The economic ‘miracle’ taking shape as the scourge of inflation vanishes

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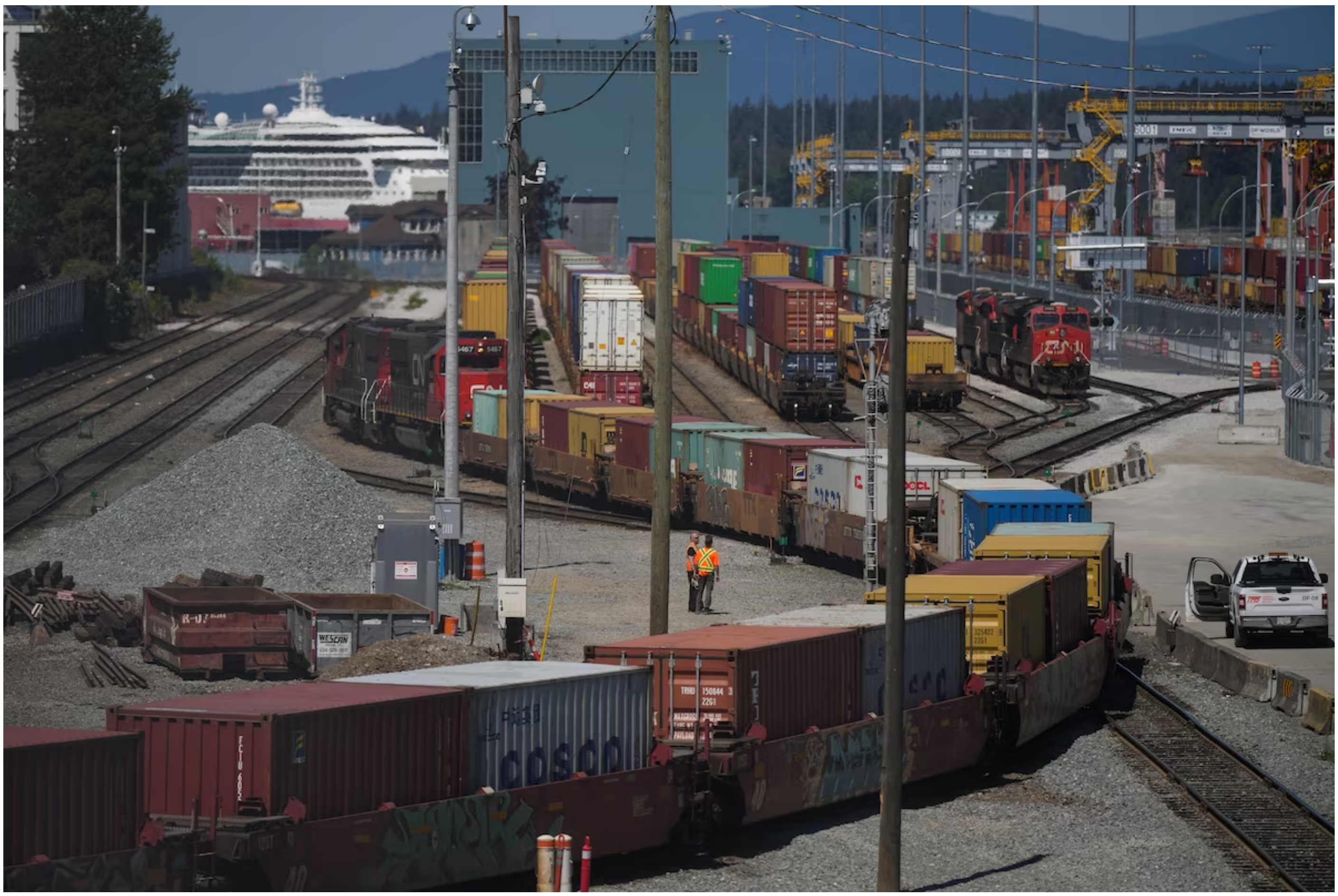


A CN Rail train moves cargo containers at the Centerm Container Terminal at port in Vancouver, on July 14.

