



ECONOMIC NOTES

IS THE 2.0% TARGET GONE?

GET USED TO AVERAGE INFLATION OF 4%

Inflation is large in scale and scope, and is likely to settle into a new and higher average rate of 4%

Central banks were slow to respond to inflation given intense economic uncertainty.

There is more to this than many large relative price shocks; there is now inertia in core prices.

Central banks will bear down on this pressure but getting it back to 2% will be hard without a recession.

This is not your 1970's stagflation but the average inflation rate is likely higher than 2.0% and unemployment will be higher than it is today.

Inflation has broken out of the 1.0% to 3.0% range occupied since the inflation targeting regime was introduced in the early 1990's and is unlikely to return to that range for some time. Inflation could settle at an average of about 4.0% into 2023-24. With inflation already 1.0% to 2.0% higher than the 2.0% target, lose talk of stagflation – the coexistence of high inflation and high unemployment – haunts our consciousness. We should all get used to a higher average rate of inflation unless the fragile economic environment or central banks deliver a deep recession.

Inflation has become surprisingly large in magnitude in the past year, it is spreading in breadth, and is increasing in depth. Here in North America US inflation is 8.5% and Canada's is 6.7%. Core inflation, netting out food and energy prices, is running at 6.5% in the US and 4.6% in Canada. With inflation showing no signs of abatement, consumer and investor inflation expectations are on the rise. While the inflation to date is the outcome of excess demand colliding with a reduction in potential supply, extremely tight labour markets and well positioned households are raising fear of a follow-through wage price cycle. This is a dangerous time for macro management.

The global economy has been buffeted in quick succession by two one-in-one-hundred-year shocks: Covid 19 and Russia's invasion of Ukraine. The first seriously disrupted global economic activity, creating costs and a dead weight drag of high bridging debt that will hang-over future years. The second has disrupted the supply of essential commodities, driving-up the price of food and energy which households find difficult to do without.

Given these large and sequential shocks, the emergence of inflation was swift and unexpected, and even the army of Ph.D. forecasters at the central banks were caught wrong-footed. We should not be harsh, the environment made an accurate forecast of inflation next to impossible.

Central banks target all items inflation but focus on core inflation for decision making because it separates relative price changes from general price changes. Core is the better predictor of future inflation trends, and if it is stable then all will be well if CPI is driven by relative price changes. However, if core inflation is rising and breaching the upper bound of tolerance then a response is likely required.

Upward pressure on inflation is traced to economies that are in excess demand, helped along by partial money financing of large fiscal transfers through the pandemic shutdowns, and this needs to be cooled for inflation to come off the boil.

The legacy of excess demand in goods has pushed prices up, but the supposed excess supply in services has not offset it on average suggesting there is no excess supply in services. Supply potential has been, at least temporarily, destroyed as providers of social consumption services struggle to attract labour.

Its all about the base

Any belief that once relative prices pass through inflation will fall back to target should be abandoned. There is a difference between a relative price change of one or a few prices and a change in all prices; the latter concerns economists and the monetary monks the most.

The impact on CPI from an increase in oil prices is well known and has been experienced many times by the current generation of central bankers. A big move in one price, even if it has a small weight in the index, can dominate the overall index for a year or so before its effect dissipates so it rarely affects longer-term inflation expectations.

Today's inflation is no longer a relative price phenomenon. Price increases have both broadened and deepened, and a broad array of elevated price changes has emerged: core inflation is rising.

To gauge just how much, we looked at the distribution of monthly changes in both all-items and core CPI in the twenty years prior to 2019, and the distribution of monthly changes in the months starting January 2020.

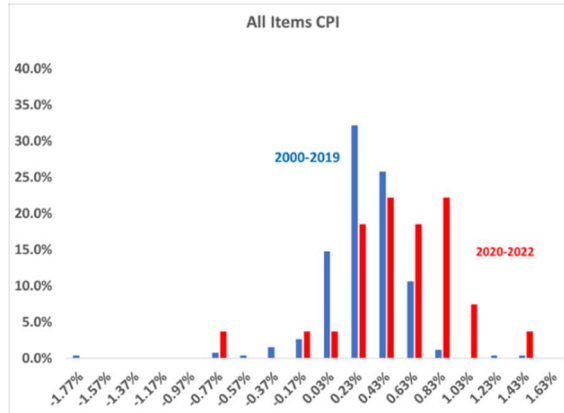
The results suggest that US inflation will rest about 3.5% to 4.0% this time next year which is 1.0% or even 2.0% higher than the 2.0% inflation we have come to expect. As chart one shows, the distribution has shifted to the right for all items and core has also shifted right.

All items CPI shows the effect of some very large changes in some prices as the tail is long, and the density of the changes is less clustered about a new and higher average. Alternatively, the changes in core prices have a greater density around a shift higher in the mean and the median meaning more prices are moving up around the new mean.

Now, the number of observations since 2020 are fewer, and the scale of the disturbance was big so is this a meaningful exercise? The answer is yes, and we draw confidence from specialized flexible and sticky price indices provided by the Atlanta Fed. The sticky price index captures inertia in price trends, and its recent move ups warns that a new and higher average rate of inflation is getting stuck-in, chart two.

