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WEEKLY ECONOMIC COMMENTARY

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- **The Inflation Situation**

Global Economic Research
50 South La Salle Street
Chicago, Illinois 60603
northerntrust.com

Carl R. Tannenbaum
Chief Economist
312-557-8820
ct92@ntrs.com

Ryan James Boyle
Senior Economist
312-444-3843
rjb13@ntrs.com

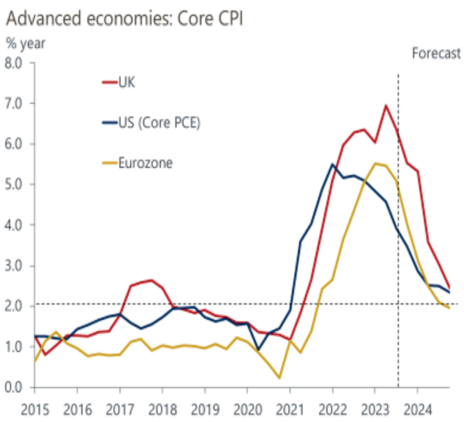
Vaibhav Tandon
Economist
630-276-2498
vt141@ntrs.com

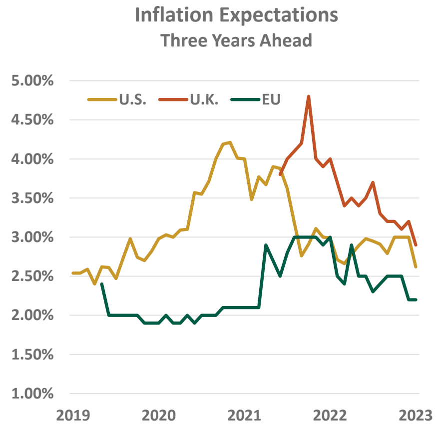
Editor's note: with major central banks meeting over the coming weeks and all eyes on interest rates, we offer some perspective on where inflation has been, and where it is going.

A few years ago, I went on a hike through the Wicklow mountains south of Dublin. The views were spectacular, especially of Guinness Lake; imported white sand at the foot of the water makes it look like a perfectly poured pint. We enjoyed one or two at the end of our trek.

We struggled on the ascent, but when we passed the peak, I assumed that the hard work was done. My hosts cautioned, however, that the trail can get bumpy on the way down. I was urged to watch my step and not relax until we had returned to ground level.

I was thinking of that adventure as I contemplated the trek we've experienced with inflation during the past three years. The price level took a steep climb, creating some rocky times for consumers. But the other side of the mountain has seemed surprisingly smooth. As leading central banks get back to business this month, they will have to watch their steps: there could still be some bumps on the path back to price stability.





Sources: Oxford Economics, Bloomberg

In some ways, the orderly decline of inflation has not come as a surprise. Price surges of 2021 and 2022 were largely due to supply shocks, which have eased. Global production and shipping chains have largely returned to pre-pandemic efficiency, creating deflation in the prices of many goods. We are monitoring the impact of Red Sea shipping disruptions, but they are unlikely to have a substantial impact on inflation.

Oil and gas prices received a shock from Russia's invasion of Ukraine in 2022. Shortages threatened Europe, but the development of alternate sources (along with the blessing of a mild 2023 winter) took the edge off. Energy costs in the major economic centers are generally lower than they were a year ago; oil prices have remained restrained in spite of the hostilities in the Middle East.

The final supply shock involved the global labor market. As we discussed in our piece examining the economic aftermath of COVID-19, the pandemic impaired some workers and prompted others to leave the labor market. Immigration was interrupted for an extended time, impacting those industries where newcomers find their first opportunities. Today, labor force participation and immigration are back to or above 2019 levels.

To certain degree, inflation has settled down by itself. The economist Paul Krugman has termed this the "long transitory" story; disruptions to the supply side of the global economy took a long time to cure, but eventually did so. In light of this, Krugman has suggested that monetary policy should not have been tightened as vigorously as it was, and that it should be eased promptly.

