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Price inflation or demand deflation?

Chief economist's comment

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- The pandemic was a simple policy problem for central banks. There was only one thing to be done: the necessary stimulus to support fiscal policy solutions.
- The war in Ukraine is felt mainly as a commodity price shock. Central banks have a contradictory policy problem: Should they focus on the price inflation or the growth deflation consequences?
- There are both direct price and growth effects, and second-round price and growth effects.
- Central banks should not rush to react to the direct inflation effects of commodity prices, as there is little they can do about that.
- Central banks should be concerned if the second-round wage-cost/price spiral effects emerge. In the absence of that risk (which does not seem to be happening at the moment), central banks should be concerned about the direct growth effect of demand destruction and possible labor market weakness.

Source: Getty Images

There was only one plausible policy response to the global pandemic: ease policy. The argument was about the right mix of fiscal and monetary accommodation (and, to some extent, the scale of easing).

The war in Ukraine impacts the global economy mainly via higher commodity prices. There are two opposing policy responses to higher commodity prices: easier policy to tackle the growth effect, or tighter policy to tackle the price effect. Central banks have to pick a side, so which side are they likely to pick?

How much do higher commodity prices matter?

Globally, *pure* commodity prices have a weight of roughly 8–10% of the headline inflation basket. This is using 2019 data and 2019 price levels. Experiences vary, however. In a developed economy, commodity prices will be about 4% of the inflation basket. This covers the full effect of a commodity price—not just the oil a consumer buys, but the impact of oil prices on transport costs, electricity generation, products that are electricity intensive, and others. The oil in your morning cup of coffee is included. (Making coffee needs electricity, which may be generated by burning oil. Coffee is transported from plantation to processor, processor to warehouse, warehouse to store, store to home—involving oil at each stage.) The importance of commodities is simply calculated by measuring the value of global commodity production as a share of global GDP.

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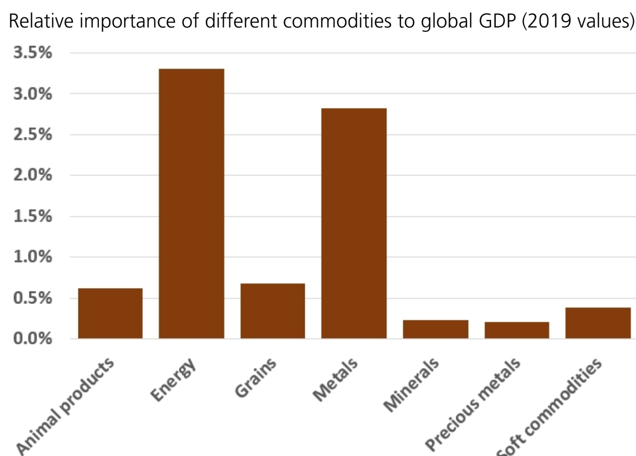
Fig. 1: How much do commodity prices matter to inflation?

Relative importance of different commodities to global GDP (2019 values)



Source: Chartbook of Real Commodity Prices, 1850–2020, David S. Jacks, February 2021; World Bank World Development Indicators; UBS calculations

How is it possible that pure commodities are less than 4% of a developed economy inflation basket, when the Bureau of Labor Statistics itself tells us that food alone is over 13% of the consumer price basket? As noted in the last *Chief Economist's Comment*, food is not food. Very few people consume commodities in a pure form. In a developed economy, only about 20% of what a consumer spends on food is actually spent on agricultural commodities (somewhat less in the United States). Most of the rest is spent on labor costs that occur after the commodity has been produced.

This does not mean that economists can ignore commodity prices. The weight may be small, but price moves can be large. If oil prices rise 100% (and assuming no profit margin squeeze), the global rate of consumer price inflation would eventually increase by 2.3 percentage points on average, for instance.

What do commodity price rises do?

Economically, commodity prices operate through two channels: higher inflation, and lower growth.

The inflation channel

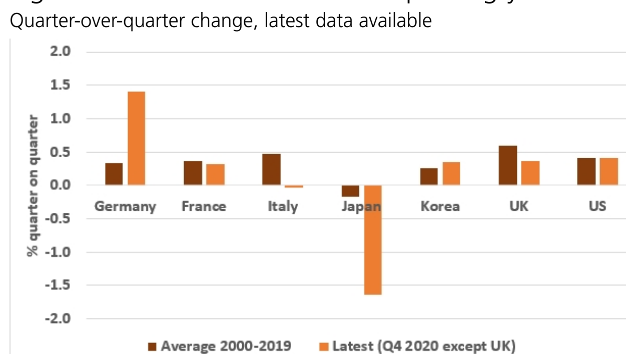
Higher cost inflation rate is obvious—as already noted, if the price of oil doubles, the global rate of consumer price inflation will rise around 2.3 percentage points. Higher commodity prices mean higher costs for all sorts of products and services. These costs are either eventually passed on to consumers or squeeze profit margins—or of course some combination of the two. This is the first-round effect.

The more important question for central banks is whether there are second-round effects. Labor costs are the largest weight in the inflation basket. If workers start demanding higher wages because of higher prices from the first-round effect, that may be another and more serious cost increase for companies. Companies that have higher wage costs may then seek to pass on their increase in labor costs with second-round price increases: the wage-cost/price "spiral." Wage costs are also more difficult to reverse than commodity prices.