DARRYL DYCK/THE CANADIAN PRESS

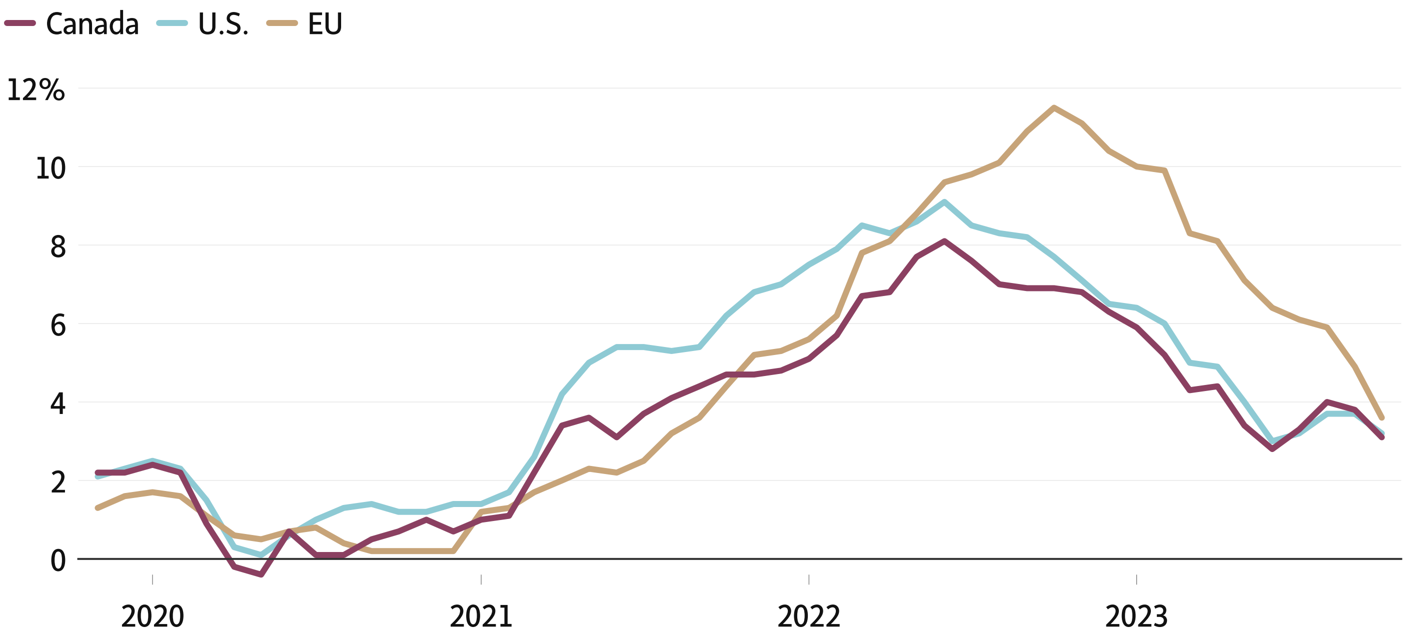
Economists who thought the age of miracles was past are bearing witness to something extraordinary.

The scourge of inflation is vanishing from advanced economies around the world, and with little of the economic carnage that was said to be necessary to restoring price stability.

In Canada, Europe and the United States, inflation has plunged from peaks of 8 to 10 per cent, down to 3 per cent – not terribly far off the targets of major central banks.

The global wave of inflation fades

Total consumer price inflation, percentage change year over year



THE GLOBE AND MAIL, SOURCE: OECD

The usual caveats apply. Some pockets of inflation are still too hot, such as services. And wages are rising too fast for the liking of some economists. There are also growing weaknesses in the Canadian and European economies keeping the threat of recession alive.

But other readings point to surprising resilience. Unemployment is not far off record lows. The Canadian economy has created 430,000 net new jobs so far this year.

