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MARKETS

The Market's Big Puzzle: What Is Happening to Growth and Inflation?

Globalization, the decline of labor unions and the rise of big multinationals may be changing the way the economy works

Chicago Fed President Charles Evans referred to Amazon's purchase of Whole Foods Market as an example of 'disruptive technology' that keeps inflation down. PHOTO: ELISE AMENDOLA/ASSOCIATED PRESS

By Jon Sindreu

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The world's major nations are reporting stronger economic growth. Yet what was once thought to be growth's constant companion is puzzlingly missing: inflation.

The U.S. economy grew at an annualized 3% in the second quarter, but in July consumer-price inflation was up only 1.7% from the prior year.

Japan's economy grew 4% annualized in the same quarter, for its longest expansion streak since 2006. Yet inflation keeps hovering around zero, as it has for most of two decades. Eurozone inflation is stuck at 1.5% despite the bloc's accelerated recovery.

Standard economics preaches that prices are ultimately set by supply and demand. When growth is strong, people demand more products and companies need to offer better pay to hire more workers, and so prices go up.

But there are signs the relationship is broken. If it is, the consequences are vast for economic policy-making and financial markets.

"There's no question this is a very fundamental challenge to our knowledge and our policy making," said Adam Posen, president of the Peterson Institute for International Economics.

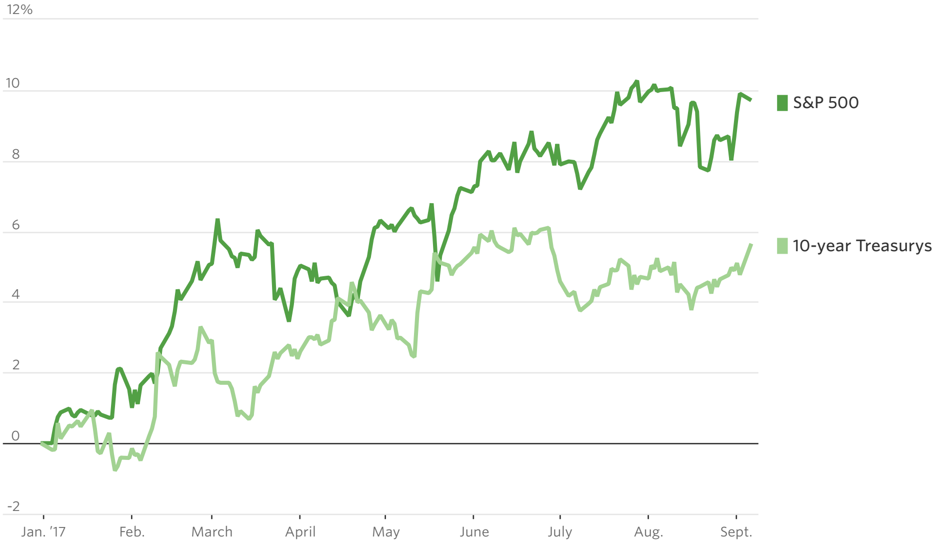
The growth-inflation relationship is the fulcrum of central banking: Central banks set an inflation target—usually around 2%—and then lower interest rates to help prices adjust whenever demand falters. If there is risk that excessive spending pushes inflation over the target, they raise rates to cool growth.

And it is essential to investors' decisions about where to put money: Bonds do well when interest rates fall, and falling interest rates traditionally are taken as signaling concerns about growth, so stocks and bonds typically cushion each other.

Yet in 2017, and for much of the postcrisis period, bonds and stocks have been going in the same direction. This year, the S&P 500 is up almost 10% while 10-year Treasury prices have gained 6%, pushing the benchmark U.S. bond yield down near 2%—a level

Investors Expect Both Strong Growth and Low Inflation

Stocks and bonds have risen together this year



Source: Thomson Reuters

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Workers' Loss of Bargaining Power Has Kept Prices Subdued

Union density and inflation in Group of Seven advanced economies have fallen in lockstep, indexes starting at 100 = 1975

*Ratio of union membership to employment

Sources: Bank for International Settlements (unions), Organization for Economic Cooperation and Development (inflation)

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typically associated more with financial distress than with improving growth.

Explanations for the breakup of the growth-inflation marriage abound. European Central Bank President Mario Draghi argued in June that statistics miss people in temporary jobs or outside the labor force—in other words, the economy isn't necessarily as strong as the numbers suggest.

In a speech Tuesday, Federal Reserve governor Lael Brainard said that "one simple explanation may be the experience of persistently low inflation": Because inflation has been low and often falling for much of the past decade, households and firms now expect low inflation in the future as well.