The sticky-price index is comprised of prices that are changed infrequently, anywhere from every five to twenty-four months. Sticky-prices make up

Chart One: Distribution of Monthly CPI Changes Pre and Post Covid



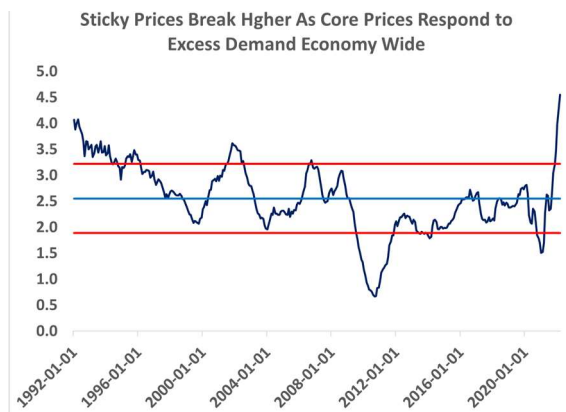
70% of all prices and account for 64% of core prices. Flexible prices are changed frequently, adjusted anywhere from one to every three months. The flexible-price index is heavily weighted to commodities and new and used

cars, all of which have recently soared. Only 14% of the flexible index could be described as a “core” prices that are free of food and energy price effects.

Price inertia is a challenge for expectations

As the chart shows, sticky prices have moved out of their thirty-year range and are now significantly higher. This broadening of inflation, one that is already of significant scale, is a worry for two reasons. First, it is seeping into inflation expectations of both consumers and investors. Secondly,

Chart Two: Inflation Inertia Has Momentum



labour markets are very tight raising the prospect of a spill-over to wages. In the US there are roughly 2 jobs on offer for every unemployed person. Central banks cannot create more supply, they can only influence demand and it is demand that

needs to cool to bring the system into balance.

Will inflation come back to 2.0% given the current expected interest rate tightening priced-into the market? The answer is likely no as the Fed and other central banks will have to deliver a positive real rate of interest to gain better control, and this is unlikely with a 2.75% or 3.00% federal funds rate they expect to stop at. To push inflation back to 2.0% will likely require a global recession. The question is whether we are already half-way there or a real policy rate of 1.0% or more is required?

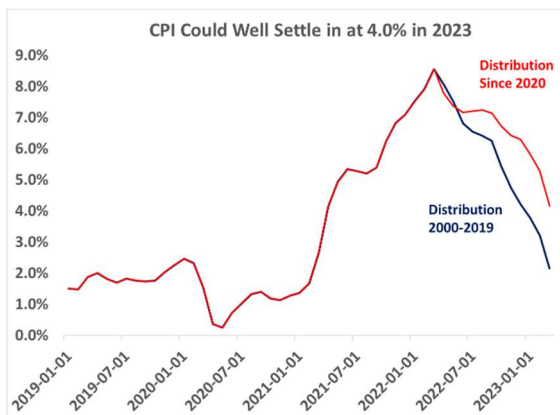
In any given year the unconditional – or chance of a recession at any time – is likely between 5% and 20%. But with potential future disruption of Covid-19 lingering, the uncertain course of the war in Ukraine and the ongoing stress this puts on the supply, and prices of, key food and energy commodities. Netflix’s ill-timed determination to push through a price increase unleashed a torrent of cancelled subscriptions. If people face higher prices for necessities, and wages are not keeping up, then items are cut not just from the wish list but from the budget – now known as the Netflix effect. Inflation makes us all poorer, and steaming is a superior good; but, the signal is that spending is being redirected putting demand in the cross-hairs.

Is the 1.0% to 3.0% range gone?

While the inflation targeting framework survived the financial crisis of 2008-2009, it is now being tested by the fall-out from the Covid-19 health and economic emergency. Fiscal and monetary policy were not tending to their normal targets of debt stability and price stability in 2020-21, so the system was unanchored and inflation left to fend for itself. While central banks delayed for too long their response to the move higher in inflation, monetary policy is now focused on its target: price stability. The Reserve Bank of New Zealand and the Bank of Canada have both made aggressive moves to tighten policy and have signalled more and swift action is coming. The Fed has now followed suit.

Now that monetary policy has refocused on its 2.0% target to the exclusion of all else, central banks are likely to do all they are able to bring inflation back to the 2.0% target. But there are lags between changes in monetary stance and its impact first on demand and then inflation. Changes in interest rates affect demand and production with a lag of six to nine months and affects inflation with a lag of eighteen to twenty-four months. This is because the economy needs to open-up some economic slack to exert downward pressure on prices before inflation can cool. And, if inflation expectations had risen measurably above the 2.0% target before the monetary clampdown, then that slack must prevail for longer. So, unemployment **will rise before inflation comes down**.

Chart Three: Two Trajectories for Inflation in the Year Ahead



We could see both high unemployment and inflation through 2023-2024, and while some may be tempted to produce this as evidence stagflation has returned, this is likely a dramatic conclusion.

The return of stagflation is highly unlikely given that the monetary and fiscal framework is entirely different from that of the 1960's and 1970s. Central banks have learned the lessons of the two oil price shocks of the 1970s and are unlikely to keep monetary stance too easy for too long.

Can mistakes be made? Yes, and they already have by waiting too long to respond to the surge in prices in 2021 but this mistake has been recognized and is being corrected.

The new inflation normal: is 4.0% inflation the new 2.0%?

Monetary policy makers can *influence* real variables for a while, but they cannot *control* them. They cannot create supply. The only thing they can control is inflation, that they now know how to do and while they are intent on doing so the cat is out of the bag. It will be tough to get inflation back to 2.0%.

We get the inflation we want and choose. To call for stagflation tomorrow is to call for central bankers to repeat the mistakes of the past and to have learned nothing.

The return of stagflation on the scale of the 1970's is improbable so long as the inflation target remains intact, and central banks are willing and able to deliver on their inflation commitments. But we need to accept that inflation will settle in closer to 4.0% than 2.0% and the unemployment rate will be higher than it is today unless we are prepared for a costly transition.

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