Economics

ECONOMIC INSIGHTS

June 16, 2022

Long run inflation: Can we do two?

by **Avery Shenfeld** avery.shenfeld@cibc.com and Katherine Judge katherine.judge@cibc.com

There's little doubt that major central banks are fully engaged in an effort to bring inflation back down to earth. Monetary tightening will push up interest rates in the months ahead, and given intensified price pressures, we've moved all of the rate hikes into 2022 and added to our peak targets in the US and Canada (Tables 3 and 4, page 6) from where we stood a month ago. That will likely include 75 basis point hikes by both the Bank of Canada and the US Fed at their next rate setting dates.

Getting the overnight rate quickly to 2.75% in Canada, and having the ceiling for the fed funds range at 3.25% in short order, will entail a sharper retreat in growth than we earlier projected, and in the more rate-sensitive Canadian economy, more than the central bank is bargaining for. While we still lean towards an outcome that avoids a true recession as long as central bankers stop at our targets, quarterly growth rates well below potential will see the jobless rate edging higher. (Tables 1 and 2, page 5).

Supply chain issues and the war in Ukraine will mean even scarier inflation numbers in Canada for the next couple of months. But on both sides of the border, we see a resolution of some of these supply issues, alongside slower demand gains, as bringing a sharper dive in inflation by 2023 than most now expect.

But then what? Should we expect the Fed, or the Bank of Canada, to be as successful as they've been in recent decades in steering close to their 2% target over the medium term, one key to achieving the lower nominal bond yields we project ahead.

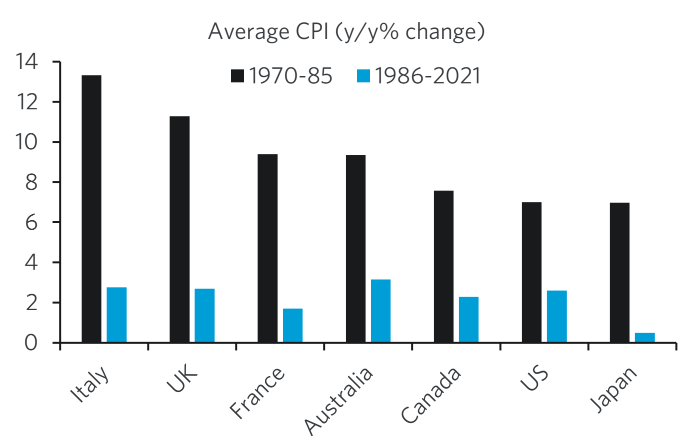
The most common fears among those wary of longer term inflation center on "deglobalization". If geopolitics, or the lessons of the pandemic's disruptions, are set to reduce the role of trade, will an end to disinflationary cost savings keep 2% inflation out of reach? That will be our focus here. But we'll also consider whether costs to prevent climate change or adapt to its consequences can prevent sustaining a 2% target.

More broadly, the issue comes down to whether we are losing tailwinds that were important to helping global central banks keep inflation at bay, or are facing lasting new headwinds. As we'll argue below, even if that's the case, a 2% inflation target is still achievable, with these negatives impacting living standards rather than inflation rates. We'll focus on the US, due to the richness of American data, but similar issues would arise for Canada, which imports an even larger share of its consumer goods.

How much did globalization matter?

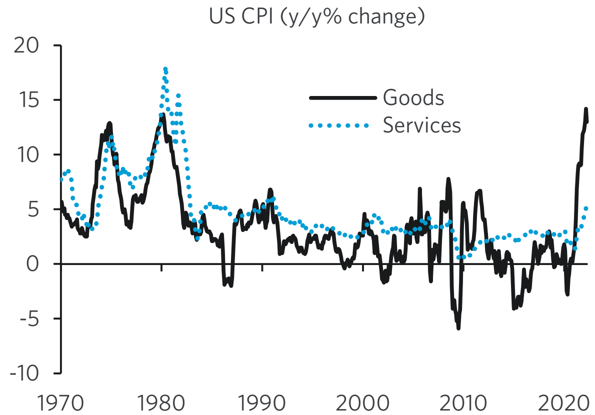
Globalization often gets a lot of credit for tame inflation, in part because inflation quiescence has been a global story (Chart 1). Most major economies shared in that trend after the mid-80s.

