ECONOMIC VIEWPOINT

What to Make of Current Inflationary Pressures?

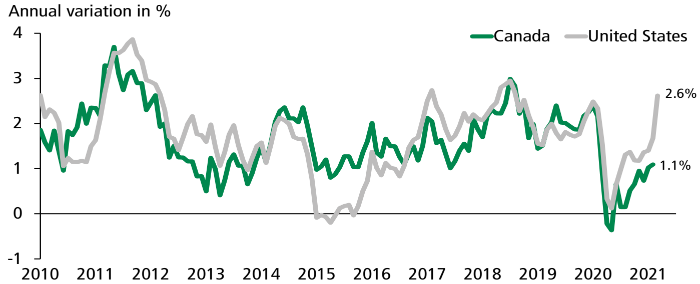
Due to the way inflation metrics are calculated, consumer price index (CPI) in Canada and the United States is set to increase drastically in the following months on the back of base effects. Beyond base effects, there are signs of price pressures that could potentially find their way through to consumers. We take stock of the current price situation in both goods and services—looking beyond consumer prices—and assess what could be the potential drivers of sustainably high inflation. This assessment leads us to believe that the days of inflation risks being mostly skewed to the downside are probably over. There is a lot to celebrate in this, particularly if it means less distortive monetary policies, but we also have to hope that policy is not overdoing it and ends up skewing inflation risks to the upside on a persistent basis.

The fact that inflation is about to increase drastically in the following months is now widely accepted; base effects alone are enough to cause an upward shift in year-over-year inflation given prices plunged at the onset of the pandemic back in March 2020. What happens after that, however, is still up for debate. Federal Reserve (Fed) officials have so far appeared unfazed by rising inflation expectations and have repeatedly played down the risk that inflation could get out of control, with Governor Lael Brainard expecting "entrenched inflation dynamics we have seen for well over a decade" to subsequently take over. In other words, higher inflation should only be temporary. But what if it isn't? Beyond base effects, there are signs of price pressures—especially in the goods-producing sector—that could potentially find their way through to consumers. The combination of unprecedented fiscal stimulus and widespread reopenings could also play an important role: both Canadian and U.S. consumers have ample reserves of savings ready to be spent on services as life gradually returns to normal.

U.S. headline CPI came in at 2.6% in March, marking the first time the measure had exceeded the 2% target since the start of the pandemic (graph 1). In Canada, March CPI will be published on April 21 and should show a similar rise. Inflation in both Canada and the United States is then expected to remain above 2% for the next few months. However, the rise in core inflation—defined as all items less food and energy[1]—has been much more modest so far (graph 2 on page 2). Although core consumer price indices such as the CPI remain tepid, other price measures (such as prices paid by firms) have been heating up significantly during the past few months. We take stock of the current price situation in both goods and services—looking beyond consumer prices—and we assess what could be the potential drivers of sustainably high inflation.

[1] The Bank of Canada defines core inflation as the average of its three preferred measures: common CPI, median CPI and trimmed-mean CPI. For comparability purposes, we focus on all items less food and energy.

GRAPH 1
Consumer price index – All items



Sources: Bureau of Labor Statistics, Statistics Canada, Desjardins, Capital Markets and Desjardins, Economic Studies

Evidence of Price Pressures in Goods

Core goods inflation has been notoriously weak over the past decade, running below the 2% target of central banks (graphs 3 and 4 on page 2). This is still the case in early 2021, despite the new stay-at-home environment of the pandemic leading to a strong rotation in consumer demand toward durable

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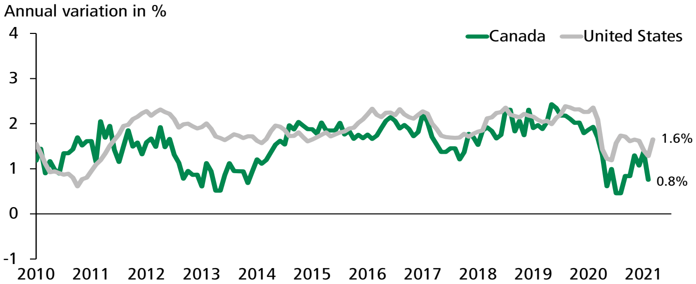
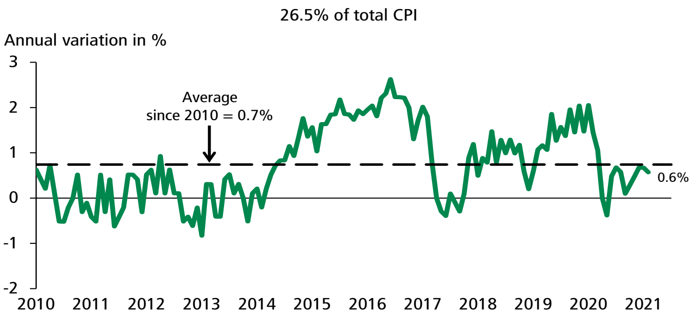
GRAPH 2
Consumer price index – All items less food and energy



