As economies around the world start to turn the corner and head down the straight towards pre-crisis norms, there is still a missing piece in the puzzle – inflation.

The Phillips curve is a model, used by central banks, that describes the inverse relationship between the unemployment rate and consumer inflation – the simple rule being the lower the unemployment rate, the greater the inflation (as wages increase). This economic theory, however, has been brought into question by the current prolonged low inflation alongside very low levels of unemployment – the most curious thing markets and central banks have seen of late.

The Federal Reserve (Fed), Bank of England (BoE) and European Central Bank (ECB) have set up networks of experts to study the causes of the less-than-perfect relationship between growth and inflation and to research the implications for policy; so far they have identified a mixture of short- and long-term factors. Commodity prices and exchange rates play havoc with short-term inflation, but over time these tend to balance out. The greater concern is what could be causing the longer-term depression of inflation and hence the broken Phillips curve conundrum. The most widely agreed upon reason for this discord is globalisation, though nothing happens in a vacuum in the real world and there are multiple other factors that have come into play which we will discuss in this article.

At levels of almost-full employment we should be seeing inflation coming through, but it has been noticeably missing in action.

Will central banks wait to see proof of inflation before they continue to tighten monetary policy and attempt to unwind QE, or is the Phillips curve no longer appropriate?

Globalisation and the changing dynamics of the labour force have altered the way in which inflation responds and may indeed result in central banks needing to reconsider their approach to monetary policy going forward.
Globalisation: not the only force at work

Globalisation is a key structural dynamic which is keeping inflation low in developed economies. Research has shown that “as GVCs (global value chains) expand, direct and indirect competition among economies increases, making domestic inflation more sensitive to the global output gap. This can affect the trade-offs that central banks face when managing inflation”.¹

The Phillips curve was created when economies were more domestically focused and the low levels of unemployment naturally led to higher wages and price inflation. However, as globalisation has become ever more prominent, wages are kept lower by competition from the global labour market. This has been highlighted by the Fed and BoE in recent speeches and suggests economies have moved towards a global Phillips curve, having outgrown national ones. Why then are we so intent on getting back to pre-crisis levels of rates and inflation when markets were different?

Companies have certainly moved manufacturing to countries where labour is cheaper in order to maximise profits. Meanwhile, cheap imports aided by the removal of tariffs from countries such as China are flooding developed markets, reducing the price of goods. These economies of scale are pushing prices down and so inflation is being kept lower than if everything had continued to be produced domestically.

The ease of buying cheaper goods has been enhanced by the rise in ecommerce, which cuts out the middleman, allows the consumer to shop around for better bargains and forces competitors to keep prices low. However, although online sales are growing quickly, this still only makes up a small fraction of total retail spending – so perhaps there is more disruption still to come?

Nevertheless, the argument to counter globalisation as the main reason for low inflation is that we should still see an increase in the price of services (which are typically domestic) despite the declining price of goods, but this has not come through – a clear indication that there must be other forces at work.

The transformative nature of technology

The sharing economy is one such change that has been deflationary and is not captured by traditional inflation measures. Today’s consumer loves a bargain and companies such as Uber and Airbnb are prime examples of how goods and services are being consumed in new ways. To put it simply: why would you buy a product when you could lease it or indeed share it with someone else for a fraction of the price? This change has kept prices lower as demand shifts. The rapid emergence and growth of sharing companies increases every day as improvements in technology enable new entrants to break into the market and disrupt the ‘traditional companies’ by making a number of things we believed impossible, possible. The central banks will simply have to find a way to keep up with these developments if they hope to truly understand the increasing amount of imperfect data that impacts inflation.

In fact, the development of new technology is adding to deflationary pressures across multiple industries. We are seeing the rapid integration of advanced technology in manufacturing processes, the rise of digital, and the development of innovative solutions and products. All of this improves efficiency and productivity and, while a significant fall in the price of goods will likely only be seen in certain industries, there is more widespread downward pressure on wages as the traditional workforce is disrupted and displaced.