It is important to note that wage costs are not the same thing as wages. Paying someone more money because they are working harder is not inflationary, and the company has no incentive to raise prices if the additional hard work offsets the higher wage rate. The economist who goes from working 60 hours a week to 90 hours a week but is paid 10% more is a force for lower inflation—the employer gets 50% more economist for only 10% more money.

Fig. 2: Unit labor costs are not spiraling yet

Quarter-over-quarter change, latest data available



Source: OECD

This means that the focus for the second-round price effects is likely to be unit labor costs—how much you have to pay to generate a unit of output. As the chart shows, recent increases in unit labor costs are not especially threatening. However, this data relates to the period before war-related price increases, and central banks will need to remain vigilant about possible second-round effects.

It is worth noting that a wage-cost/price spiral requires a continuous process of raising wage costs and prices. A one-off increase in wage costs is a structural readjustment and should not be considered an inflation driver. For example, the shift to online retail and higher demand for goods in 2021 led to a surge in demand for long-haul delivery drivers relative to the available labor force. That led to large increases in wages. However, that increase in wages has brought the supply of and demand for long-haul drivers back into balance, and there is no need to do a similar increase in wages in 2022.

While the higher cost of living might encourage higher wage demands, it may also increase labor supply (depressing wage demands). People may take second jobs to support their real incomes, and people who have left the workforce (for instance, by taking early retirement) may return as they find that inflation has eroded living standards dependent on non-employment income. Wage costs may also be limited as workers start to question job security—which is why the growth channel is so important.

The growth channel

Lower growth occurs in commodity-consuming areas (net commodity producers get higher growth as a result of higher commodity prices). Higher oil prices are bad for New York's growth, but good for Texan growth. Again, there are first- and second-round effects.

If you are spending more money on food and fuel, you have less money to spend on other things, and so demand drops (the first-round effect). How much demand will drop depends on whether household income is rising, whether there are savings available to smooth the consumption pattern, and whether consumers can change their spending behavior.

Income is growing more slowly than are consumer prices in most major economies today, so that is unlikely to stop the demand switching. However, some households have savings left over from the pandemic and could use that to smooth demand. Unfortunately, the signs are that lower-income households, who are more vulnerable to rising commodity prices, are less likely to have savings to draw on.

The most interesting possible shift is that of reducing demand for oil. With every oil price spike, consumers have been driven to some further fuel efficiency. To produce a dollar of GDP in 2022 takes less than half the oil it took in 1973 as a result of this efficiency. Japan in the wake of the Fukushima disaster has shown the world that energy demand can drop sharply in the face of a crisis. The less oil we consume, the less an oil price increase will impact demand for other products.

It is possible that the drop in demand for energy this time will be even more significant than in previous oil price spikes (economists would say that the price elasticity of demand for oil has risen). Much of the Fourth Industrial Revolution is about increasing efficiency, and several changes have been accelerated by the pandemic, allowing for greater efficiency than in the past. For instance, why should someone pay more money to fuel their car, in order to drive to an office they do not need to work in? The International Energy Agency estimates that if advanced economies implemented working from home for up to three days a week (where possible), oil demand could be reduced by 340,000 barrels per day. If people are buying less oil, there is less need to cut back on non-oil consumption.

Assuming that there is some reduction in the consumption of non-commodity goods and services, there is a potential second-round effect. If you are making goods or providing services in a sector with falling demand, you may lose your job or have increased job insecurity, and have to cut back on demand generally (the second-round effect). For example, higher food costs may encourage people to eat less at restaurants. Less demand for restaurant services reduces demand; restaurant workers could lose their jobs. Unemployed former restaurant staff spend less, further reducing demand in the economy.

There is little evidence of second-round demand effects at the moment. Some sectors were struggling to recruit labor at the end of 2021—this is likely to make employers more cautious about firing workers, even as demand shifts. However, if companies go bankrupt in the face of reduced demand or there is an expectation that demand is going to be weaker for longer, this second-round effect could become more significant in the future.

How do central banks react?

Central banks should focus on second-round price effects, and first- and second-round demand effects. There is little that central bankers can do to influence global commodity prices—especially when the price move relates to risk and supply concerns. Federal Reserve Chair Jerome Powell would struggle to dig an oil well in Washington DC, and European Central Bank President Christine Lagarde is unlikely to grow wheat in a Frankfurt window box. The only way to directly address a commodity supply shock would be to create enough of an economic downturn to significantly reduce commodity demand. This is unlikely to be acceptable. Such an economic downturn means unemployment, and for all the focus on price stability we should not forget that central banks generally have some kind of employment mandate as well.

Second-round price effects can be tackled by central bank policy. Pushing growth below trend, or generally reducing demand in the economy, will create spare capacity in the labor market relative to the status quo. This does not have to mean higher unemployment—bringing labor supply and demand into closer balance should reduce wage pressures and break the potential for a wage-cost/price spiral.

In the absence of a wage-cost/price spiral, central banks will be concerned to stabilize growth around trend. That does not mean that policy remains unchanged. The wartime

level of neutral interest rates is certainly higher than the pandemic level of neutral interest rates. The challenge for central banks trying to manage the demand cycle is that the quality of economic data in real time has deteriorated. The risk of policy error has increased, which might suggest that the prudent course of action would be a slow and steady pace of tightening to ensure that demand deflation does not get out of hand.

Appendix

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