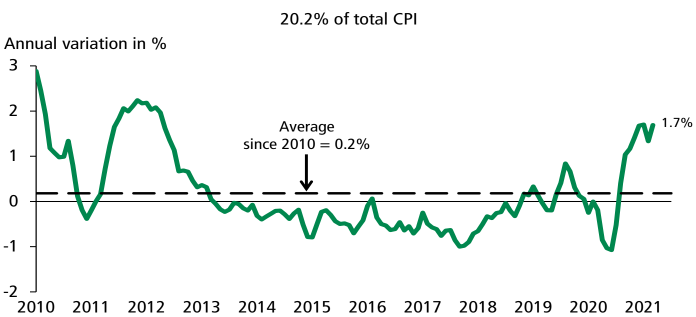
Sources: Bureau of Labor Statistics, Statistics Canada, Desjardins, Capital Markets and Desjardins, Economic Studies

GRAPH 3
Canada CPI – Goods less food and energy



CPI: Consumer price index
Sources: Statistics Canada, Desjardins, Capital Markets and Desjardins, Economic Studies

GRAPH 4
United States CPI – Goods less food and energy

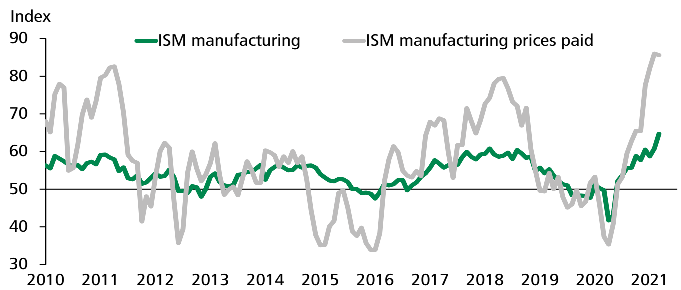


CPI: Consumer price index
Sources: Bureau of Labor Statistics, Desjardins, Capital Markets and Desjardins, Economic Studies

goods. As of February, real consumption of durable goods was up 20% year-over-year in the United States. Although this rotation has led to higher inflation in durables (currently 2.8% in Canada and 3.7% in the United States), this has been partially offset by deflation in non-durables such as clothing and clothing accessories, especially in Canada where apparel's weight in total CPI is almost twice as big as in the United States (5.2% vs 2.7%, respectively). This sizeable difference in basket composition might be behind the stronger core goods inflation currently seen in the United States; at 1.7%, it is significantly higher than its average reading of 0.2% since 2010, whereas core goods inflation is much more modest in Canada.

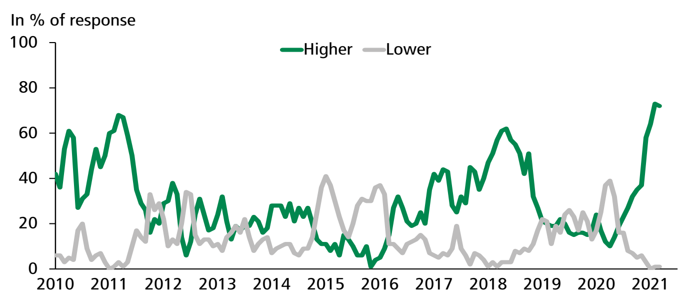
The ISM manufacturing came out at 64.7 in March 2021 (graph 5), the highest such reading since December 1983. The ISM prices paid index was even stronger (85.6) and expanded for the 10th consecutive month, and according to the Institute for Supply Management, it indicates "continued supplier pricing power and scarcity of supply chain goods". Indeed, 72% of firms reported paying higher prices for raw materials, 27% reported paying the same and only 1% reported paying less (graph 6). Price increases for aluminium, copper, steel, chemicals, plastics, wood and lumber products were singled out as being a result of product scarcity.

