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Will the World Economy Avoid an Inflationary Bust?

Today's high inflation is being compared to the 1970s. However, robust consumer spending, fueled by pandemic savings, makes for a different set of circumstances.

Insight from sub-adviser Schroders Investment Management

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As the price of Brent crude oil temporarily climbed above $139 a barrel in the wake of Russia's invasion of Ukraine, memories of the 1970s were frequently evoked. During those troubled years, skyrocketing oil prices and elevated rates of consumer inflation plunged some of the world's major economies into recession.

Using the definition of recessions from the National Bureau of Economic Research, there have been seven such downturns in the US since the 1970s.

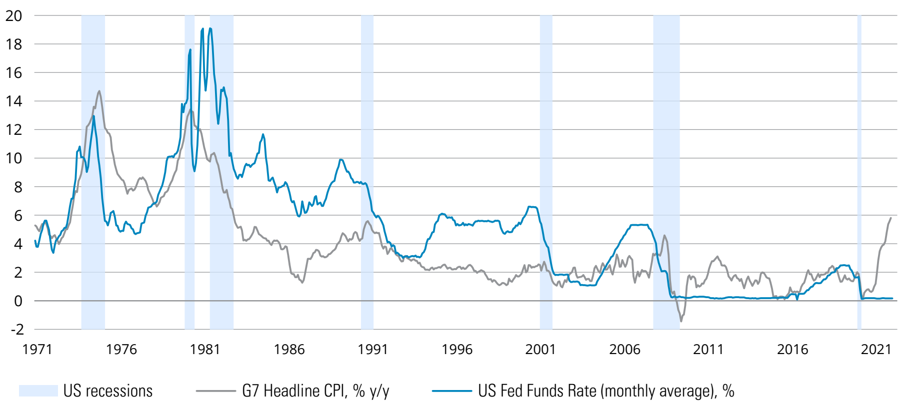
The first four were all preceded by a pick-up in inflation and interest rates (**FIGURE 1**). The decision by the US Federal Reserve (Fed) to raise interest rates amid signs of broadening US inflationary pressures—as they did in the 1970s—has brought further parallels with the past back into focus.

Key Points

- While today's market conditions are similar to those of the 1970s, economists are banking on consumer savings and the re-opening of the economy to stave off a recession.
- The broadening of inflationary pressures seen in some major economies is a concern, especially if they result in a wage-price spiral in which inflation expectations become a self-fulfilling prophecy.
- COVID-19 induced supply-chain disruptions had already set the global economy on a stagflationary course prior to Russia's invasions of Ukraine, but the war has amplified these trends.

FIGURE 1

Inflation, Interest Rates, and Recessions



Note: Recession periods shown are those as defined by the National Bureau of Economic Research. The Consumer Price Index (CPI) is a measure of change in consumer prices as determined by the US Bureau of Labor Statistics. The federal funds rate is the target interest rate set by the Federal Open Market Committee. This target is the rate at which commercial banks borrow and lend their excess reserves to each other overnight. Source: Refinitiv, Schroders Economics Group, 3/15/22.

Around $2 Trillion of Savings Each in US and Europe

Could this economic cycle play out like those from the 1970s, '80s, and '90s, when economic conditions seemingly resembled those seen over the past two decades? The economic cycle (aka the business cycle) is the period in which an economy moves from a state of expansion to one of contraction, before expanding again.

Certainly, pre-2000 recessions followed a familiar pattern: faced with high inflation, the Fed would either raise its base borrowing costs or hike the federal funds rate to cool economic activity. This time, however, economists are hoping for consumer spending to hold up.

Despite the tightening of monetary conditions, economists expect this consumer resilience to continue as people run down savings accumulated during the COVID-19 pandemic. In addition to raising interest rates, central banks are adjusting other monetary policies such as quantitative easing (QE).

Since the Global Financial Crisis, QE has been used to inject money directly into the financial system by way of asset purchases (mainly bonds) to support economic activity. These unconventional policies were again deployed in response to the pandemic fall-out.

Keith Wade, Schroders' chief economist, says: "Households still have considerable firepower, and the consumer is potentially the mainstay of economic growth in 2022. They have a cushion to absorb the impact of higher energy costs with excess savings built up during the pandemic, which we estimate at around $2 trillion in the US and a similar figure in Europe."