Changes in employment and labour unions

The change in the way people view work has been called ‘casualisation’; a shift to less structured and more task-oriented jobs. There are an increasing number of people working part time or job-sharing – part of the evolving ‘sharing economy’. It has been suggested that “this impacts the quality of work in the economy even as the quantity reaches levels not seen for many decades”\(^1\). As such, this goes a long way to explaining why the levels of unemployment are not reflecting the true state of employment and therefore delaying the rise in wages. For example, in the UK approximately 43% of the workforce is self-employed, part time, or on temporary or zero-hours contracts and it is these workers that drive wage pressure for workers more broadly, along with unions.

An ageing population in the developed world has accounted for a drop in the unemployment rate and indeed the very definition of unemployment has its flaws, which could explain the prolonged lag in wage inflation pick-up. We saw three decades of positive shocks to the labour force (baby boomers in the 60s, emergence of the Soviet Union in the 70s and increase in workers in China in the 80s) which has been compounded by the reduction of labour unions over the past few decades putting downward pressure on wage inflation. Labour unions give individual workers the ability to demand higher wages as the voice of many. With less people becoming members of unions across the US, UK and Europe, wages have been allowed to dwindle near their lows, contributing to the lack of wage inflation. This impotence of the worker to increase wages is heightened by globalisation reducing labour pricing power on a country level due to competition and the threat that businesses will relocate to somewhere cheaper.

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The unemployment rate excludes those who have chosen not to work and includes those working part time for minimal hours, so very low levels of unemployment will not directly translate into wage growth. If indeed some of those choosing not to be in the labour force re-join, then there would be an additional increase in downward pressure on wage growth – a potential risk to the assumption that wage growth is coming.

Furthermore, as the BoE pointed out, wage puzzles in advanced economies can be partly solved by recognising that post-crisis structural reforms have lowered natural rates of unemployment by broadening measures of labour market slack to include involuntary underemployment, and by acknowledging that weak wages are one consequence of sustained poor productivity growth. Maybe we need to be more patient with inflation?

Politics plays its part

Inflation in the US has been hit by dollar appreciation following President Trump’s election and the disappointment of Trump’s policies not coming through as easily as promised. This has been further compounded as commodity prices, driven down by Chinese economic policy, have added to the pressure on inflation. In order for us to see a turnaround in inflation, Trump would need to deliver on his promises in the form of significant fiscal stimulus, which is looking increasingly less likely with the repeal of Obamacare delaying tax reform. As we eagerly await the politicians coming to an agreement, we will continue to watch inflation slipping further from the 2% target and hope for the elusive wage inflation to appear. Every time inflation undershoots that 2% target, the credibility of the Fed’s Federal Open Market Committee is undermined, something which Janet Yellen has stated could “cause inflation expectations to drift and actual inflation and economic activity to become more volatile”.

With Brexit on the horizon, it is important to understand how globalisation has impacted inflation so as to try to prepare for the UK’s ‘de-globalisation’. This is something that was considered in a recent speech by Mark Carney who posed the question: “If globalisation is disinflationary, won’t Brexit be inflationary?”

The key points in support of Brexit being inflationary include tariffs, reduction in global labour supply and disruptions to in-bound value chains from Europe, which would all steepen the Phillips curve. However, in the short term, Brexit will naturally be disinflationary given 44% of UK exports currently go to the EU and there is likely to be a ‘Brexit break’ while trade agreements are worked out and global supply chains finalised. Nevertheless, post-Brexit: “The inflation outlook will balance the inflationary effects of the exchange rate, imported inflation due to higher tariffs and a steeper Phillips curve from supply chain and labour market impacts, with the disinflationary impacts of reduced EU demand of UK goods and services, adverse effects on spending, including business investment, from the anticipation of lower growth, and any effects of uncertainty on domestic demand.”

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“If globalisation is disinflationary, won’t Brexit be inflationary?”

Conclusion

Overall, whether prolonged low inflation is caused by globalisation, technology, a reduction in labour unions, or a need to change how unemployment is measured, does not really matter. The key concern is that prolonged low levels of inflation that miss targets could mean that any negative shock would require central banks to make further stimulus when rates are already near the zero lower bound.

In a world of uncertainty, active management is arguably the best way to navigate these uncertain markets when we can clearly see that traditional models are failing to grasp what is going on in the economy. Our global perspective advantage enables us to identify and capture economic and market inefficiencies and navigate these for our clients.