GRAPH 5
ISM manufacturing



Sources: Institute for Supply Management, Desjardins, Capital Markets and Desjardins, Economic Studies

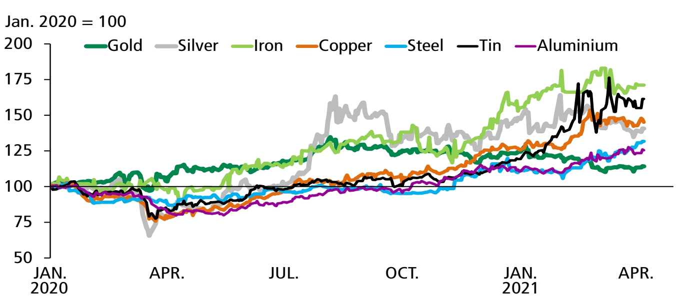
GRAPH 6
ISM manufacturing – Prices higher/lower than previous month



Sources: Institute for Supply Management, Desjardins, Capital Markets and Desjardins, Economic Studies

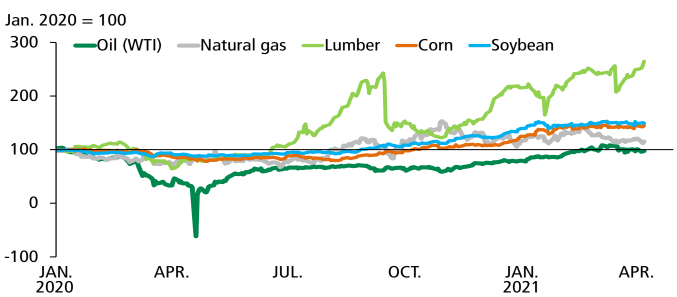
Indeed, the surge in commodity prices since the start of the pandemic has been spectacular. Between January 1, 2020 and April 7, 2021, the price of a wide variety of metals has soared, in some cases more than 50% for iron and tin (graph 7). The prices of other commodities such as corn, soybeans and especially lumber have risen significantly as well, while oil has now completely recovered from last year's dramatic plunge (graph 8). On the demand side, China's buoyant economic growth since bringing its COVID-19 outbreak under control has certainly played a major role as the country consumes about 50%–60% of the world's metals and 20% of the world's softwood lumber.

GRAPH 7
Selected metal prices since January 2020 (futures)



Sources: Bloomberg, Desjardins, Capital Markets and Desjardins, Economic Studies

GRAPH 8
Selected commodity prices since January 2020 (futures)

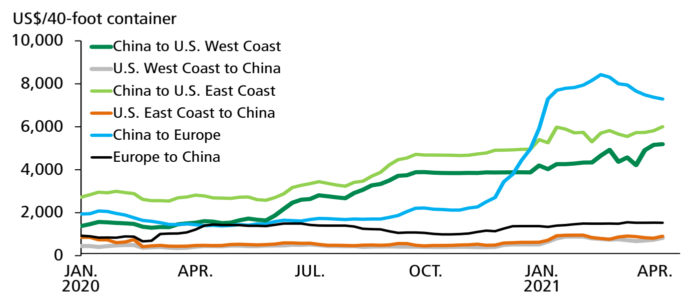


WTI: West Texas Intermediate
Sources: Bloomberg, Desjardins, Capital Markets and Desjardins, Economic Studies

However, the recent surge in commodity prices was also driven by supply factors. The dramatic shift in consumer demand from services to durable goods, caused by the pandemic, has led to significant supply chain disruptions across the world. Semi-conductors have been one of the most visible examples. The move to remote working has increased demand for information technology (IT) devices and components, with reverberations through many manufacturing sectors, including motor vehicles.

