June 2024

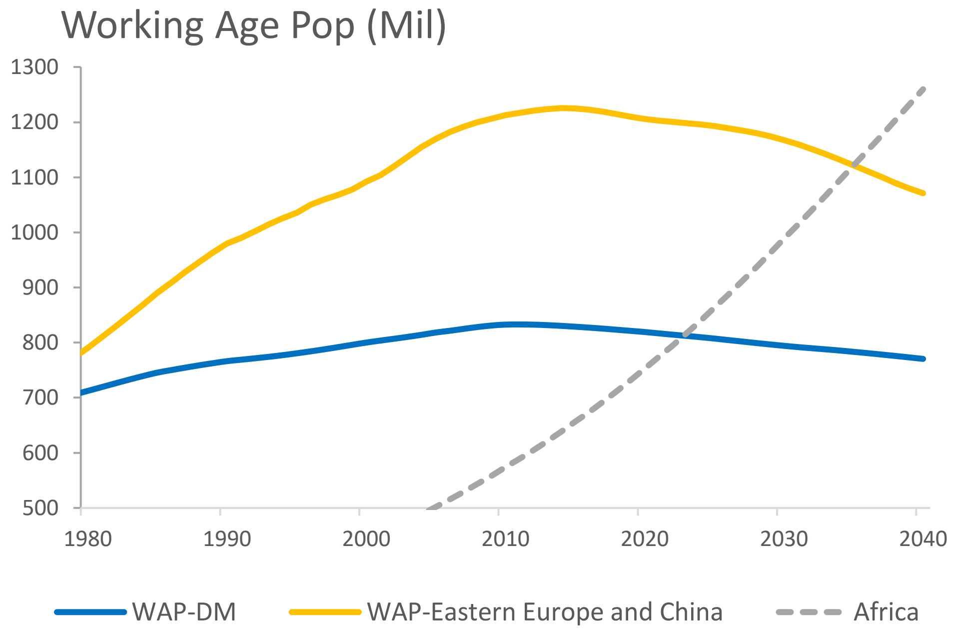
The 'Grey' Normal: An Age of Fiscal Excesses, Attritional Rates