The U.S. economy, meanwhile, is bustling along close to full employment, with gross domestic product growing at an annualized pace of 5.2 per cent last quarter. Not exactly the hallmarks of a recession.

Behold the immaculate disinflation. At least, that’s what some people are calling it.

Vanquishing runaway inflation without triggering a full-blown recession is a rare, if not unprecedented, feat. Certainly no advanced economy in the postwar era has pulled it off.

“It might seem like a miracle, but it has real-world origins,” said Royce Mendes, the head of macro strategy at Desjardins Securities.

The global economy is still being reshaped and distorted by the aftershocks of two opposing tectonic forces – the COVID-19 pandemic that brought the world economy to a standstill on one hand, and the shock-and-awe stimulus thrown at the crisis on the other.

A closer look at those forces can help us understand why inflation came on so ferociously, and why it has made such a hasty retreat.

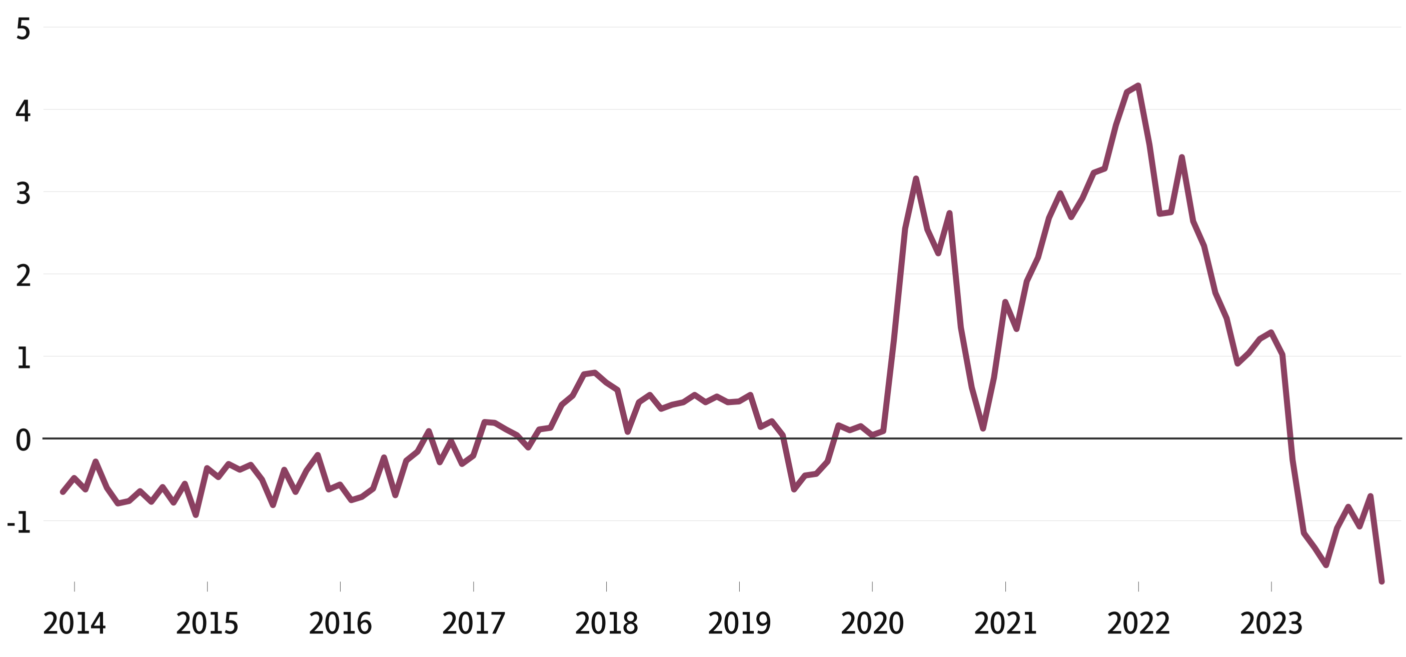
The unsnarling of the supply chain

Here’s a great recipe for inflation: Confine billions of people to their homes and stuff their bank accounts with cash. This creates booming demand for goods at the precise moment the world’s supply chain is incapable of keeping up.