Russia's shocking invasion of Ukraine—and the consequent impact on energy and food prices already seen—has certainly added a new dimension to the inflation picture.

Schroders now expects a global consumer price inflation rate of 4.7% this year (up from 3.8%) as the impact of the war continues to reverberate around global markets. These forecasts for consumer inflation are based on year-over-year (y/y) movements in consumer-price indices.

Inflationary pressures, however, had already been building following the rapid global economic recovery as COVID-19 induced restrictions were gradually eased. The easing resulted in shortages of materials, energy, and transport, coupled with strong demand (especially for goods given restrictions around services sectors).

The pressure in global supply chains has resulted in sharply rising costs for producers of goods, who've in turn raised prices for consumers. Even before Russia's invasion of Ukraine, CPI inflation had been at its most elevated level for decades in the US, Europe, and the UK.

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Stagflation—the More Likely Outcome

Wade says: "We're optimistic on supply chains gradually returning to normal in 2022 and can see scope for a moderation in commodity prices should the situation in Ukraine stabilize."

As inflationary pressures ease, Wade expects global y/y CPI inflation to fall back sharply to 2.8% in 2023, up only marginally from 2.7% forecast before the Ukraine invasion.

That said, the broadening of inflationary pressures seen in some major economies, and notably the US, is a concern, especially if they result in a wage-price spiral in which inflation expectations become a self-fulfilling prophecy.

"Initially the rise in inflation in 2021 was led by the re-opening sectors such as airlines, hotels, and restaurants. More recently, however, we have seen a pick-up in the cyclical areas such as housing in the US where shelter prices have accelerated sharply," explains Wade.

"Overall, 80% of the US CPI basket components are now rising at over 4% y/y. Not only are one-off supply bottlenecks accelerating inflation, but cyclical prices are also reflecting excess demand.

"The broadening of inflation into the cyclical areas of the US economy is a concern as trends in this area can persist and could feed a wage-price spiral."

The fear of wage-price spirals is seen as a further justification for parallels with the inflation experience of the 1970s. This was a period when oil prices were very volatile (initially due to an embargo by oil-producing nations following the Yom Kippur War and, subsequently, as a result of the revolution in Iran) for an extended period and wages were rising in the West.

Stagflation, a combination of slowing growth and accelerating inflation, turned into outright contraction and recession for many of these economies as a result.

Risk of Recession Has Gone Up

COVID-19 induced supply-chain disruptions had already set the global economy on a stagflationary course prior to Russia's invasions of Ukraine, but the war has amplified these trends.

Alongside the increase to its inflation forecasts, Schroders has cut its expectation for global growth for 2022 (from 4.0% to 3.7%) and now sees risks of further growth slowing and inflation remaining higher for longer. Again, there remains a high level of uncertainty around these forecasts as the economic implications of the Ukraine invasion become clearer. Wage-price spirals, or an escalation of the Ukraine crisis are some of the key dangers in this regard.

Wade comments: "We have a risk scenario in which Russia continues to occupy Ukraine and turns its attention to its new neighbors, prompting tensions with Eastern Europe (Poland, Romania, Hungary, Slovakia) and the Baltic states. The rise in commodity prices drives inflation even higher, putting a major squeeze on consumers and business. Economic activity slows significantly. The result is an even more stagflationary outcome with global growth weaker and inflation higher this year and next."

There are also other risks. Recession in today's world, believes Wade, could result from a collapse in consumer spending due to other factors: "There are two main risks: The first is simply that bottlenecks prevent spending from taking place. Big-ticket items such as cars are in short supply and travel is still restricted in many regions, particularly Asia. This could create another air pocket for the economy where activity dips until supply can respond. The second is that people choose not to spend their savings after all."

For now, however, pandemic savings look to be a key difference in comparison to past economic cycles in which higher inflation and aggressive tightening in monetary policy triggered a consumer collapse and recession. Economists are expecting consumers to be a mainstay for the global economy as they run down savings and as the world continues to re-open.

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Talk to your financial professional about how you can better prepare for inflation.

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