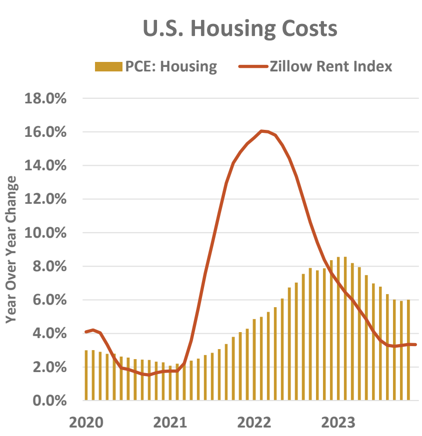
It is not clear how much monetary policy can be credited for taming inflation.

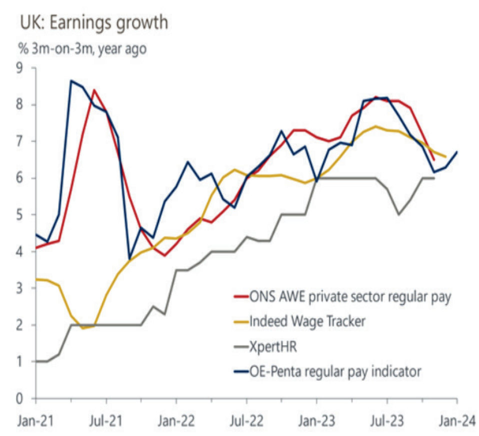
Defenders of central banks respond that interest rate hikes took the edge off the massive amounts of pandemic-era fiscal stimulus that was implemented in major markets. Further, the tone taken by monetary policy helped to keep inflation expectations well-anchored. Given the role of expectations in the evolution of actual inflation, this has been an important achievement.

We'll never know how inflation would have evolved in the absence of restrictive monetary policy. But central banks were not willing to take the chance of finding out. Their targets and their credibility were at stake. They seemed willing to risk a recession to preserve their reputations.

Fortunately, that price has yet to be paid. Economic growth in the United States has been robust; while results have been more mixed in Europe, a downturn has yet to set in. Amazingly, levels of unemployment have risen only slightly from their low points. To date, progress on prices has not come at the expense of jobs.

One reason for this is the long lags associated with monetary policy in this cycle. Households were the beneficiaries of substantial stimulus payments, which were used to reduce debt. Homeowners locked in low rates on their mortgages; corporations did the same with their bonds. With borrowing now increasing and debt rollover and repricing gathering steam, easier monetary policy would help reduce the weight of higher interest rates.





Sources: Oxford Economics, Haver Analytics, Zillow, ONS

Prospects of getting inflation all the way down to the target level of 2% in each center will hinge critically on the following factors:

- In the **United States**, shelter costs are something of a holdout in the rapid retreat of inflation. The biggest component of American inflation indices, housing costs have been held high by shortages of dwellings in many parts of the country. Inflation in this category has come down, but has been stuck near 6% for the past several months.

- In the **United Kingdom**, the wage/price spiral needs to be broken. Labor shortages and outsized increases in the costs of living empowered workers, many of whom took to striking to improve their lots. Wage growth in Britain has peaked, but it remains elevated. This will tend to keep pressure on prices, especially for services.
- In the **eurozone**, the demand side of the economy will be key. Economic growth in the euro area has been stagnant for much of the year; forecasters are expecting better things ahead, as consumer sentiment and real incomes improve. The pace of disinflation will depend on how quickly household spending ramps up.

These areas will bear close watching. Central bankers will want to ensure that progress on the price level is sustainable. But the risks to inflation are more balanced than they were a year ago.

Interest rate cuts should start in the second quarter.

Interest rates in the U.S., U.K. and the euro area are deeply restrictive. Given the lags involved with monetary policy, central banks will not wait for inflation to reach 2% before starting to ease. We think the European Central Bank will be the first to move in that direction, with the Fed and the Bank of England to follow by midyear. More details on these expectations can be found in our latest U.S. forecast and our latest global forecast.