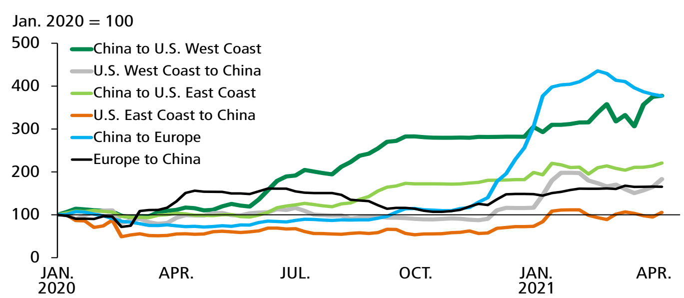
Another major source of price pressures on firms has been the surging cost of container shipping. Rising consumer demand for goods and a shortage of empty containers at Asian ports have caused the cost of shipping from China to skyrocket (graph 9). Since January 2020, the cost of shipping a 40-foot container from China to Europe or the U.S. West Coast has nearly quadrupled (graph 10). But even shipping to China—while still relatively cheap—has gotten significantly more expensive since early 2020; for example, the price of shipping goods from Los Angeles to Shanghai has almost doubled.

GRAPH 9
Container shipping costs – Freightos index (level)



Sources: Bloomberg, Desjardins, Capital Markets and Desjardins, Economic Studies

GRAPH 10
Container shipping costs – Freightos index (relative)

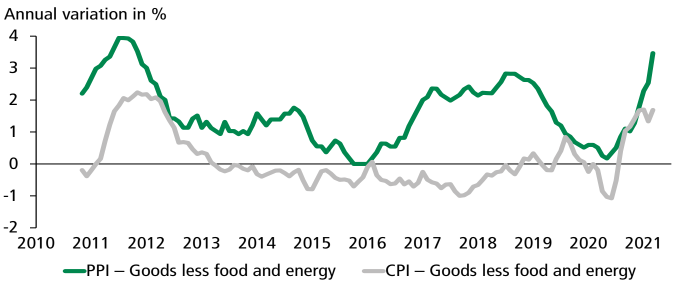


Sources: Bloomberg, Desjardins, Capital Markets and Desjardins, Economic Studies

At the onset of the pandemic, international trade plunged as countries around the world imposed strict lockdowns and closed down factories, forcing shipping vessels to remain idle. In the latter half of 2020, as factories returned to full production and western consumers started buying goods again—many of which are made in Asia—thousands of containers were stranded away from Asian ports where they needed to be. As exporters in China deal with a shortage of containers, boxes are piling up elsewhere as well, leading to bottlenecks, long delays and rising costs. With international travel still severely depressed, cargo that is usually shipped in passenger aircraft is now competing with other goods for space on shipping vessels.

It is important to keep in mind that although there is undeniable evidence of mounting price pressures for firms within the goods-producing sector, the pass-through from rising producer prices to consumer prices was not very strong during the last economic cycle (graph 11). Indeed, the producer price index (PPI)—which measures the average change over time in the selling prices received by domestic producers for their output—has only been loosely correlated with CPI since the beginning of the series in November 2010. Even the tariff war between the United States and China during the Trump administration did not result in marked price pressures at the consumer level. Still, a potential driver of sustainably high inflation would be firms eventually running out of ways to absorb additional costs in the face of continued producer price increases, leading to higher consumer prices.

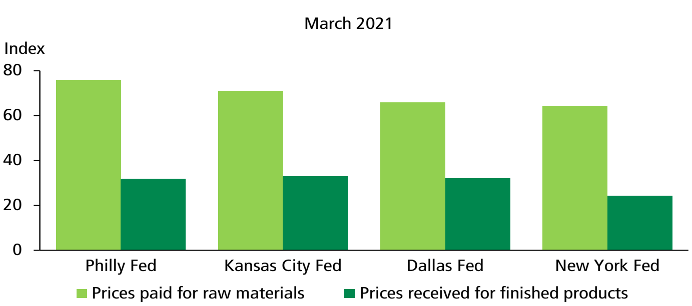
GRAPH 11
United States PPI and CPI – Goods less food and energy



PPI: Producer price index; CPI: Consumer price index
Sources: Bureau of Labor Statistics, Desjardins, Capital Markets and Desjardins, Economic Studies

This does not seem to be the case so far (graph 12). Regional manufacturing surveys conducted by regional Feds include questions regarding both prices paid by firms for materials and prices received by firms for their products. In all cases, the prices-paid index is running much higher than prices received, suggesting limited pass-through to consumer prices.

