What Does "Good" vs. "Bad" Inflation Really Mean?

Insight from sub-adviser Wellington Investment Management

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THE GLOBAL MACRO DISCOURSE HAS SHIFTED OVER THE PAST FEW MONTHS TO A DEBATE AROUND "GOOD" VS. "BAD" INFLATION. I think there is a better way to frame it. In my view, as we look ahead, the question should be: Will we see a continuation of the status quo or are we on the verge of a regime change? I think there is a high chance it will be the latter.

Over the past 20 years, there have been a number of instances when inflation has jumped higher. Often this has been due to higher energy costs, occasionally a response to strong demand, and sometimes tax changes. Each time, the jump has proved short-lived, but has acted as a tax on consumers, eroding the purchasing power of households by squeezing real wages. In response, consumer spending has slowed, and the economy has cooled. In effect, these temporary bouts of inflation acted as an automatic stabilizer on the economy. Was that bad inflation? For households, yes—but not for the system. The system had an anchor.

That anchor for the system came from two sources. First, structural changes to the labor market had weakened the bargaining power of workers in a variety of ways, be it through increased global competition, potential substitutes on domestic markets, or less generous safety nets. The second source was central banks. The real economy understood that if inflation increased, any evidence of second-round effects—on wages—would result in interest-rate rises.

It is those anchors that I think are under threat.

There are now good reasons why the bargaining power of workers may have improved. If, coming out of this shock, participation rates are permanently lower, firms increasingly source labor locally, and households perceive safety nets as more generous, then there is a higher chance that wages respond to higher inflation and demand, despite high unemployment rates.

Added to that, there is a risk that central banks are no longer playing the role of anchor. They are prepared to gamble their inflation "credibility" to exaggerate any economic rebound. Sadly, long-term history is littered with episodes underlining the idea that once inflation credibility is lost, it is hard to regain. What we are learning is that the pandemic shock

Key Points

- Historically, periodic inflation jumps have tended to be short-lived, stablizing events for the economy.
- Two things could signal a change in the inflation regime: The pandemic may have fundmationally changed the labor market, and central banks may have lost some of their power to temper inflation.
- Inflation expectations are rising, hinting that markets are beginning to sense a broader change on the horizon.

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may have been a temporary hit to demand (though probably not to supply), but its effects aren't likely to prove temporary on policy. At a time when the market is discussing when the US Federal Reserve and other central banks might raise rates—perhaps at the end of 2022 or early 2023—the fact is that global central banks are still adding liquidity into the system, with another US$1.5 trillion of asset purchases due in the next six months.

Of course, I am aware in making the arguments above that I could be crying wolf. Breaking anchors can take time. Not least because, for many investors, having unwavering faith in central banks has been a winning trade for the entirety of their careers. And accelerated technology shifts could reduce household bargaining power further. If those anchors remain in place, the rise in inflation will prove temporary.

But I would argue that the probability we are on the verge of a regime change is high. I believe rising inflation expectations hint that markets are beginning to sense that, too. Pre-committed central banks risk losing the ability to get the market to do the work for them and this will mean when they act further down the line, they will need to do more. There is a danger that central banks are no longer seeking to create the conditions for economic stability but instead are actively trying to exaggerate cycles. I believe this will bring higher volatility, higher medium-term inflation, and steeper curves.

Wider Implications

I feel confident the next five to 10 years will look a lot different from the past 20. For markets, the past 20 years have been about following factor number one: global liquidity. All central banks responded to the same shock in the same way—more liquidity. Whatever the shock, the answer was always more liquidity. This forced a sustained disconnect between market pricing and economic growth. The liquidity element is likely to remain key for the next year at least. But the environment ahead feels much more complicated.

I believe we are likely to see much greater country differentiation, as the questions each country's policymakers will be trying to answer will differ. US politicians' motivations may be about reducing income inequality. In other countries, the motivation may be to reduce regional inequality (UK) and high debt burdens. But the political appetite for inflation is likely to be lower in countries where households/voters have high savings and aging populations.

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