Manoj Pradhan

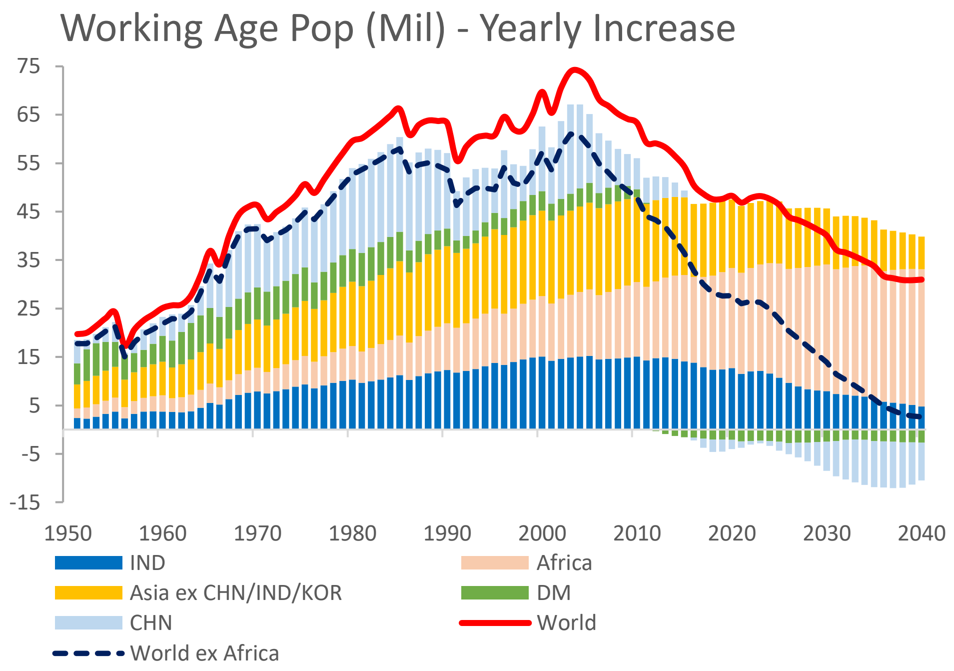
The Structural Case for Inflation

Four Pillars of the Great Demographic Reversal

Globalisation reversing



Workforces declining

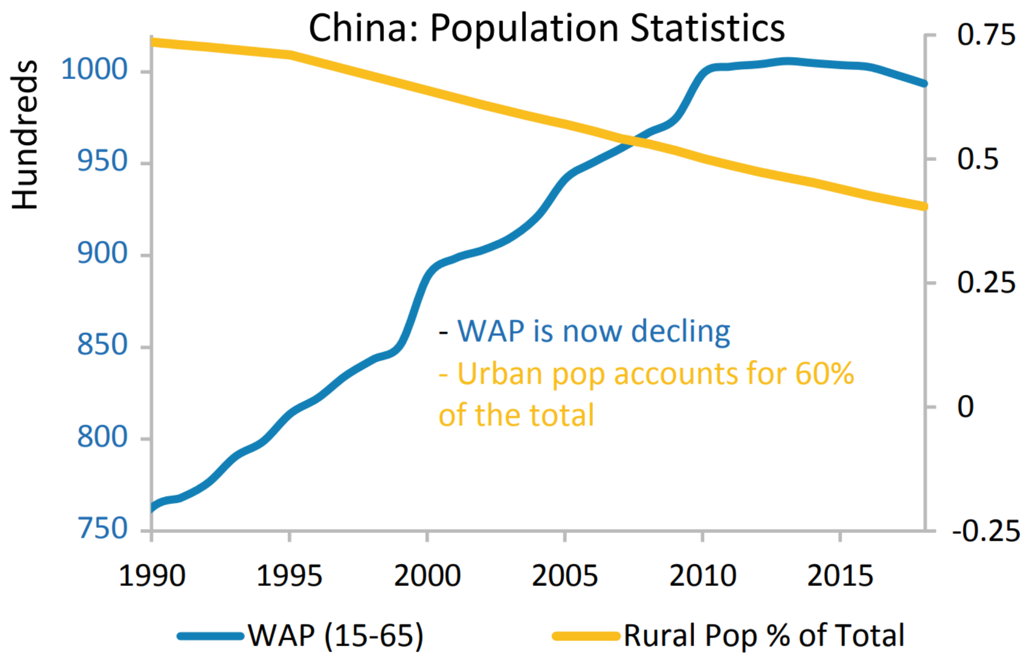


Source: Talking Heads Macro

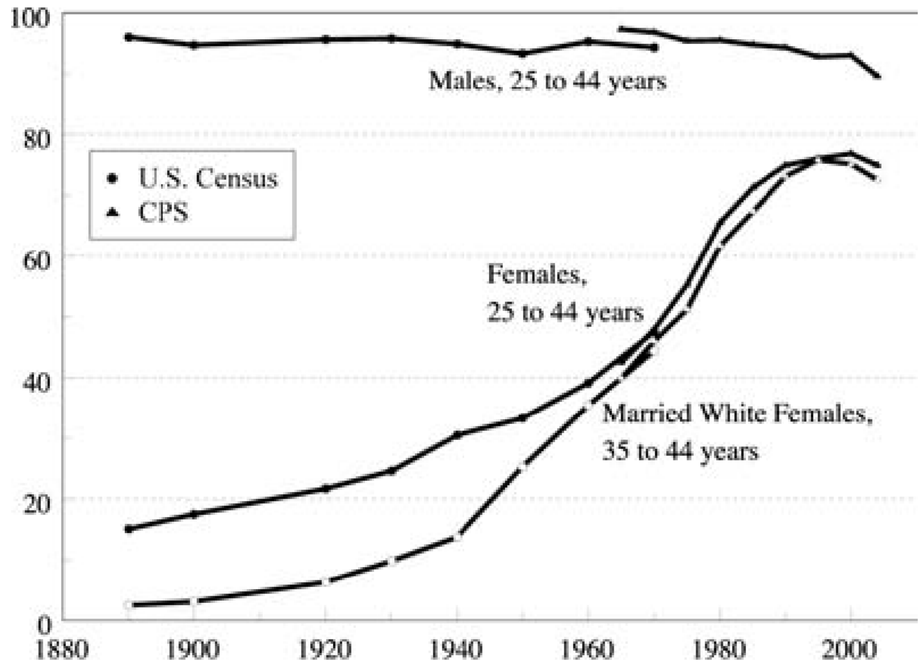
THMacro
www.talkingheadsmacro.com

Four Pillars of the Great Demographic Reversal