My Irish trail guides proved prescient. The route down the other side of the mountain was filled with rocky outcroppings, threatening to sprain a poorly placed ankle. But with patience and good guidance, we reached our target safely. And that was cause for a toast.

Compensation

A key signal of inflation's remaining progress will be wage gains. Labor is a major cost for every employer; for firms in the knowledge economy, salaries represent the majority of costs. When input costs rise, firms must either absorb them through lower margins, or pass them on through higher prices. While most material input costs have settled after the pandemic surge, wages are still increasing at a rate that could add to inflation.

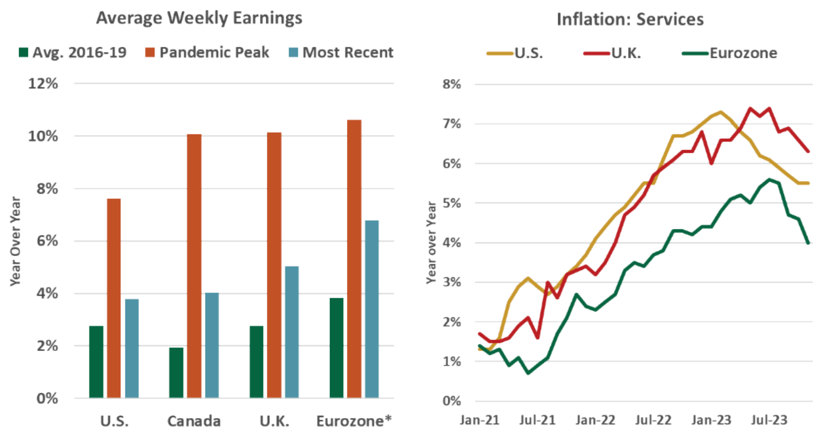
The pandemic gave new power to workers, and it has endured. As COVID spread, some employers used their traditional recessionary playbook and cut headcount; unemployment rates surged worldwide starting in spring 2020. But this was not a traditional recession. Demand in many sectors did not abate, and firms were quickly short-staffed. Workers were not readily available: many retired; some fell ill or stayed distanced to avoid severe COVID outcomes; others relocated or took time to attend to family obligations. Wages rose to attract and retain the limited supply of workers, and that trend has remained in place. In addition, unions have undertaken strikes to make up for the wage gains that their members did not receive due to longer-term labor agreements.

Wage gains sound great. Who doesn't want a raise? But ongoing gains carry the important risk of sparking a wage-price spiral, as we observed in the discussion of the U.K. above. When wages do not keep pace with inflation, consumers fall behind in real terms, but lower demand should help to keep price gains in check. The risk of a spiral remains as long as wage gains are elevated.

Wage growth is holding firm. U.S. average hourly earnings rose by a tenth to 4.1% year over year in December, arresting a five-month decline. Earnings trends in Canada and across Europe have also entered an uneven trajectory, not supporting a steady disinflationary trend.

The recent IMF World Economic Outlook observed that "Wage growth tends to rise with inflation expectations and fall with labor market slack." As mentioned above, inflation expectations have stayed fairly well anchored, adding to hopes that wage pressures will abate. But labor market slack is nowhere in sight, with unemployment rates holding low, layoffs staying muted, and job openings still relatively abundant.

Wage growth will keep pressure on the prices of many services.



*Sources: BLS, StatCan, ONS, Eurostat, Haver Analytics, Bloomberg; *=Quarterly aggregate wages*

Salaried workers in the U.S. are learning of their annual increases now, and spring wage negotiations in Europe may cause another uptick in labor costs. The raises will be welcomed, but not if they raise the risk of more inflation.

Indigestion

Rapid increases in commodity costs, particularly food and energy, have been among the main drivers of global inflation since 2021. Disruptions caused by the pandemic, the war in Ukraine, export bans and extreme weather events have shocked the supply chains that feed the world. Moscow's blockade of Ukraine's Black Sea ports had a profound impact, cutting off one of the world's largest grain exporters at a time when demand was starting to recover. Surging transportation costs on the back of disruptions at ports and the energy shock all added to the expense of getting groceries onto shelves.