Chart 1: Low inflation has been a global story



Source: World Bank, CIBC

Chart 2: Goods, more trade-exposed, have seen tamer inflation until recently



Source: BLS, CIBC

Chart 4: Globalization didn't increase after 2011

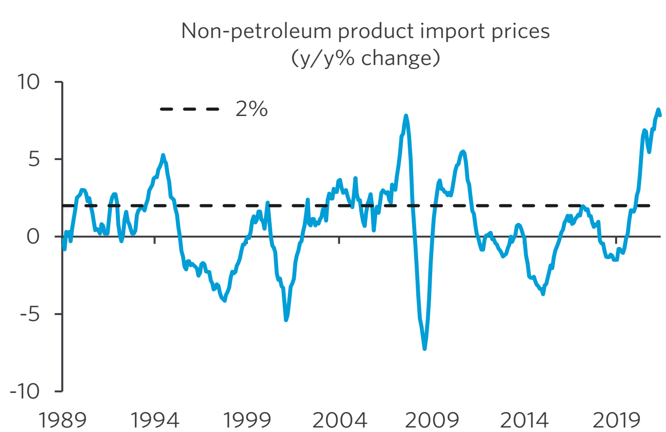
Source: World Trade Map, IMF, CIBC

Simply noting that inflation in many developed economies was well contained in recent decades, and that the same period also featured an expanded role for global trade, doesn't prove cause and effect.

The same era also saw improved monetary policy discipline in major developed economies, which served to anchor inflation expectations. Globally, we also saw the rapid adoption of new technologies, including improvements that lowered quality-adjusted prices for phones, vehicles and other products. Telecommunications costs plunged as long-distance charges melted away with the advent of free alternatives. Particularly in the US, we had declining unionization rates that reduced worker bargaining power. Apportioning the credit for well-controlled inflation among all of these factors isn't a straightforward exercise.

Global trade garners attention because, until this year, US inflation rates have been particularly low for goods prices (Chart 2). Goods markets tend to be more trade-exposed than services, many of which, including key CPI components like housing rents and medical care, are largely or entirely non-tradable. A house in Peru would be cheap, but an Indiana factory worker can't live there. But the goods sector is also where a lot of the benefits of technology change reside; computers, phones and manufacturing processes have changed much more than how haircuts are done.

Chart 3: Import prices generally tame, but not always



Source: BLS, CIBC

The evidence suggests that imported goods prices contributed to tame inflation at the retail level, although disentangling the degree which that has been the case isn't a simple task. Low import inflation could have had additional benefits if they forced down price gains for competing American made products. But prices at the border might not have fully translated to retail prices if imports were simply price-takers matching prevailing domestic prices. Moreover, at the retail level, the CPI for imported consumer goods would include the US-based costs for wholesaling and retailing.

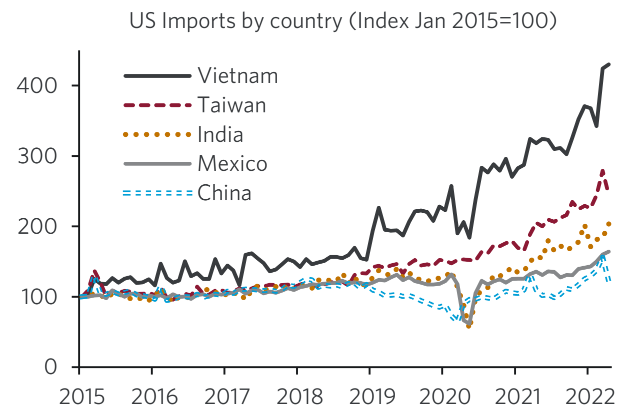
While import inflation for non-petroleum products did run well below the Fed's 2% inflation target in the last business cycle (from 2010 to 2019), note that imports averaged much closer to 2% inflation in the prior cycle (from 2002 to 2007), and yet US core CPI inflation was also contained in that period (Chart 3). That suggests that if globalization was helpful to holding down inflation in the US in recent years, allowing the US economy to run hotter in services prices, that's clearly not a necessary condition for 2% inflation, for reasons we explain further into this paper.

