

INFLATION & WAGE PRICE SPIRAL

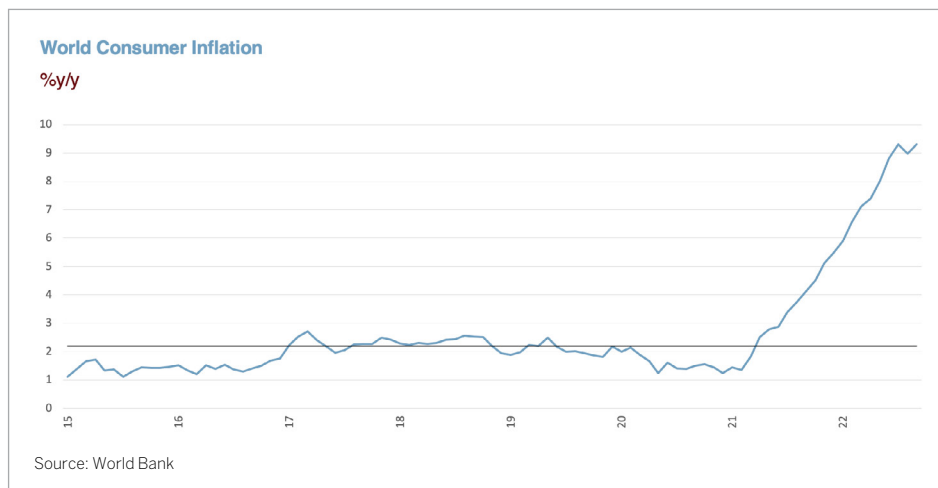


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14 October 2022

Higher wages risk prolonging the fight against the inflation

Over the past 18 months, the cost of living has surged globally, with world inflation rising sharply from an average of less than 2% in 2020 to over 9% currently. This increase in inflation is evident within both developed as well as emerging markets, and in some countries, inflation is the highest it has been in four decades.

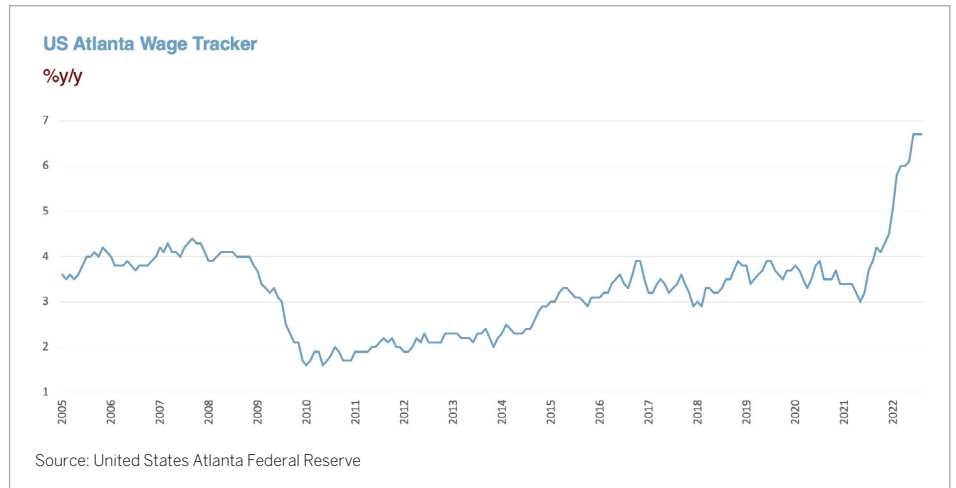


As economies recovered from the initial impact of the COVID-19 pandemic, prices were pushed higher by expansive fiscal and monetary support, a surge in pent-up consumer demand, changes in consumer preferences for goods over services, pandemic related supply chain disruptions and rapidly rising commodity prices. All of which was exacerbated by the Russian invasion of Ukraine that resulted in sharply higher fuel and food prices.

Initially inflation expectations stayed anchored, however, more recently expectations of future inflation have ratcheted higher as price pressure broadened into a much wider range of consumer goods and services and as an increasing number of countries experienced a similar surge in prices. This is especially noticeable in the United States, where sharply rising housing prices and prolonged input supply shortages have kept inflation elevated for longer. Elsewhere, currency weakness against a stronger Dollar has exacerbated the upward pressure on prices.

Critically, as economies recovered from COVID a resurgence in demand for labour, that quickly outstripped supply, started to add an important layer of complexity to the inflation problem. This was partly because the lack of labour supply was due to a range of unique factors including changes in work-life balance, a hesitancy to return to work because of ongoing health concerns, difficulties in finding child and family care, and issues relating to social distancing and lockdown restrictions. Understandably, this demand-supply imbalance resulted in tighter labour markets, placing upward pressure on wages.

