Intelligence MEMOS

From: Andrew Spence

To: Inflation Watchers

Date: May 28, 2020

Re: **WHITHER INFLATION WHEN SUPPLY CHAINS COME HOME?**

Canada was forced to ride into the medical supply wild west as pandemic driven supply shortages laid bare our inability to handle surge capacity in healthcare.

And the suddenly exposed lack of domestic production capacity for key medical supplies and pharmaceuticals is one factor in the chorus of calls for more Canadian supply chains and reshoring generally.

Healthcare is but one example of the need for more robust, generally shorter, supply chains. Given that pandemics have become recurrent, corporate efficiency and lean production will likely give way to surge production capacity, despite its cost.

What are the implications for inflation control if we pivot to domestic supply – in healthcare and beyond?

Stepping back, it is clear that the proliferation of global supply chains in the past half century delivered a large positive productivity shock to advanced economies and, as a result, lower inflation.

By severing the link between domestic wages and prices, globalization de-fanged organized labour, vanquished cost-push inflation through increased aggregate supply with more players competing on important goods and services, and stabilized inflation expectations by reducing inflation persistence. This helped central banks bring inflation into their target ranges with relative ease, and it has helped keep inflation in check ever since.

As globalization took hold through the 1970s and beyond, the price persistence coefficient (a measure of how likely a price continues to move in its current direction) fell, meaning inflation expectations fell with it. The International Monetary Fund estimated that this coefficient only dropped from 0.6 to 0.4, but over time it had a powerful cumulative effect on inflation and inflation expectations.

Current low inflation expectations are hard to break, and are especially important given the current big negative shock. They keep our assumptions about inflation and its control grounded. However, once expectations break higher, with all actors presuming prices will rise, they can have a devastating impact on inflation control, and the expectation genie is difficult to put back in the lamp without enormous cost.

In Canada, and other advanced countries, inflation has remained very low since the early 1990s, and this can be attributed almost entirely to goods prices. For example, in Canada goods prices have been on average one percent lower than service prices since 1993. The reason why is simple: service prices are mostly determined by domestic wages; offshoring a haircut to low-wage developing countries is not possible.

The persistent trend in lower goods prices inflation left more income to spend on services, making social consumption an ever-larger share of the economy.

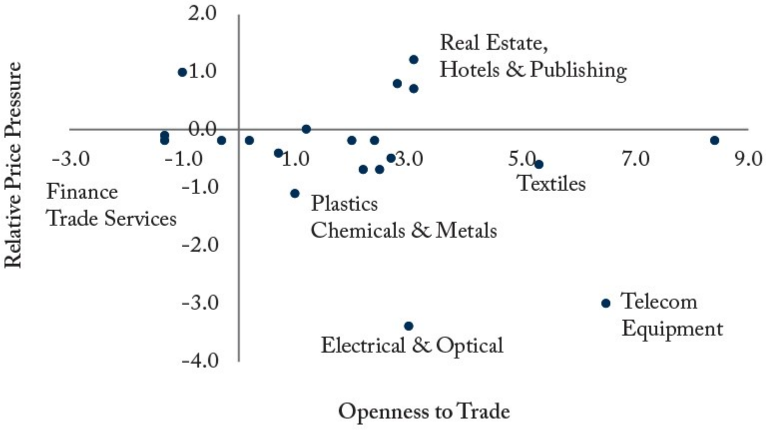
As the scatter plot below shows, industries across 11 advanced countries that were most open to trade, contributed most to relative price declines. This is what one would expect given the large productivity shock from globalization.

However, this may now be reversed. Many of the industries that restrained prices the most are among those most likely to be ordered home: medical supplies, pharmaceuticals, medical equipment and pharmaceutical chemicals. It doesn't take a leap of imagination to see that offshore production's helping hand to inflation risks being withdrawn.

Economic policy matters, and the coming transformation of our economies and the state's role in them is coming clearer.

The challenge will be to marry the rebuilding of domestic strategic surge capacity to manage future emergencies without losing the benefits of globalization.

Open Industries Experienced Lower Prices



Source: IMF. Change in relative producer prices relative to a change in trade openness based on OECD data from 11 advanced countries.

Andrew Spence is former Global Head of Rates and FX Research at TD Securities, and VP and Chief Economist for Ontario Teachers' Pension Plan.

To send a comment or leave feedback, email us at blog@cdhowe.org.

The views expressed here are those of the author. The C.D. Howe Institute does not take corporate positions on policy matters.