INTUITION

Learning Insights

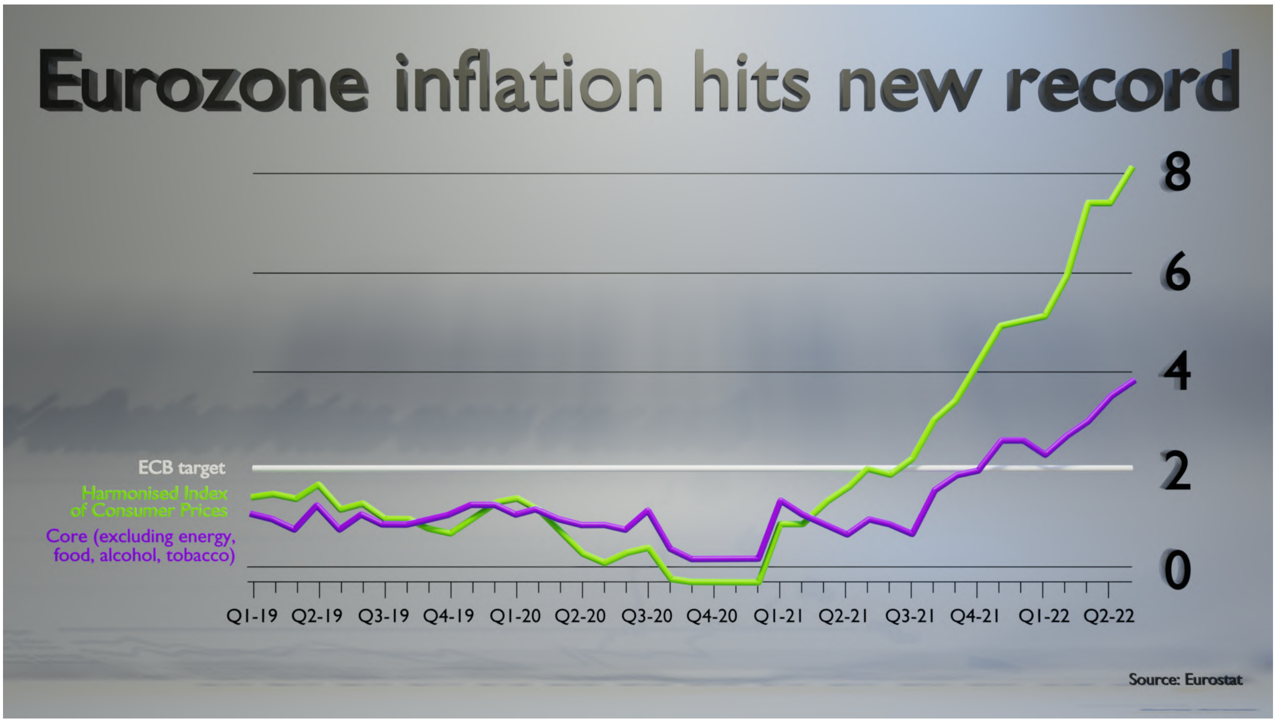
ISSUE 4 2022

In this issue:

New Inflationary Regime Takes Hold

Around the world major economies are grappling with an extraordinary bout of inflation that has put to an end a disinflationary regime that lasted for 40 years.

The euro area hit a record 8.1% rate in May. The UK's consumer price index (CPI) rose by 9% in April – a rate not seen since the early 1980s. The Japanese producer price index (PPI) rose to 10% year-on-year the same month. Germany's Chamber of Industry and Commerce expects inflation to reach 7.7% in 2022 – double last year's rate in this the most inflation-phobic of countries.



The critical question is whether current inflation rates are temporary or whether they are of a structural nature. Indications are that initial optimism is giving way to a realization that an extraordinary disinflationary era has come to an end. At the very least, senior officials – most notably US Treasury Secretary Janet Yellen – are now admitting that belief that the inflation spike of 2021 would prove temporary was incorrect.