It's also not obvious that increases in "globalization", typically defined as a period in which global trade outpaces global GDP, are key to sustaining tame goods prices. Global trade was no longer outpacing world GDP from 2011-2019 (Chart 4), and yet that period continued to see moderate inflation, both overall and in non-energy goods prices. If we sustain trade's current share in world GDP, there's little reason to fear that will keep 2% inflation at bay.

Chart 5: US imports don't show evidence of re-shoring production

Source: Kearney Analytics, CIBC

Chart 6: Other low-cost countries have replaced China in US import market



Source: Census Bureau, CIBC

Deglobalization: Is it real, and how costly would it be?

So the concern is really not over the end of additional globalization, but a reversal of that process. Are we headed for deglobalization, in which more of what Americans consume is made in the US of A?

Challenging the idea that a wave of reshoring is just around the corner is the fact that we never seem to actually get to that corner. A widely cited Boston Consulting Group study found that half of the large companies they surveyed were planning on moving jobs and production back to the US within two years. The problem is that the study was published way back in 2011, and to the extent that anything materialized since then, it's been swamped by other decisions that prevented any decrease in America's dependance on cheap imports.

For example, the idea that manufacturing activity is being re-shored from low-cost locations in Asia back to the US isn't supported by the data. Instead, a Kearney Analytics report showed that imports of manufactured goods from such locales have actually been growing relative to US manufacturing output in the last two years, extending the trend that was in evidence in most years since the 2008 recession (Chart 5).

Moreover, empirical evidence shows that offshoring has had a positive impact on productivity in the US manufacturing industry, highlighting why US firms would be hesitant to re-shore production. Research by Amiti and Wei (2009) found that 15% of productivity growth in manufacturing in the US from 1992-2000 was attributable to offshoring, with services accounting for 10% of total productivity growth. That was, however, the period in which the NAFTA deal was implemented, so it's unlikely that trade and offshoring played as large a role in US productivity gains in most of the years in which globalization advanced less dramatically.

The same narrative can be extended to US exporters, as the evidence shows that an increase in imports used in the production process results in greater productivity (Constantinescu et al., 2019), implying that global value chains will likely remain the most cost-effective option for US businesses.

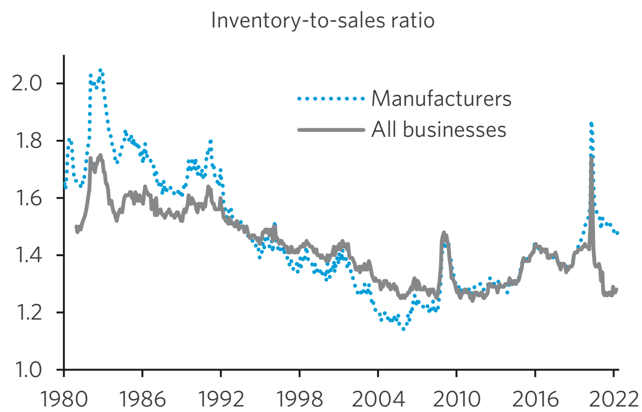
That's not to say that the recent experience with supply chain disruptions, or trade tensions with Russia and its allies, or China, won't have logistics and production executives rethinking their strategies. But not necessarily in a way that will materially reduce the cost savings tied to trade.

For one, surveys of businesses that are actually reshoring operations point to cost savings as a key reason. That might reflect mechanization that reduces the savings from operating in low wage countries, increases in shipping costs from such locales, or other factors that make the all-in costs of being closer to the home market more attractive. Such shifts in production, by definition, won't be inflationary, since they are aimed at all-in cost savings.

Other adjustments seem to be at least as prevalent. One is what we would call re-globalization, entailing a continued reliance on trade, but with a shift in geography. A labour intensive manufacturing process that isn't amenable to mechanization, but facing geopolitical risks or tariffs, is more likely to move from China, to Vietnam for example, than it is to relocate in Manhattan.

In other cases, if distance and shipping are the issues, near-shoring to Mexico can be the alternative to East Asia or the US. Perhaps reflecting early trade tensions, or simply rising costs in China as its pay scales grew, China's share of US imports stalled out in 2016, with more growth coming in shipments from other low wage countries (Chart 6).