GRAPH 12
Regional Fed manufacturing surveys

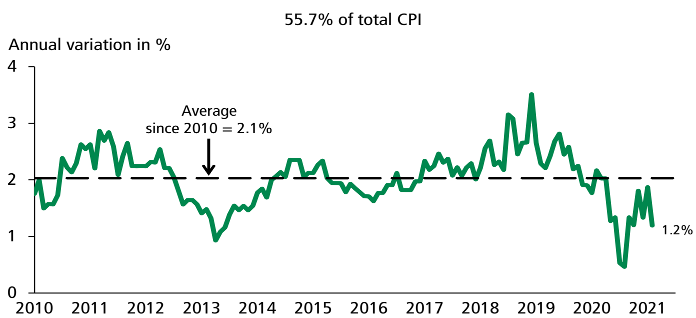


Fed: Federal Reserve
Sources: Fed Bank of Philadelphia, Fed Bank of Kansas City, Fed Bank of Dallas, Fed Bank of New York, Desjardins, Capital Markets and Desjardins, Economic Studies

How Are Price Pressures in Services Looking?

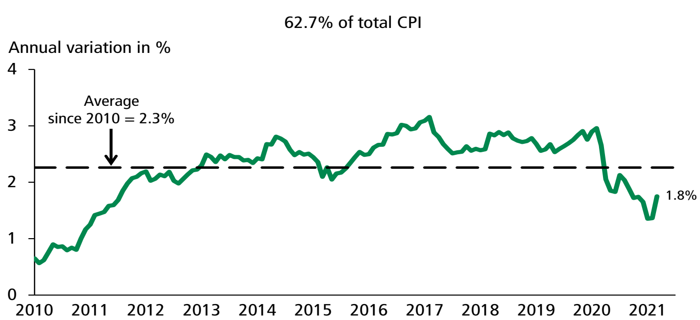
While there is clear evidence of price pressures mounting within the goods-producing sector, the overall inflation outlook will also heavily depend on developments within services. It has been well-documented that compared with past recessions, the COVID-19 pandemic and ensuing public health restrictions have disproportionally affected the services-producing segment of the economy. Industries such as accommodation, air transportation and travel tours were practically brought to a halt for months on end, leading to deflation in multiple CPI components related to services. Consequently, services inflation in both Canada (1.2%) and the United States (1.8%) is currently running well below its average of the last decade; indeed, for much of the previous economic cycle, services inflation had been much stronger than goods inflation, hovering around—or even above—central bank targets of 2% (graphs 13 and 14).

GRAPH 13
Canada CPI – Services



CPI: Consumer price index
Sources: Statistics Canada, Desjardins, Capital Markets and Desjardins, Economic Studies

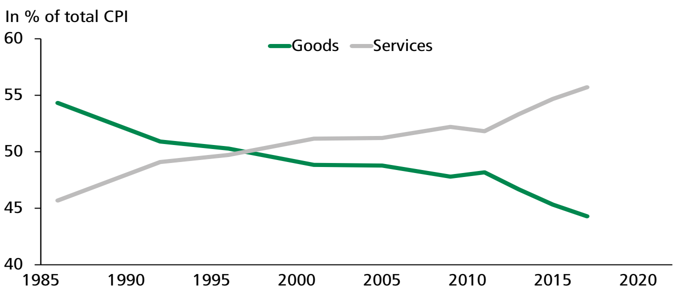
GRAPH 14
United States CPI – Services



CPI: Consumer price index
Sources: Bureau of Labor Statistics, Desjardins, Capital Markets and Desjardins, Economic Studies

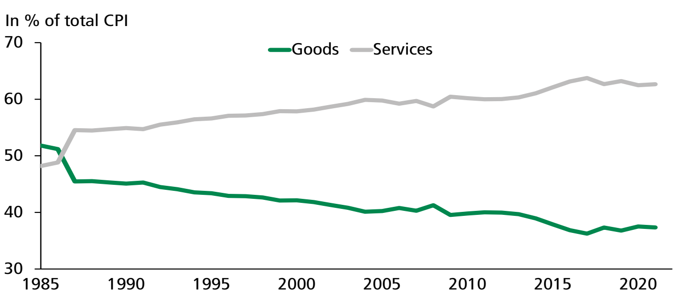
Part of the reason why central bank officials are not overly concerned about price pressures in goods is because of the relatively small weight that goods occupy within the CPI basket. Indeed, the importance of services relative to goods in the CPI has been steadily growing for decades (graphs 15 and 16). More specifically, the weight of core services (total services less food and energy services) is now double the weight of core goods (total goods less food purchased from stores and energy goods); core inflation is thus unlikely to meaningfully overshoot central bank targets as long as services inflation remains as weak as it currently is.