Fiscal support fuels price rises

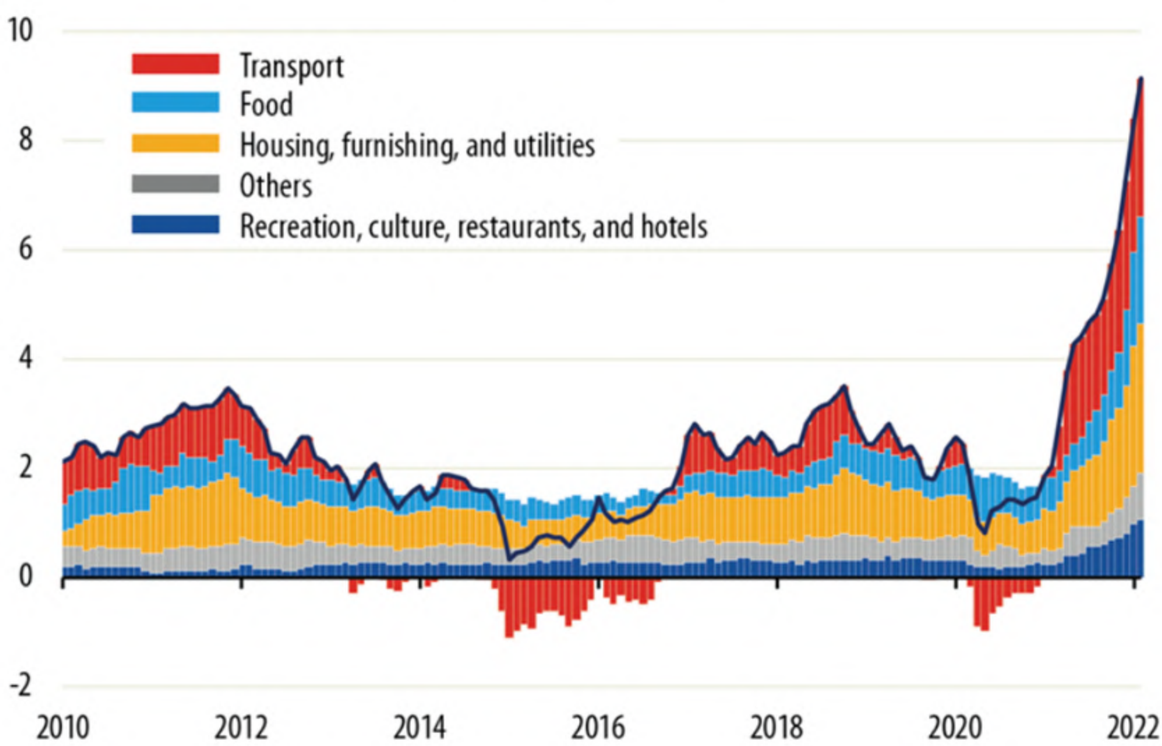
The response to the onset of COVID-19 was a massive level of fiscal support which propelled a strong post-COVID recovery. A surge in demand for goods at a time when lockdowns were suppressing international trade, in tandem with scarce raw materials and increased energy prices, meant that elevated producer prices soon worked their way into consumer price inflation. According to International Monetary Fund (IMF) data, world consumer inflation reached 7.5% in December 2021.

Chart 1

Headline inflation in OECD countries and its contributions

Inflation across Organisation for Economic Co-operation and Development (OECD) countries is at record highs.

(OECD consumer price index, 12-month percentage change, weighted by GDP)



Source: Authors' calculations based on OECD data.
Note: The OECD dataset includes data for the US from 2012 and Canada from 2016.

Were these considered temporary phenomena then the global economy could take some comfort, but the impact of the war in Ukraine has exacerbated the problem, and this alone makes any visibility as to a possible end of the current inflation wave difficult to discern.

The longer the current inflationary wave endures, the higher the risk of secondary effects as various economic actors look to preserve their purchasing power: employees seek pay rises while companies raise prices in order to maintain their margins, ultimately supporting higher inflation rates for longer and prompting monetary authorities to tighten policies.

