On Inflation

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There has been a lot of fearmongering on inflation recently. Year over year inflation is up 4.4 percent. This is definitely above historical norms, although this number needs to be put into perspective. There have been some short-term factors playing into this increase but the underlying deflationary factors that have kept inflation low for a generation are still there and will eventually prevail.

Let's start with the definition of inflation. In Canada, the inflation measurement is the Consumer Price Index (CPI). The CPI represents changes in prices as experienced by consumers. It measures price changes through time of a fixed basket of goods and services. This basket would include housing, transportation, food, healthcare, education, household spending etc.

Why does inflation matter? And why such a focus on it? Firstly, high inflation will affect interest rates. Interest rates decide how much we can pay for a house or car or to invest in a new business or project. The higher interest rates are the less disposable income we will have to do other things with since we have to service our debt. Because of previously high inflation and interest rates starting 40 years ago which we will examine below, central banks around the world have made keeping inflation within a certain band their first priority. Inflation became the banker's boogey man. And with their typical hubris they took credit for slaying it by the 1990s. It is only recently that they are beginning to realize that maybe they don't have that much influence on these price fluctuations.

Inflation does eat into purchasing power over time. Statistics Canada has measured inflation for a hundred years. We will focus this discussion on 1950 onward given that prior to that there were so many dramatic events affecting inflation that it is relatively meaningless for comparison. WW1, depression, boom, depression and then WW2 were cataclysms that we hope our generation won't have to contend with. By using the CPI from 1950 to 2021 it would take 140 dollars today to purchase what was worth $12.80 then. That is why we got rid of the penny.

Much of that erosion of purchasing power occurred from the early 1970s to the early 1990s. This period of high inflation has been attributed to many factors, from the oil shock to high government spending to abandoning the gold standard to inflation expectations being a self-fulfilling prophecy. But we have had oil shocks since and we definitely had high government spending in 2008 and these didn't cause big spikes in interest rates. The only explanation that seems to fit the evidence is demographics.

Throughout the developed world there was a big jump in inflation as the baby boom cohort entered their peak spending years. They were clamouring for debt to buy houses, cars, household appliances etc over that 20 odd year period from the early '70 to the '90s. The previous generation of savers didn't have that much money to lend and aligned with prudent fractional banking inflation and interest rates skyrocketed. This happened from Japan to Europe to North America.

Then, as those former baby boom debtors became net savers inflation began falling. This, combined with the other demographic trend of smaller families, has caused the world to be awash in cash. Plus, the pandemic has increased saving rates dramatically.

The proof in this is the structurally low interest and inflation that we have had for a generation. It happened first in Japan, with its low birth rate and immigration, and a population older than the rest of the world. They have had near zero interest rates since the late '90s. The government actually tried to cause inflation through enormous infrastructure spending. All this did was cause the country to have a debt to GDP ratio twice as high as Canada's. Then zero interest rates hit Europe in 2008 and have stayed there. Again, because of an average population age higher than North America and low immigration and birth rate. These near zero or negative rates have taken longer to get here because of our slightly higher birth rates and high immigration of young people.

So we come to recent headlines about rampant inflation and the ensuing hand wringing. There was a major economic dislocation as economies shut down during Covid-19. There will be a period of adjustment getting supply back to where it was. This adjustment is already happening in some commodities such as lumber. We all heard of the big spike in lumber prices a year ago. But lumber supply is once again ramping up to meet demand. When I was a teenager, I worked at a small lumber mill piling boards after the logs got sawed. Nothing like hauling 16-foot 2x8s all day to realize a desk job might not be too bad. Most of those small mills shut down over the years as the industry got more and more mechanized. But last year, with the price spike, those small mills started to reopen. Demand will increase supply.

The same will happen with oil. Oil went below zero in 2020. As it now breaks 80 dollars a barrel all those frackers that came through this recession will be rushing to get their product to market. There is no shortage of crude out there, especially at these elevated levels.

Commodity price increases account for much of the recent inflation. And we know this will abate soon. The next concern is supply chain disruptions. As the pandemic swept across the globe factories, ports and transportation were shut down to contain it. Though there are still sporadic interruptions the logistics to trade should work themselves out as vaccines and improved Covid-19 protocols are rolled out. Again, these issues should be temporary in most cases. There are some industries and products now deemed essential that will take longer to sort out, but the vast majority should be resolved soon.

There are other long term factors, besides demographics, pointing to low inflation. Automation and artificial intelligence for example. I am not going to go into this here, but these are trends that are going to continue into the foreseeable future.

For investors a sustained inflationary spike would be a cause for worry. The ensuing high interest rates would cause a repricing of all assets, from housing to equities. However, at this time the inflationary boogey man is still on life support.

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