In 2021, the global supply chain broke down. A system largely built on just-in-time manufacturing and inventory management proved vulnerable to the profound disruptions of the pandemic.

Supply chain crisis is in the past

Global Supply Chain Pressure Index, standard deviations from average



THE GLOBE AND MAIL, SOURCE: FEDERAL RESERVE BANK OF NEW YORK

Stockpiles of economically critical commodities vanished. Resource prices soared in the face of shortages of metals, energy and agricultural commodities – what Jeff Currie, the widely-followed head of commodities research at Goldman Sachs, called at the time a “molecule crisis.”

The flow of manufactured goods seized up. Container ships piled up at U.S. ports, waiting for days to offload. A shortage of computer chips hobbled the auto industry, leaving car dealership lots barren.

This enormous demand-supply imbalance was largely behind the swift escalation of prices worldwide in 2021 and 2022.

Want to know why inflation now seems to be melting away? Look again at the supply chain.

“The disinflationary story, at least so far, is largely an unwinding of these same dynamics,” the White House Council of Economic Advisers (CEA) wrote last week.

The great global backlog has largely cleared. In November, the New York Fed’s Global Supply Chain Pressure Index, which tracks things such as costs, backlogs and delivery times within the global transportation network, hit its lowest level on record, two years after soaring to unprecedented heights.

The CEA’s model shows that more than 70 per cent of excess U.S. core inflation from 2021 to 2022 can be chalked up to supply chain pressures. And the unsnarling of the supply chain can explain more than 80 per cent of the disinflation seen so far this year.

In Canada, the rise and fall of inflation has dominated the economic conversation for the past two years. There is intense attention on the Bank of Canada’s rate decisions and the local causes and effects of inflation. But this is largely a global phenomenon, beyond the control of the Bank of Canada.

“If the question is how has inflation come down this much, it’s mostly a supply story,” Mr. Mendes said. “On the other hand, how do we raise rates so sharply and not cause a recession? That’s more complicated.”

The recession that refuses to show

Under normal circumstances, a sudden shock of mass unemployment would be a bad thing for household finances. But in the bizarro world of pandemic-era economics, the opposite happened.

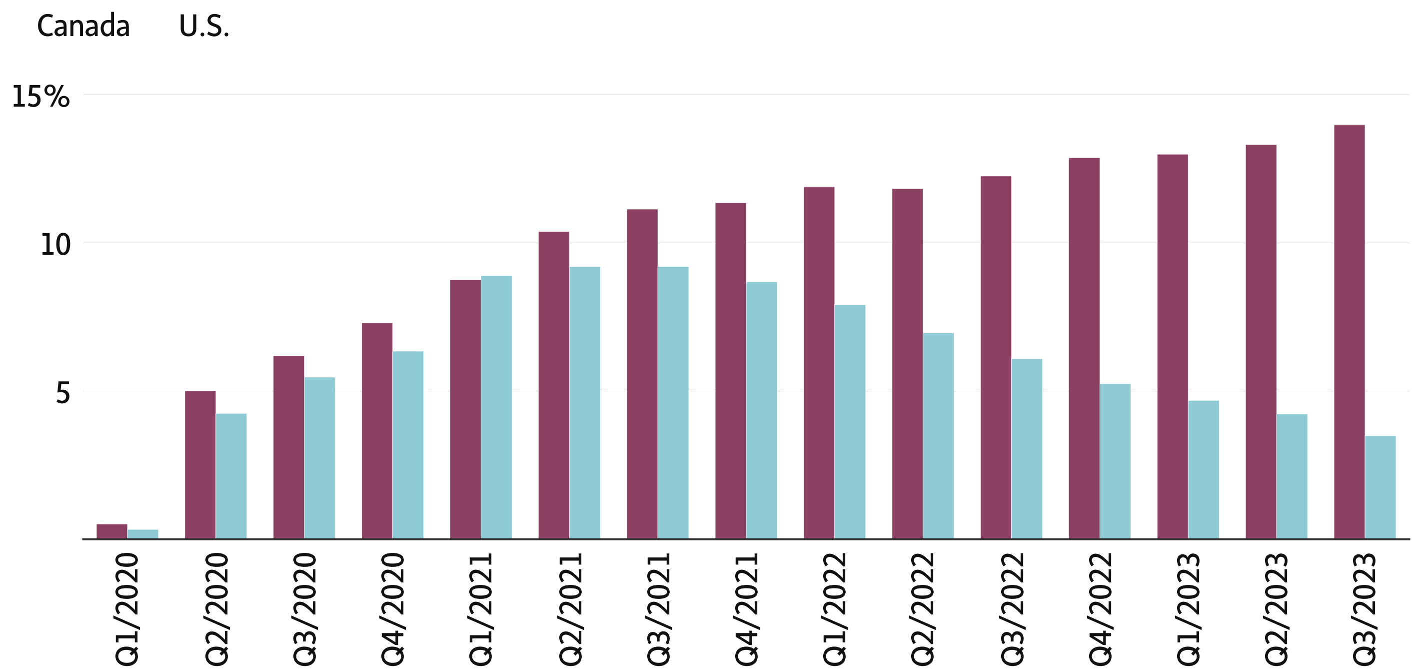
When the COVID-19 crisis struck in Canada, the unemployment rate rose from less than 6 per cent to 14 per cent within two months. Even that understates the extent of the carnage, as many people who lost their jobs were classified as having exited the labour force, rather than joining the official ranks of the unemployed.