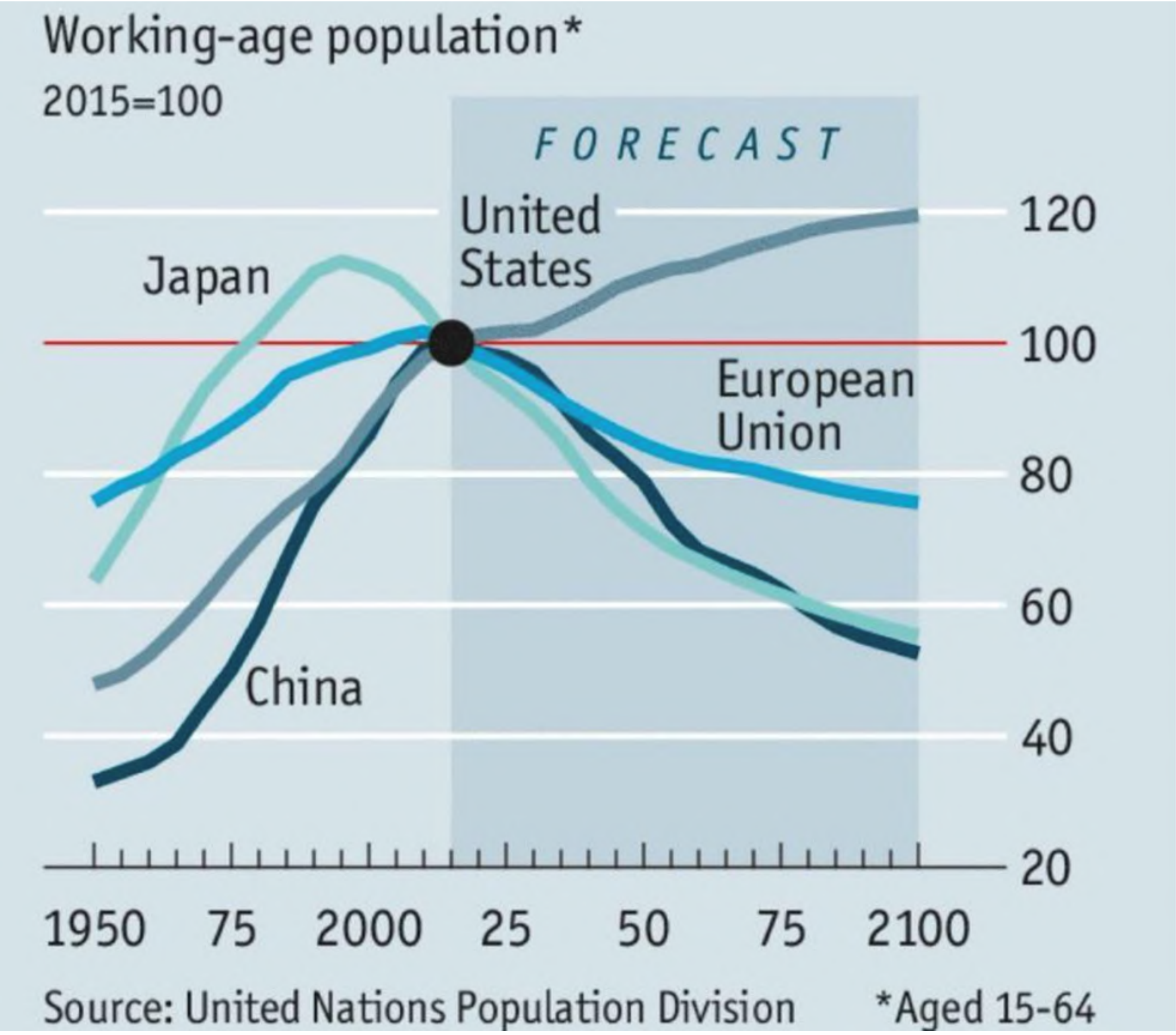
Five factors behind inflation rates

A de-escalation of the war in Ukraine would certainly help reverse the inflationary trend but there are sound reasons to believe that the current wave is more structural in nature. Commentators have identified five factors that support this thesis:

1 Demographics

It has long been a tenet of economic theory that there is a direct link between long-term inflation and demography. This theory posits that a country with a large working age population relative to its non-working age grouping will have an abundant labor supply. This is something that will restrict wage growth and will therefore be disinflationary. In short, the larger the proportion of retirees – who tend to be pure consumers – the higher the rate of inflation.

The theory has been contradicted by the example of Japan, which is the 'oldest' major economy in the world (in 2020 some 28% of its population was over 65 years of age). Between 1980 and 2000, when its population of retirees rose rapidly, core inflation trended downward before turning into deflation. The explanation advanced for this was that the 'younger' old age cohort tends to push up inflation (but once the population gets over 75 years of age the effect is highly deflationary).