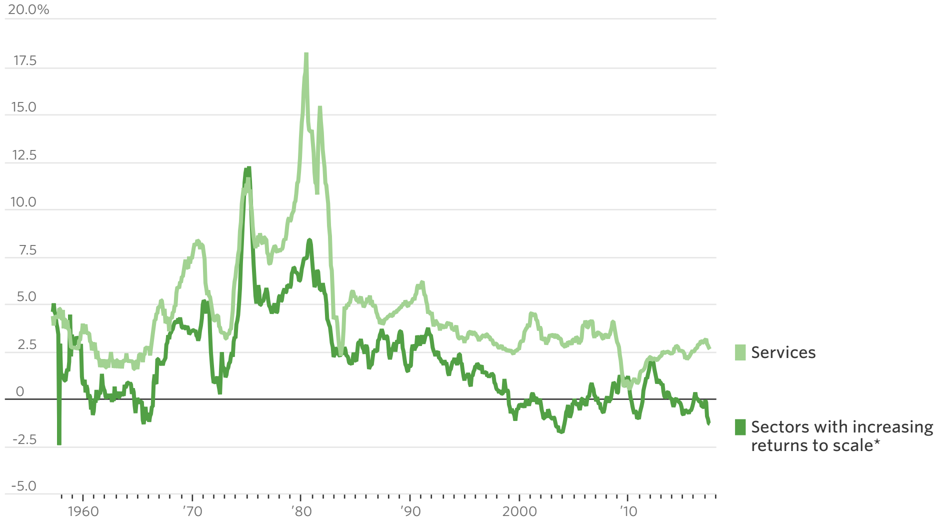
Paul Donovan, chief economist at UBS Wealth Management, believes the bond market is giving the wrong signal about inflation. "Bond markets are rigged," he said, by extraordinary demand for safe debt, created by an aging population, regulation and central-bank buying.

But it is also possible, investors say, that something deeper has changed. Candidates include globalization, the decline of labor unions and the rise of big multinationals holding down consumer prices in efforts to grab market share.

Bond markets aren't imagining low inflation. Unemployment across the developed

Companies Benefiting From Economies of Scale Are Pricing Lower

Change from a year earlier in U.S. consumer-price indexes



*Vehicles, apparel, furnishings, communication, technology and recreation

Source: U.S. Bureau of Labor Statistics

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world has fallen to where it was before 2008, so in theory companies should be offering more generous pay raises to attract workers and increasing prices to offset the cost. Neither is happening.

A partial explanation is that workers can't demand pay raises. In its annual report in June, the Bank for International Settlements found a "positive and significant" link between wages and the strength of unions. Unionization has dropped by half over four decades.

Enrique Martínez-García, economist at the Federal Reserve Bank of Dallas, published research in July showing that globalization is part of why inflation has been low and unresponsive to growth.

Companies can outsource production or import if the wage bill starts getting too high, rather than raise prices. China has flooded international markets with cheaper goods, ultimately pushing down prices.

BIS data shows that in the U.S., 10% of the change in labor costs between 2006 and 2016 was determined by the price of labor abroad, compared with 2% between 1995 and 2005. For the world overall, it is 22%, up from 11%.

The Dallas Fed has started "to seriously consider the impact of globalization on inflation," Mr. Martínez-García said.

What makes the conundrum difficult to solve is that inflation hovered around policy makers' targets for more than two decades until 2008, after shooting up in the 1970s. Central banks were then credited for subduing inflation by raising rates and cooling the economy, but many investors now doubt they can effect similar magic in reverse.

"Inflation is not a leading indicator" of growth any more, said Didier Borowski, head of macroeconomic research at Amundi, Europe's largest asset manager. He said "much more competition at the global level" is leading producers to price more aggressively.

Indeed, the focus of many analysts is now on the market power of so-called "superstar firms," especially technology giants such as Alphabet Inc. or Amazon.com Inc., rather than on traditional supply-and-demand explanations.

"When Amazon enters a market, it drives prices down," said Jason Helfstein, a tech-sector analyst at Oppenheimer & Co.

Chicago Fed President Charles Evans referred to Amazon's purchase of Whole Foods Market Inc. as an example of "disruptive technology" that keeps inflation down.

For extra demand to lead to higher prices, like many textbooks say, a company must face higher costs when making more of a product. However, economists have long documented that, in the real world, many industries benefit from economies of scale. For them, producing more is cheaper—and might not even require more workers, because bigger markets can spur investment in labor-saving equipment. So even if growth and demand increase, prices need not.

U.S. data for the past 60 years show that inflation for goods produced by sectors where economies of scale rule—such as apparel, technology and automobiles—is much lower than in others. Since 1999, it has turned negative, even as prices in services rise at an annual pace of 3%. In the tech sector, inflation in early 2017 fell close to minus 7%.

“The more people there are in the market, the more valuable it is to join their network,” William Brian Arthur, external professor at the Santa Fe Institute, said of tech giants. In this world, “it becomes much harder to predict inflation.”

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