GRAPH 15
Canada CPI basket weights



CPI: Consumer price index
Sources: Statistics Canada, Desjardins, Capital Markets and Desjardins, Economic Studies

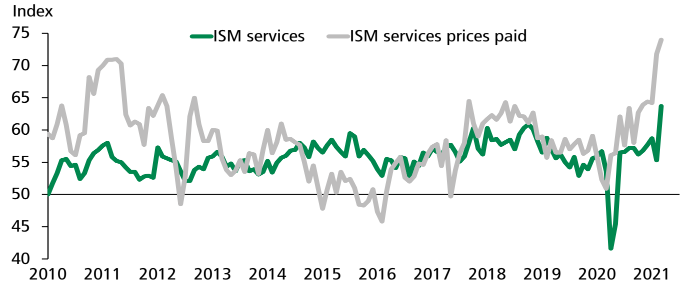
GRAPH 16
United States CPI basket weights



CPI: Consumer price index
Sources: Bureau of Labor Statistics, Desjardins, Capital Markets and Desjardins, Economic Studies

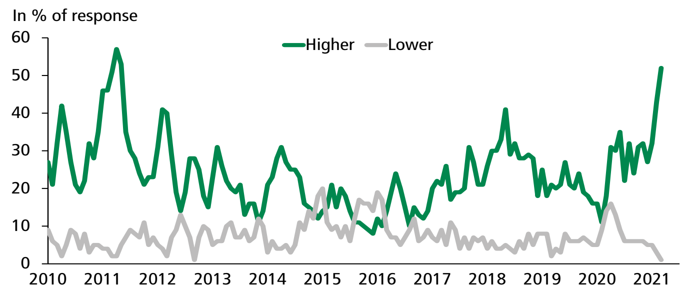
During the past few months, price pressures akin to those seen in the goods-producing sector have started to appear in the services industry. The ISM services was at an all-time high of 63.7 in March (graph 17), with the index of prices paid at 74.0—the highest it has been since July 2008. Indeed, 52% of surveyed service organizations reported paying more for materials and services, 47% reported paying the same and only 1% reported paying less (graph 18). Respondents noted that "logistics delays and uncertainty are creating significant problems with suppliers and inventories" as are "cost concerns regarding inflated pricing due to logistics and shortages".

GRAPH 17
ISM services



Sources: Institute for Supply Management, Desjardins, Capital Markets and Desjardins, Economic Studies

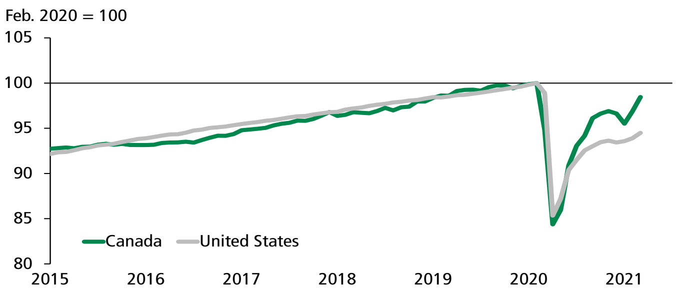
GRAPH 18
ISM services – Prices higher/lower than previous month



Sources: Institute for Supply Management, Desjardins, Capital Markets and Desjardins, Economic Studies

Wages and salaries represent a significant proportion of firms' total costs, and that is particularly the case in services. Given the severe hit to employment caused by the pandemic, it is probably unlikely that we will see strong inflation in services before we achieve full employment, as aggregate wage growth should remain tepid. So far, Canada has substantially outperformed the United States in terms of job market recovery (graph 19 on page 6); however, that could change in the following months as Canadian provinces are tightening public health restrictions again while U.S. states are quickly reopening their economies given more than 39% of Americans have received at least one dose of the COVID-19 vaccine and 25% are fully vaccinated. Rising housing costs could also be a potential source of higher inflation within services; the housing market has been on a tear lately in both Canada and the United States, leading to significant home price appreciation. With interest rates bound to increase moderately as central banks gradually normalize policy, some CPI components, such as mortgage interest costs, could start contributing to higher inflation.