Chart 7: US firms making greater use of inventories since 2008



Source: Census Bureau, CIBC

We do have companies rethinking their supply chains because they've experienced costly disruptions to their business in recent years. That process may go back further than the pandemic, since many manufacturers were similarly frustrated by supply shortages in the wake of Japan's Fukushima tsunami back in 2011. But many of the firms we talk to are looking at having more than one foreign supplier, or increasing inventories of parts of finished goods as ways of instilling greater resiliency, rather than reshoring. Indeed, inventory-to-sales ratios were already trending up in the years ahead of the pandemic, suggesting that corporate America was moving away from the extremes of just-in-time inventory systems (Chart 7).

Where deglobalization and supply-chain shifts could have more material impacts on costs is when they're not a corporate response to opportunities for efficiencies, but a reaction to tariffs or trade sanctions that impose additional costs on, or barriers to imports. Some studies found significant pricing impacts from trade wars during the Trump administration, not only due to the pass through of tariffs on goods that continued to be sourced abroad, but from their impact on prices that domestic competitors to those imports could charge.

Indeed, the Biden administration is said to be considering dropping some of those tariffs as a one-time anti-inflation measure. But at the same time, it has been looking at the imposition of Buy America restrictions on green infrastructure projects that could add to their costs, and any tit-for-tat action by Canada could raise prices on imported goods north of the border. Russia and its allies were not major suppliers to the US or Canadian economies overall, but sanctions imposed on their exports are part of the upsurge in inflation in globally traded commodities, and the world might end up relying on alternative sources of supply that are more costly.

Back to Econ 101: Demand matters

In sum, there are a number of factors, including diminished globalization, trade sanctions, a possible slowing in technology change, or the costs of measures to prevent or adapt to climate change, that could make the coming cycle different than the one that preceded it. But those differences needn't imply a higher trend rate of inflation, because the price level is still tied to overall demand, and that remains under the control of monetary policy.

As we noted above, in the years leading up to the pandemic, a period in which globalization ceased to advance, import prices failed to accelerate. In the business cycle from 2002-07, import inflation wasn't really far below 2%, yet core inflation remained near 2%. Further back, the US had a sustained run of tame inflation from the mid-1950s through to the mid-1960s, at a time when Americans were still largely buying locally-produced vehicles, appliances, and even clothing.

By raising or lowering interest rates, the central bank can impact the degree to which demand in the economy creates slack or overheats markets for goods, services and labour. If wage inflation is held reasonably in check, then not only will domestic business costs be contained, but the total nominal level of consumer purchasing power in the economy can be held to a path that is inconsistent with inflation running above 2%.

Suppose instead of imports sporting a 1% inflation rate, deglobalization were to result in Americans buying domestic goods with faster rising costs, leading to a 3% inflation rate for consumer goods. Or this could be a scenario is which costs of containing climate change impact goods prices. The Fed's control over the overall level of demand would squeeze purchasing power to the point where services prices are running below 2%.

Real consumption, and therefore living standards, would be growing more slowly in this scenario, but inflation can still be held to 2%. In sum, the worries surrounding deglobalization, carbon reduction costs, or the costs incurred in a failure to contain climate change, should be focused on the implications for real incomes and living standards, and not on trend inflation.

That's why although short-term price spikes can be caused by wars, droughts, and other shocks that impact costs, Milton Friedman was right when he concluded that, on a sustained basis, "inflation is always and everywhere a monetary phenomenon". That will still be true even if post-pandemic supply chain adjustments or geopolitical trade frictions add to business costs.

Table 1: Canada forecast detail (real % change, SAAR, unless otherwise noted)

Variable	22Q1A	22Q2F	22Q3F	22Q4F	23Q1F	23Q2F	23Q3F	23Q4	2021A	2022F	2023F
Real GDP Growth (AR)	3.1	4.1	1.5	0.9	1.1	1.3	1.8	2.1	4.5	3.4	1.5
Real Final Domestic Demand (AR)	4.8	2.5	1.5	1.1	1.0	0.8	1.5	2.0	5.6	3.5	1.3
Household Consumption (AR)	3.4	4.9	1.8	1.1	1.5	1.1	1.7	2.2	5.0	4.7	1.7
All Items CPI Inflation (Y/Y)	5.8	7.3	6.9	5.7	3.8	1.3	1.0	1.5	3.4	6.4	1.9
Unemployment Rate (%)	5.8	5.2	5.2	5.4	5.6	5.5	5.5	5.4	7.4	5.4	5.5