One of the biggest factors in keeping inflation low in recent decades has been the entry from China of more than 600 million low-cost workers into the global workforce since 1990. The effect of this on inflation in the western world has been significant in two areas: cheaper consumer goods and suppressed wage growth for blue-collar workers.

Meanwhile, in most advanced economies, the generation of post-war 'baby boomers' has been reaching retirement age and are leaving the labor market. This has occurred at a time of falling birth rates, leading to reduced working age population in many countries.

2 Globalization

Inflation has been increasingly influenced by global rather than local factors: the liberalization of capital flows, a globalized labor supply, and greatly increased international trade. These factors have been highly disinflationary. This trend is now somewhat in reverse since the outbreak of a tariff war between the US and other countries, notably China in 2017. At the same time, the war in Ukraine has exposed supply chain vulnerabilities which have led to a tendency toward repatriation of manufacturing closer to home.

3 Innovation

For many years the productivity gains made by innovation have contributed to disinflation. This now may be at an end as the dominant position of major innovators evolves into a monopolistic situation. This could mean lower spending on investment and a less innovative economy that reduces levels of innovation and associated disinflationary effects.

4 State Intervention

The COVID crisis (like the global financial crisis of 2008) caused unprecedented and extraordinary injections of money into the global economy, with a corresponding increase in public debt. This may lead governments to 'inflate away' debt to reduce the debt-to-GDP ratio.

5 Climate Change

Energy transition costs are likely to contribute to higher inflation over the next decade. Until new energy sources attain sufficient economies of scale, they will likely be more expensive than traditional sources, while the latter will also be more expensive through government incentives to reduce dependence on fossil fuels.

Whatever the case, the outcome of a change in the inflationary regime would be profound, not just for monetary policy, but also for financial stability as high inflation increases the volatility of macroeconomic factors and the policy response.

Intuition has a number of tutorials relevant to the content of this article:

- Economic Indicators – An Introduction
- Inflation – An Introduction
- Inflation Indicators
- GDP – An Introduction
- GDP Indicators
- Employment & Unemployment – An Introduction
- Labor Market Indicators
- Trade Indicators
- Monetary Policy Analysis
- Fiscal Policy Analysis
- Climate Risk – An Introduction