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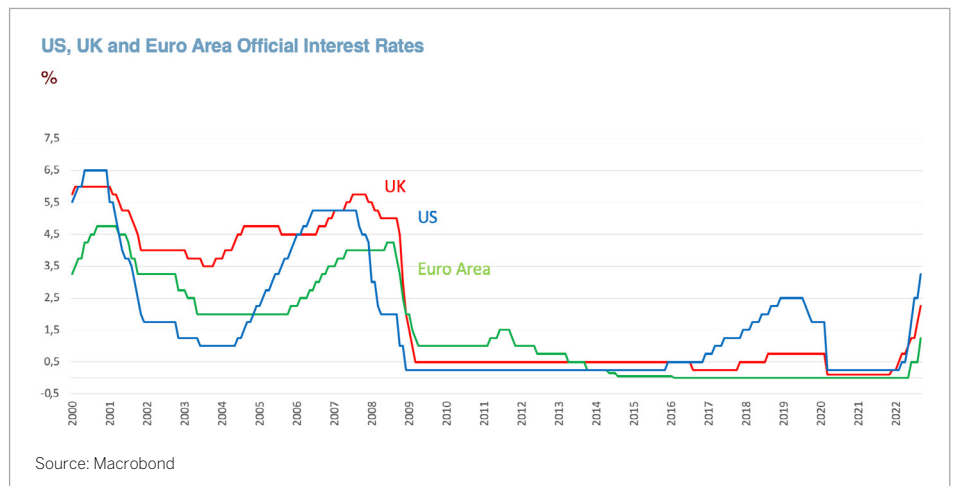


Unsurprisingly, the International Monetary Fund (IMF), in their latest World Economic Outlook that was released on 11 October 2022, warned that sustained higher inflation may feed into wages, leading to a wage price spiral, which could prolong the fight against inflation.

Effectively, rising inflation expectations and tighter labour markets push workers to persistently demand wage increases to either catch-up to, or exceed the recent rise in inflation. Typically, this wage-price spiral occurs over several quarters where both wages and price inflation rise simultaneously.

Furthermore, the empirical evidence presented by the IMF indicates that the risk of a wage price spiral depends on how businesses and workers formulate their expectations for inflation. The IMF's analysis suggests that the anchoring of inflation expectations is critical to obtaining or maintaining a low inflation rate. That is why many countries make use of an inflation target to both guide monetary policy, as well as anchor inflation expectations. In other words, the strategy of the central bank is to reiterate their commitment to an inflation target, using every opportunity, including press conferences and statements, to repeatedly explain that they are adamant in achieving the inflation target on a sustainable basis.

The IMF warns that given current circumstances policy makers have a narrow path to manage inflation and that anchoring inflation expectations will require a stronger monetary policy response than is already evident.

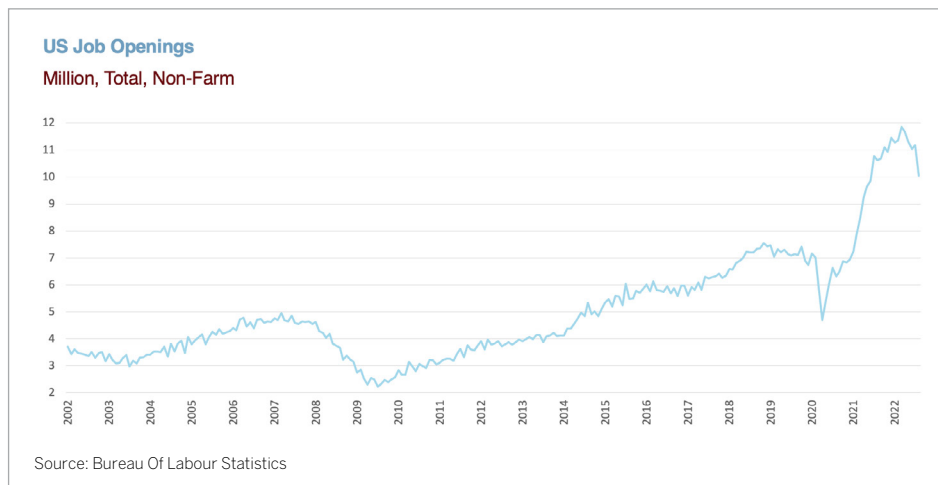


The net result is that central banks will need to remain aggressive in hiking interest rates even if this pushes economies into recession. Unsurprisingly, the chances of an outright recession occurring in the United States during 2023, or even the world economy in aggregate, have risen appreciably. Furthermore, the abrupt change in monetary policy, coupled with a general tightening of financial market conditions have not only amplified global growth risks but have also contributed to mounting stresses in financial markets.

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More positively, a clear indication that interest rates are helping to control inflation will provide significant relief to financial markets – especially if there is an orderly slowdown in economic activity that helps to control wage demands in the major economies, most especially the United States. Stated differently, a durable rally in financial markets is unlikely until the major central banks can demonstrate that inflation is under control and that interest rates have peaked.



Consequently, the task for central banks is to find the appropriate amount of monetary policy tightening that helps to both dampen wage demand and anchor inflation expectations, but at the same time avoids pushing the major economies into a severe and self-reinforcing recession. This is not an easy job, but the era of 'easy money' and record low interest rates could not continue indefinitely.

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