Table 2: US forecast detail (real % change, SAAR, unless otherwise noted)

Variable	22Q1A	22Q2F	22Q3F	22Q4F	23Q1F	23Q2F	23Q3F	23Q4	2021A	2022F	2023F
Real GDP Growth (AR)	-1.5	2.5	2.8	1.0	0.7	1.3	1.2	1.4	5.7	2.5	1.3
Real Final Sales (AR)	-0.4	2.0	2.4	0.8	1.0	2.4	1.8	1.6	5.3	1.4	1.6
All Items CPI Inflation (Y/Y)	8.0	8.5	8.4	7.0	4.8	2.6	1.5	1.7	4.7	8.0	2.6
Core CPI Inflation (Y/Y)	6.3	6.0	5.9	4.8	3.3	2.4	1.8	2.0	3.6	5.7	2.4
Unemployment Rate (%)	3.8	3.6	3.7	3.8	3.9	3.9	3.9	3.9	5.4	3.7	3.9

Table 3: Canadian interest rates (end of period)

Variable	2022 15-Jun	2022 Sep	2022 Dec	2023 Mar	2023 Jun	2023 Sep	2023 Dec
Overnight target rate	1.50	2.75	2.75	2.75	2.75	2.75	2.75
98-Day Treasury Bills	1.89	2.80	2.80	2.75	2.70	2.65	2.60
2-Year Government Bond	3.31	3.25	3.10	2.95	2.85	2.80	2.70
10-Year Government Bond	3.52	3.20	3.15	3.00	2.75	2.60	2.45
30-Year Government Bond	3.37	3.10	3.10	3.00	2.90	2.75	2.55
Canada - US T-Bill Spread	0.16	0.00	-0.33	-0.25	-0.10	-0.05	0.10
Canada - US 10-Year Bond Spread	0.15	0.00	0.10	0.05	-0.05	-0.05	0.15
Canada Yield Curve (10-year — 2-year)	0.21	-0.05	0.05	0.05	-0.10	-0.20	-0.25

Table 4: US Interest rates (end of period)

Variable	2022 15-Jun	2022 Sep	2022 Dec	2023 Mar	2023 Jun	2023 Sep	2023 Dec
Federal funds rate	1.625	2.875	3.125	3.125	3.125	3.125	3.125
91-Day Treasury Bills	1.73	2.80	3.13	3.00	2.80	2.70	2.50
2-Year Government Note	3.21	3.30	3.15	3.00	2.85	2.75	2.55
10-Year Government Note	3.37	3.20	3.05	2.95	2.80	2.65	2.30
30-Year Government Bond	3.40	3.25	3.20	3.10	3.00	2.80	2.60
US Yield curve (10-year — 2-year)	0.16	-0.10	-0.10	-0.05	-0.05	-0.10	-0.25

Table 5: Foreign exchange rates

Exchange rate	2022 15-Jun	2022 Sep	2022 Dec	2023 Mar	2023 Jun	2023 Sep	2023 Dec
CAD-USD	0.77	0.78	0.79	0.78	0.78	0.78	0.78
USD-CAD	1.29	1.28	1.27	1.28	1.29	1.29	1.29
USD-JPY	134	135	130	128	125	122	120
EUR-USD	1.04	1.07	1.08	1.10	1.11	1.12	1.14
GBP-USD	1.22	1.22	1.23	1.26	1.28	1.30	1.33
AUD-USD	0.70	0.75	0.77	0.79	0.80	0.81	0.81
USD-BRL	5.05	5.70	5.70	5.90	5.70	5.50	5.30
USD-MXN	20.4	21.5	21.5	21.0	21.5	21.3	21.5

Contacts:

Avery Shenfeld
416 594-7356
avery.shenfeld@cibc.com

Benjamin Tal
416 956-3698
benjamin.tal@cibc.com

Andrew Grantham
416 956-3219
andrew.grantham@cibc.com

Karyne Charbonneau
613 552-1341
karyne.charbonneau@cibc.com

Katherine Judge
416 956-6527
katherine.judge@cibc.com

FICC Strategy
Ian Pollick
416 594-7057
ian.pollick@cibc.com

CIBC Capital Markets
PO Box 500
161 Bay Street, Brookfield Place
Toronto, Canada, M5J 2S8
Bloomberg @ CIBC

economics.cibccm.com