, there is lots of policy support for demand, but it is not at all clear that the supply chain problems will be fixed in a short period of time. Some major global corporations are warning that supply will be disrupted for at least the next year.

Policy makers know this history well. While the signature of the 1970s shock may be on today's paper, a different hand holds the pen.

The big danger is that the extreme rise in relative prices needed to restore supply does not achieve the expected effect. In which case, we have a negative supply shock that must be managed and central banks will have to respond. But they will have to tread carefully as the pandemic is not over, and corporations and governments have assumed large bridging debt to cross the Covid-19 divide. That debt will have to be serviced. The economy is already febrile, and likely very sensitive to interest rate increases. This is a very difficult place to be.

Central banks are betting that the disruption to global supply chains is not permanent, that the positive gains from globalization have not been reversed, and that they do not need to bring demand in line with supply now. In fact, they are likely betting that demand needs to be sustained long enough to get supply back on line, and relative prices need to do their job even if the average rate of inflation exceeds their targets for some time.

For now, this seems to be the right wager, but it does make for very tense and nervous times for the monetary monks.

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