Staring down the barrel of an economic depression, governments unleashed a torrent of emergency spending. Programs such as the Canada Emergency Response Benefit distributed about $110-billion in pandemic benefits directly to Canadian workers.

Personal finances in Canada, in aggregate, actually improved. In the second quarter of 2020, disposable income rose by nearly 45 per cent annualized – the strongest pace on record by a good margin, according to Jean-François Perrault, chief economist at Bank of Nova Scotia.

It was a similar story in the U.S., where households received US$1.8-trillion in pandemic stimulus. That money gave consumers the financial leeway to weather the pandemic recession, pay down debt and squirrel away an enormous stockpile of savings.

'Excess savings' as a percentage of annual GDP



THE GLOBE AND MAIL, SOURCE: RBC

Fast forward to the inflation crisis. Central banks quickly switched to a war footing, trying to quell inflation by cooling the economy. But by that point, households were fairly well insulated. "You can raise interest rates all you want, but people suddenly had all this cash to manage the rate shock," Mr. Perrault said.

Consumers have had the means to continue spending, staving off the recession that seemed all but inevitable a year ago. This effect can also help explain why the U.S. and Canadian economies have diverged so sharply this year.

For the past two years, U.S. consumers have been spending freely by drawing down their stockpile of savings. In the third quarter, per person spending in the U.S. was up by nearly 2 per cent, year over year.

"The U.S. has significantly outperformed Canada this year, with per capita consumer spending continuing to soar well above prepandemic levels," Carrie Freestone, an economist at Royal Bank of Canada, said in a note.

Canadians, on the other hand, have turned more frugal. Per capita spending as of the second quarter was down 1.4 per cent year over year – the largest decline since the global financial crisis, excluding the pandemic.

The average Canadian is also still socking money away well in excess of prepandemic levels. The stockpile of excess savings sits at about $376-billion, equivalent to 13 per cent of GDP, according to RBC.

Divergent spending and savings habits go a long way to explaining why the disinflation has been somewhat less "immaculate" in Canada than the U.S.