China's internal migration flatlines



Female labour force participation peaks



Source: Talking Heads Macro

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Demography and Inflation: Stolper-Samuelson

Dependents (Young, Old) Consume
But Don't Produce

Dependents
Inflationary

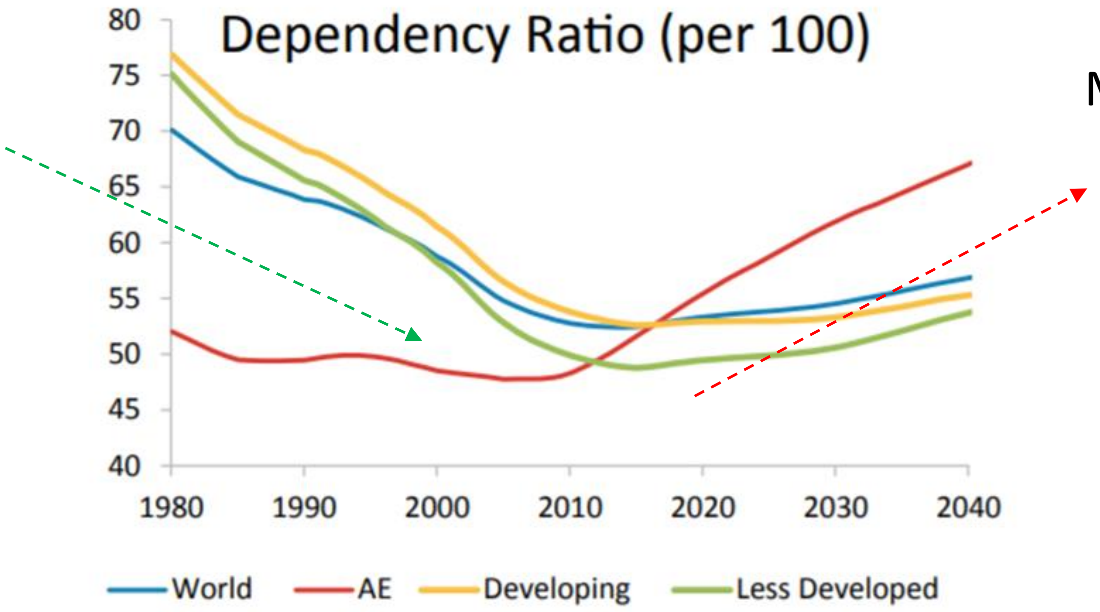
Workers Consume + Produce + Save
Wages < Production, Consume < Wages