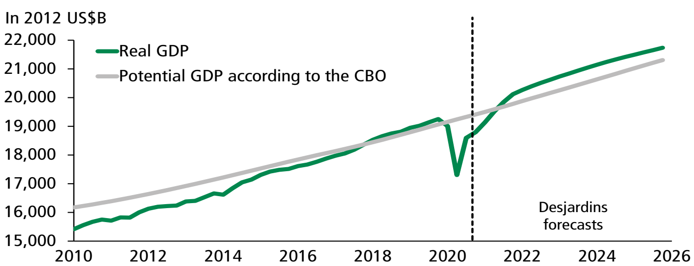
GRAPH 19
Canada and United States total employment



Sources: Bureau of Labor Statistics, Statistics Canada, Desjardins, Capital Markets and Desjardins, Economic Studies

The main element that could lead to sustainably high inflation remains the overheating of the economy, with actual GDP rising markedly higher than potential GDP on the back of a combination of ultra-accommodative monetary policy, unprecedented fiscal spending and significant pent-up demand from consumers as the economy reopens. We forecast the U.S. output gap to close in the third quarter of 2021, with GDP running above potential for the next few years (graph 20), which could lead to inflationary pressures beyond the base effects of the next few months.

GRAPH 20
U.S. GDP forecast compared with potential GDP



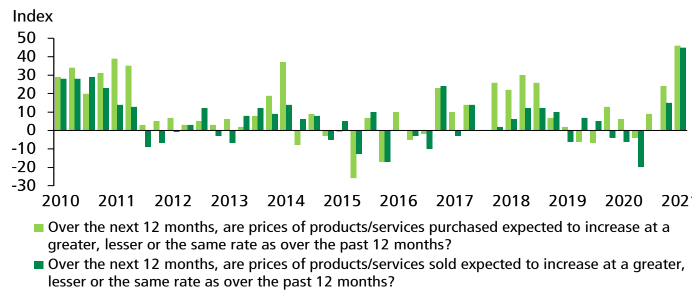
CBO: Congressional Budget Office
Sources: U.S. Bureau of Economic Analysis, CBO, Desjardins, Capital Markets and Desjardins, Economic Studies

Conclusion

When pandemic pessimism peaked in March 2020, markets were pricing in inflation hovering at around 0.5% over a 10-year horizon. In contrast to the Japan-like scenario some had been briefly entertaining, not only did inflation manage to find its footing, but there are now searing pressures on business costs, which have raised concerns over the risk of inflation settling at higher-than-expected levels once the base-year gyrations of the next few months are behind us. So far, central banks appear to be unfazed by these risks, chalking them up to the list of temporary influences; in March, Fed Chair Jerome Powell said that "our best view is that the effect on inflation will be neither particularly large nor persistent".

This view is sensible to the extent that cost pass-through remains as weak as it has been during the last cycle, and as inflationary pressures within services remain subdued amid restrictions on services spending persisting for some time. But weak pass-through should not necessarily be taken for granted. In Canada, the Spring 2021 edition of the Business Outlook Survey gave a strident warning, with the balance of opinions on both input and output prices reaching new record highs (graph 21), and commentary suggesting that several businesses were intent on passing down costs—particularly from higher commodity prices—onto their customers.

GRAPH 21
According to the Bank of Canada's Business Outlook Survey, pass-through intentions are at record highs



Sources: Bank of Canada, Desjardins, Capital Markets and Desjardins, Economic Studies

Neither can it be assumed that inflation in services will remain well-tamed. In the last cycle, both in Canada and the United States, looking only at services, it would have been difficult to claim that central banks failed to achieve their inflation targets. True, the starting point is low for services and excess capacity remains significant overall. However, the combination of vaccination and high-powered fiscal and monetary stimulus could have dramatic effects on inflation beginning next year.

At a minimum, the confluence of developments seems to suggest that the days of inflation risks being mostly skewed to the downside are over. There is a lot to celebrate in this, particularly if it means less distortive monetary policies (e.g., negative rates) in this next cycle and if sound fiscal policy helps remove some of the pressure central banks have felt to respond to each and every shock at the cost of even more distortion. But we also have to hope that policy is not overdoing it and ends up skewing inflation risks to the upside on a persistent basis. Even if it is true that central banks know how to deal with high and persistent inflation, that does not make the requisite prescriptions any less painful.

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