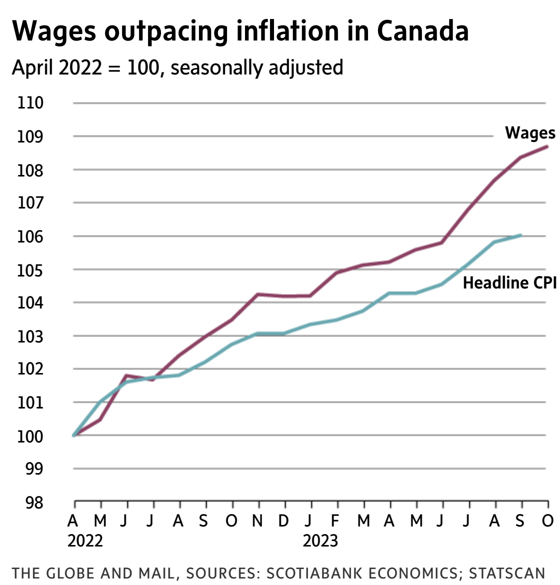
Revisiting transitory inflation

Policy makers and economists who insisted that inflation was transitory have been thoroughly denounced. By early 2022, that call looked like a disastrous miscalculation, as inflation spiralled out of control.

But they may have been right after all about the nature of the shock – that it was a temporary confluence of pent-up demand and supply constraints. They just underestimated the length of the distortion.

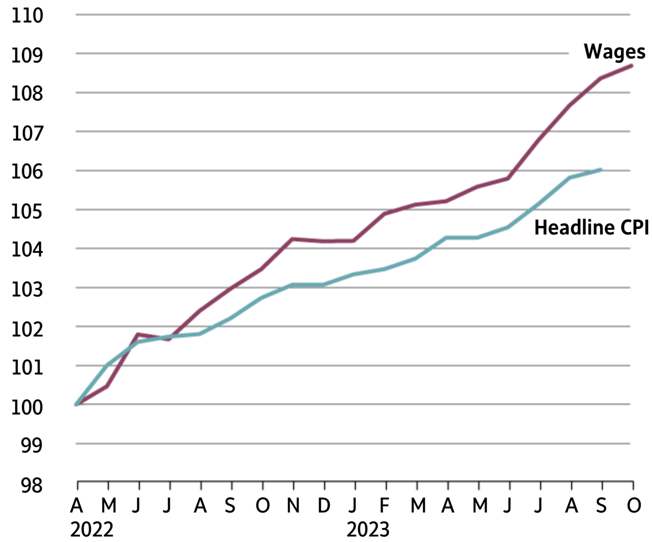
"Those who argued that the inflation spike would prove to be transitory can plant a belated victory flag, at least in terms of goods inflation," wrote Avery Shenfeld, chief economist at Canadian Imperial Bank of Commerce.

Even so, central bankers lost a lot of credibility in the process. "They gave Canadians and Americans the false sense that inflation would come down," Mr. Perrault said. "When it didn't, people didn't know what to believe anymore."