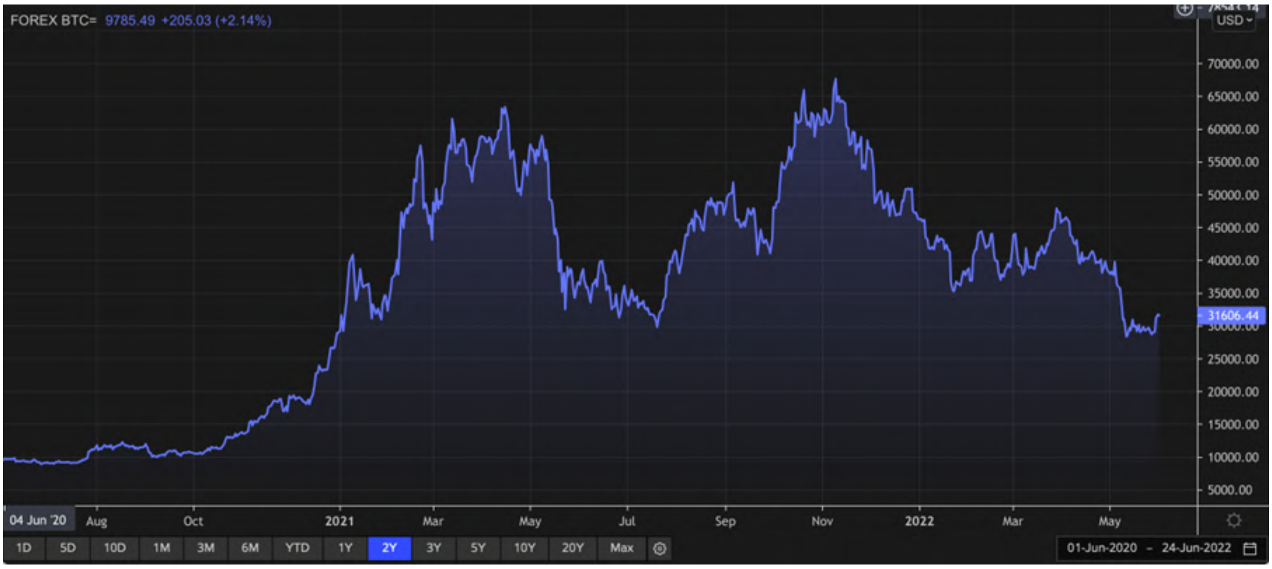
Cryptocurrency Risk Worries Multiply

Investment is a perpetual search for superior returns relative to risk. At different points in time, various asset classes came into vogue. In the 1970s, gold was in favor. The 1990s saw emerging markets take on a new prominence. This century has seen the rise of alternatives.

All of these asset classes share certain characteristics. They are difficult to gain access to; they have low correlations with existing asset classes; they are relatively illiquid; and they are significantly riskier.

Bitcoin/US Dollar FX Spot

Cryptocurrencies also promised superior returns – indeed their returns over certain time periods have been nothing short of spectacular. But recent reversals have confirmed the skepticism of their critics who contend that crypto can never be taken seriously as an investable asset: this is on the grounds of their volatility, difficulties over their valuation, and an inherent unsustainability given the vast amount of energy expended in the 'mining' process.



Source: Refinitiv

Central authorities tackle cryptocurrency risk

There is also risk related to the decentralized blockchain technology that is the foundation of crypto assets; the risk of fraud and the risk of holders losing their holdings through their own errors.

The result has been a determination on the part of central authorities to apply downward pressure on the crypto boom, notably the banning of cryptocurrency transactions in China in 2021. At the same time, central banks have accepted that there is a demand for crypto and this has initially been manifested in their efforts to develop central bank digital currencies (CBDC).

For central banks, CBDCs go some way to countering the crypto threat to their mission, in spite of the fact that (relative to crypto) they lack the key feature of anonymity that makes cryptocurrencies so compelling for many. That said, as a means of payment, CBDCs will likely dominate crypto given their official endorsement, safety, and widespread recognition.

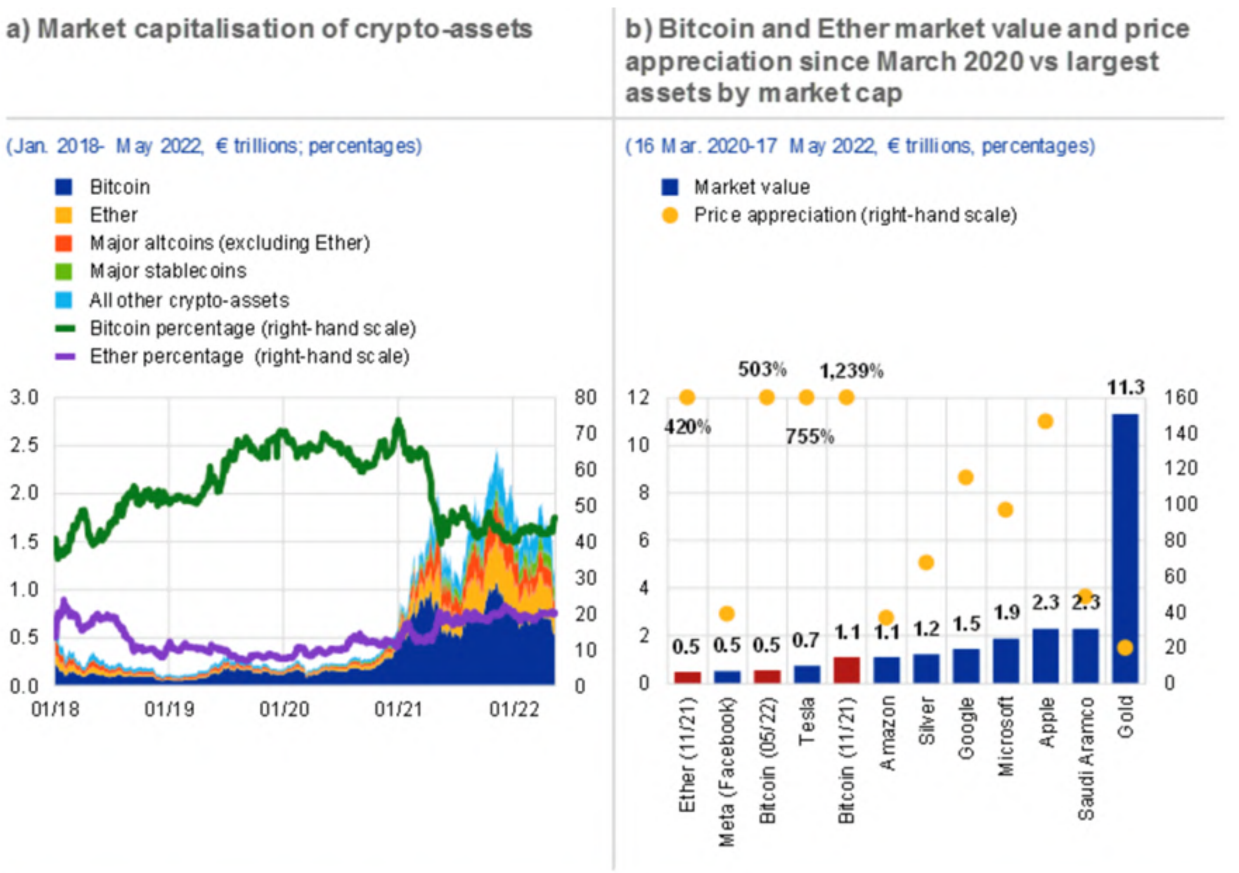
Cryptocurrency threatens financial stability