Closer international linkages in the global food system over the past two decades resulted in a stronger pass-through of global developments to local markets. These developments added 5 and 6 percentage points to global food inflation in 2021 and 2022, respectively, pushing increases in the costs of living to multi-decade highs.

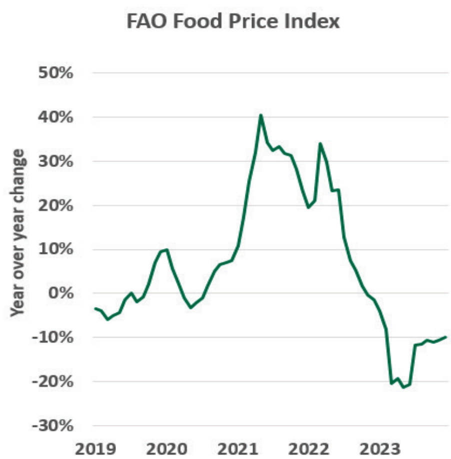
But as has been the case with energy markets, the supply and prices of groceries have calmed in the past 12 months. Last year, global food costs posted the biggest annual drop since 2015. After peaking in March 2022, global agricultural food commodity prices have declined by 26% as of December 2023.

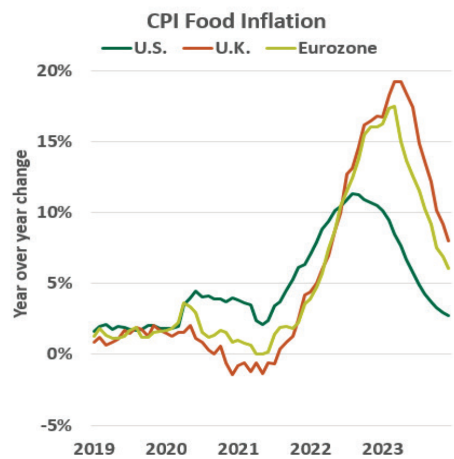
Food costs are heavily influenced by the prices of cultivated crops. As economies emerged from COVID lockdowns, growers were able to ramp up output of agricultural commodities. A deal allowing grains to be exported out of Ukraine along with a bumper crop in Russia last year were helpful in bringing agricultural prices down. Wheat prices dropped to a near three-year low in late 2023. Moderating transport and storage costs have also eased the pressure on food supply chains.

Lower import or wholesale prices of groceries have been feeding through to supermarket shelves. Food inflation in high-income nations, like the U.S. and Europe, has more than halved from the peak of 16.2% year over year in November 2022 to below 6.5% at the end of last year.

Though falling, food inflation remains elevated in many parts of the world, especially Europe. Some inflationary pressures in the price base of food producers and retailers are still present. Adverse weather conditions (like El Niño) are impacting the harvest of key consumables such as sugar. Wages gains and energy costs are moderating, but they are still above pre-COVID and pre-war levels in Europe. Wages, on average, account for a little over 10% of the costs of food manufacturing in the continent. This explains why grocery inflation is higher in Europe than America, where it is returning to more normal rates.

Food prices have the power to influence inflation expectations and, in turn, monetary policy decisions.





Sources: FAO, Haver Analytics

Global price shocks only partially translated into higher domestic prices of essentials in the U.S., owing to its relatively low share of imported agricultural food commodities. While the strong domestic supply insulated American households from the worst effects of external shocks, higher demand for U.S. food exports still pushed up prices meaningfully.

Generally, central banks do not react to price swings in commodities like food. Commodity prices are volatile and beyond the influence of monetary policy. But for consumers, food prices are a tangible and immediate experience of inflation. A sustained period of higher costs can affect expectations of future inflation, leading to a self-fulfilling inflationary spiral. The sharp cooling in food prices not only offers a welcome reprieve to households, but to central bankers as well.

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@NT_CTannenbaum