Wages outpacing inflation in Canada

April 2022 = 100, seasonally adjusted



THE GLOBE AND MAIL, SOURCES: SCOTIABANK ECONOMICS; STATSCAN

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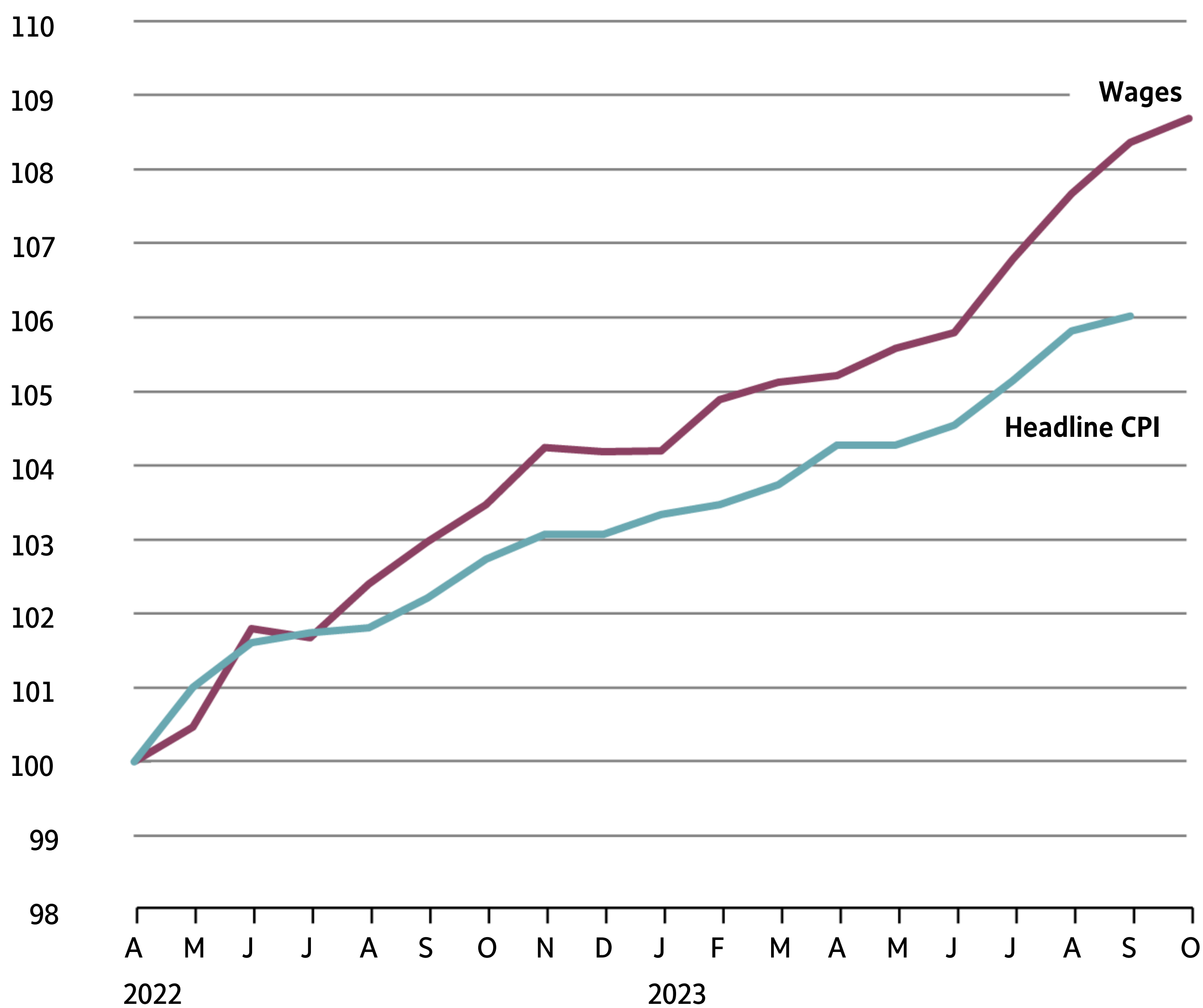

THE GLOBE AND MAIL, SOURCES: SCOTIABANK ECONOMICS; STATSCAN

Credibility is everything in central banking. Without it, long-term inflation expectations may become seriously unanchored from the target for price growth. This is precisely what happened in the 1970s and 1980s. Workers came to expect sky-high inflation, so they acted accordingly, demanding higher wages. Businesses responded by hiking prices, fuelling more inflation in a negative feedback loop known as the wage-price spiral.

That hasn't happened this time around, as inflation expectations haven't risen to dramatically. But Canadian wages are outpacing inflation, lately tracking at about 5 per cent growth, year over year. That's good news for workers, but it presents another challenge in wrestling inflation back down to 2 per cent. And the Bank of Canada needs Canadian workers to believe that it can fully restore price stability.

That's why Bank of Canada Governor Tiff Macklem is still talking tough, floating the possibility of further interest rate hikes, if needed. That rhetoric may seem out of sync with the current economic and financial reality. Growth has stalled, inflation is fading and the money market is pricing in Canadian rate cuts starting in March.

Fooled once by inflation, the Bank of Canada is in no mood to make the same mistake again. "That makes them super data dependent," Mr. Perrault said. "And it makes them slow to react to things."

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