And there is further systemic risk posed by crypto that concerns central banks, who view its rise as something inherently unstable in the financial system.

The European Central Bank (ECB) in its Financial Stability Review published in late-May singled out the rise in cryptocurrency for special treatment.

> *"The stellar growth, volatility and financial innovation currently seen in the crypto-asset ecosystem, as well as the rising involvement of institutional investors, show how important it is to gain a better understanding of the potential risks that crypto-assets could pose to financial stability if trends continue on this trajectory. Systemic risk increases in line with the level of interconnectedness between crypto-assets and the traditional financial sector, the use of leverage and lending activity. It is important to close regulatory and data gaps in the crypto-asset ecosystem to mitigate such systemic risks."*
>
> ~ European Central Bank, Financial Stability Review, May 2022

While the ECB report notes that crypto-asset markets currently represent less than 1% of the global financial system in terms of size, they have grown significantly since the end of 2020. Yet, despite recent declines, "they remain similar in size to, for example, the securitised sub-prime mortgage markets that triggered the global financial crisis of 2007-08." The report also observes that "increasing correlation of crypto-asset prices with mainstream risky financial assets during episodes of market stress casts doubt over their usefulness for portfolio diversification".



Sources: Bloomberg Finance L.P., Crypto Compare and ECB calculations.

Cryptocurrency increases links to traditional finance

Interconnectedness with the wider financial system has been growing. According to the ECB's report, this is occurring "mainly via expanded portfolios or ancillary services associated with digital assets (including custody and trading services)." But the report also notes that major payment networks have increased support of crypto-asset services through their retail networks. This has made crypto-assets more easily accessible to consumers and businesses who are vulnerable in the face of its volatility. Institutional investors, including hedge funds, family offices, some nonfinancial firms, and asset managers are now also investing in Bitcoin and crypto-assets more generally, with market intelligence suggesting that the growing involvement of asset managers is largely in response to demand from their own clients.

For some industry observers and practitioners, increased regulatory scrutiny is timely. A group of leading technologists has written to US lawmakers to counter the crypto boom, as quoted by the Financial Times: “We urge you to resist pressure from digital asset industry financiers, lobbyists, and boosters to create a regulatory safe haven for these risky, flawed, and unproven digital financial instruments.”

In this respect, this group are fully aligned with the ECB which concludes that "if the present trajectory of growth in the size and complexity of the crypto-asset ecosystem continues, and if financial institutions become increasingly involved with crypto-assets, then crypto-assets will pose a risk to financial stability."

Intuition Know-How has a number of tutorials relevant to the content of this article:

- Cryptography
- Blockchain – Primer
- Crypto Assets
- Asset Classes – Primer
- Asset Classes & Investing
- Asset Classes – Types
- Alternative Assets – An Introduction
- Commodities – Gold & Other Precious Metals
- Emerging Markets – An Introduction
- Payments – An Introduction
- Digital Money & Mobile Payments