CUSTOMER TREASURY SERVICES

Economist's Weekly Market View

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Will low global inflation last?

A belief that inflation will stay subdued despite the pick-up in global growth, is driving market expectations that interest rates will remain very low for the rest of this decade. This is a key call for financial markets as low interest rates are underpinning elevated stock markets, low bond yields and tight credit spreads.

Past history would suggest that inflation should rise as GDP growth strengthens, with most notably, a pick-up in wage inflation as unemployment falls to low levels. This has not happened in this cycle. Core inflation rates remain below 2% in most countries. Meanwhile, the decline in unemployment rates to circa 4% or below, in countries such as the US, Germany, UK and Japan is not being accompanied by any appreciable acceleration in wage inflation.

Numerous reasons have been advanced to explain this unusual phenomenon. The OECD notes that increased domestic and international competition as well as technological advances are holding down goods prices and also impacting the prices of some services.

The OECD also notes that the long period of low inflation may have weakened inflationary expectations, possibly resulting in a convergence of price setting behaviour around a low level of inflation, including wage inflation.

Others argue that the most important factor explaining low inflation are changes in the labour market that have seen the bargaining power of employers rise and that of workers decrease. A falling rate of unionisation is one symptom of this, as well as the availability of a greater pool of labour because of increased migration, most notably in Europe.

Another factor is shifts towards part-time work and short-term contracts, with more freelance work (the so-called gig economy), and a move away from permanent jobs with long-term career paths and built in wage increases.

One of the most dangerous assumptions in economics is the belief that "this time it's different" and that past behaviours will not re-emerge. The US Federal Reserve has concerns that low inflation may be due to temporary factors. It believes that inflation could eventually pick up as labour markets become increasingly tight and the scarring effects on confidence of the last, very deep recession, which saw large scale job losses, subsides.

The Irish Central Bank published research recently examining continuing subdued wage inflation in Ireland despite strong jobs growth and a sharp fall in unemployment. It too warns that some of the weakness in wage inflation may be due to temporary factors, as well as to how labour slack is measured.

It also suggests that there is a "non-linear relationship" between wage growth and unemployment, whereby the degree sensitivity of wages is higher during periods of low unemployment, which we have not quite reached yet in Ireland.

The Phillips curve, a well-known economic theory, prescribes that inflation will rise when unemployment falls to low levels. Previous cycles saw an acceleration in wage growth and inflation in many economies when the unemployment rate fell to around 5%. It may be that because of the numerous factors mentioned above, inflation will not pick-up in this cycle until unemployment falls to a much lower level.

In truth, we won't know the answer until the global economy has come through this cycle in full. Growth has also been quite moderate in this upturn. A strengthening in activity in economies where unemployment has already fallen to low levels would really test whether the shift to low inflation is permanent or not.

The US and UK economies will bear close watching in this regard in the next couple of years, especially if there are tighter migration controls and growing trade protectionism.

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