Workers
Deflationary

More Workers
Than Dependents

=

Inflation Falls



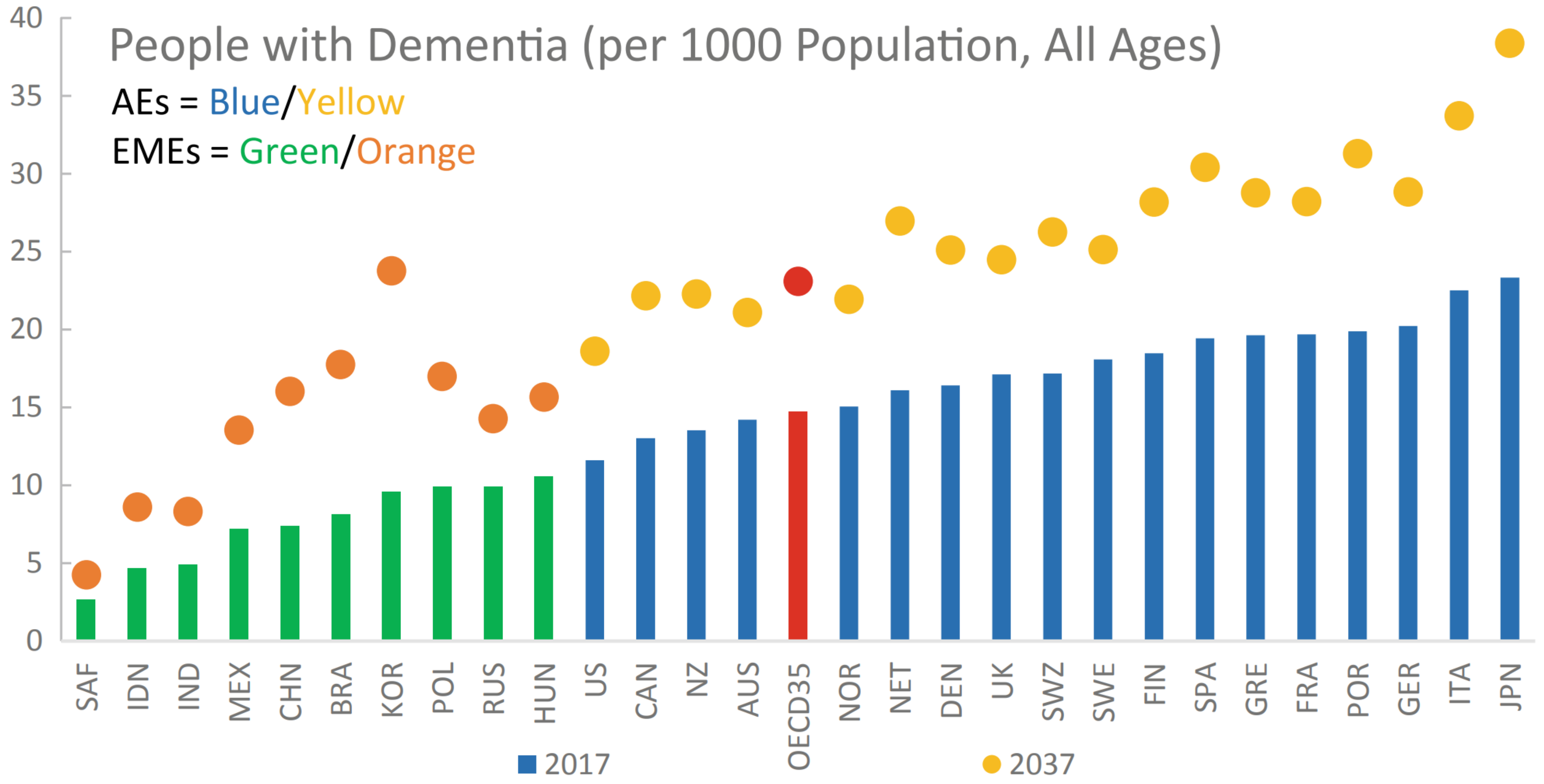
More Dependents
Than Workers

=

Inflation Rises

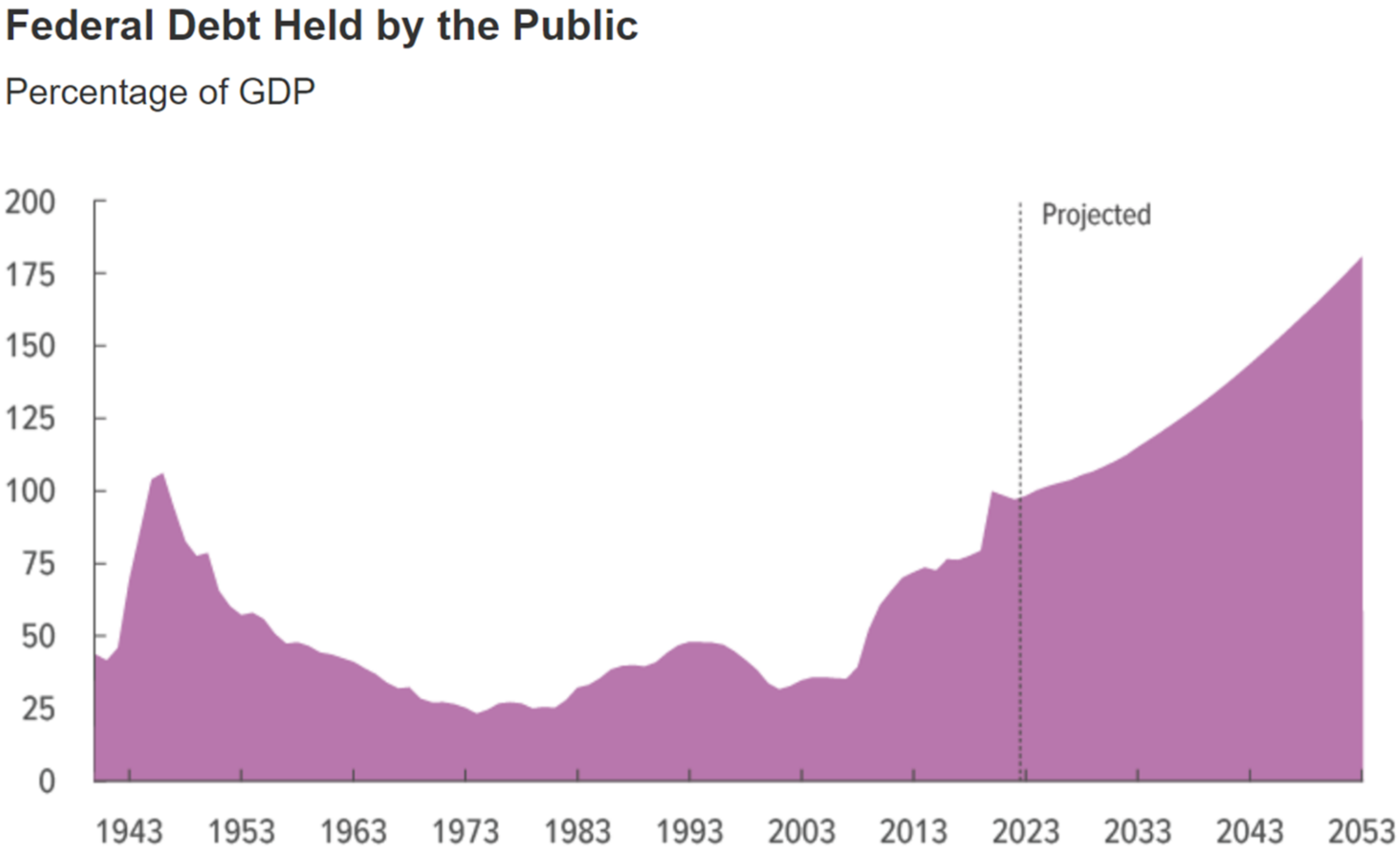
Source: Talking Heads Macro

Ageing Will Raise Medical Dependency and Public Debt



Source: OECD Health Statistics 2017

Steady Deficits + Steady Borrowing Rates = Rising Debt



Source: National sources, Haver Analytics, Talking Heads Macro

A Slow-Motion Mis'Truss't of Fiscal Sustainability

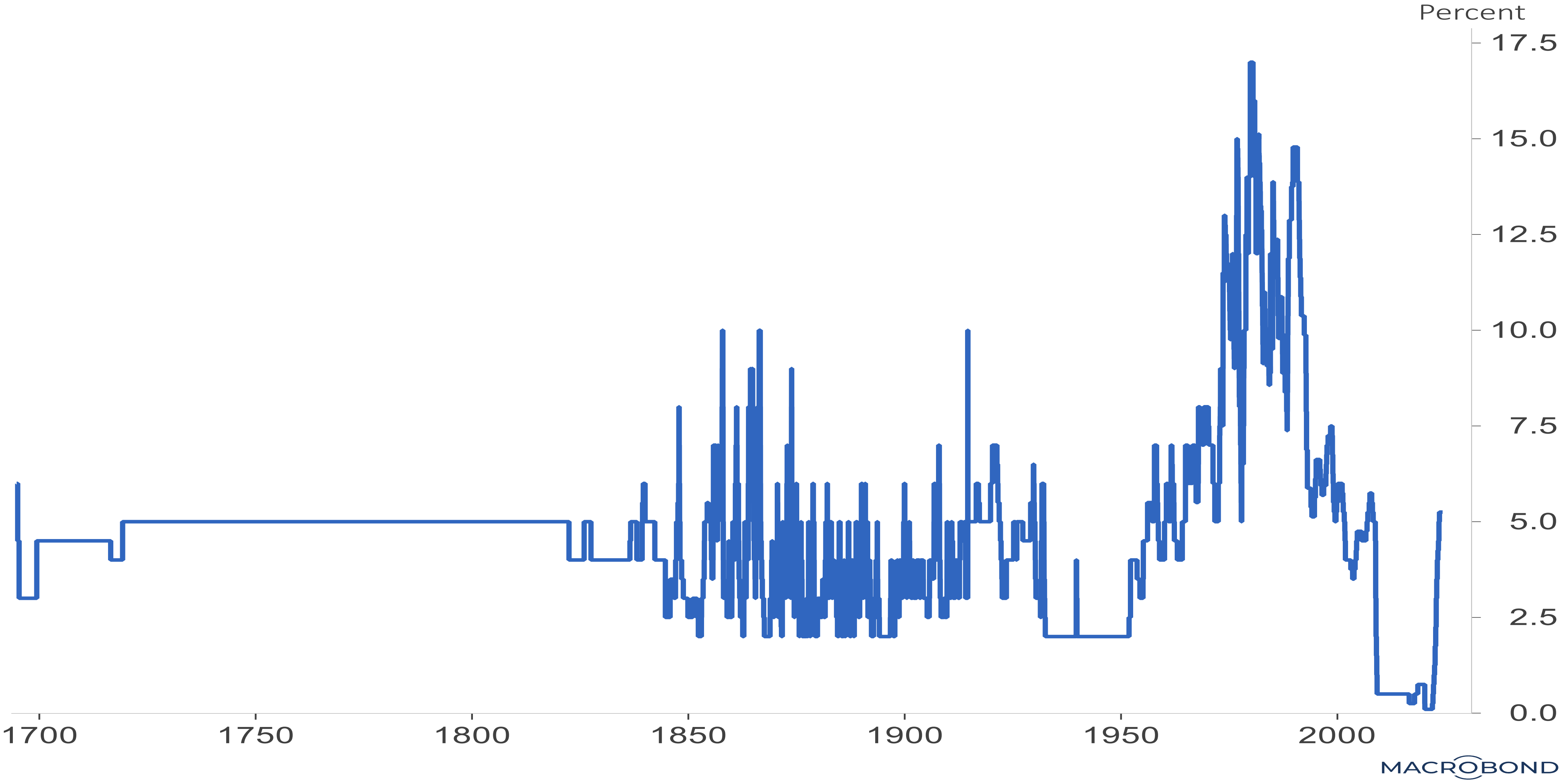
Fiscal policy:
Much higher issuance = markets demand higher interest rates

Monetary policy:
(i) Fight inflation in stable times, but support financial stability in volatile periods
(ii) Bigger balance sheet to absorb issuance, higher rates to (somewhat) fight inflation.

Fiscal sets the level of rates, monetary chooses the inflation vs *r** mix.

Source: National sources, Haver Analytics, Talking Heads Macro

A Return to Normal Rates… A 'Grey Normal'



Source: National sources, Haver Analytics, Talking Heads Macro

Five Key Pushback Questions

Question 1 (Kenneth Rogoff): Central banks control medium-term inflation – so how can a demographic impulse generate inflation?

Question 2 (European Stability Mechanism): If an inflation surprise is fully incorporated into coupon rates, that level of inflation can no longer reduce the real burden of debt. Will inflation have to keep surprising to the upside?

Question 3 (Guido Tabellini, IGIER): Inflation will be a policy choice. Why would debt restructuring not be the policy choice?

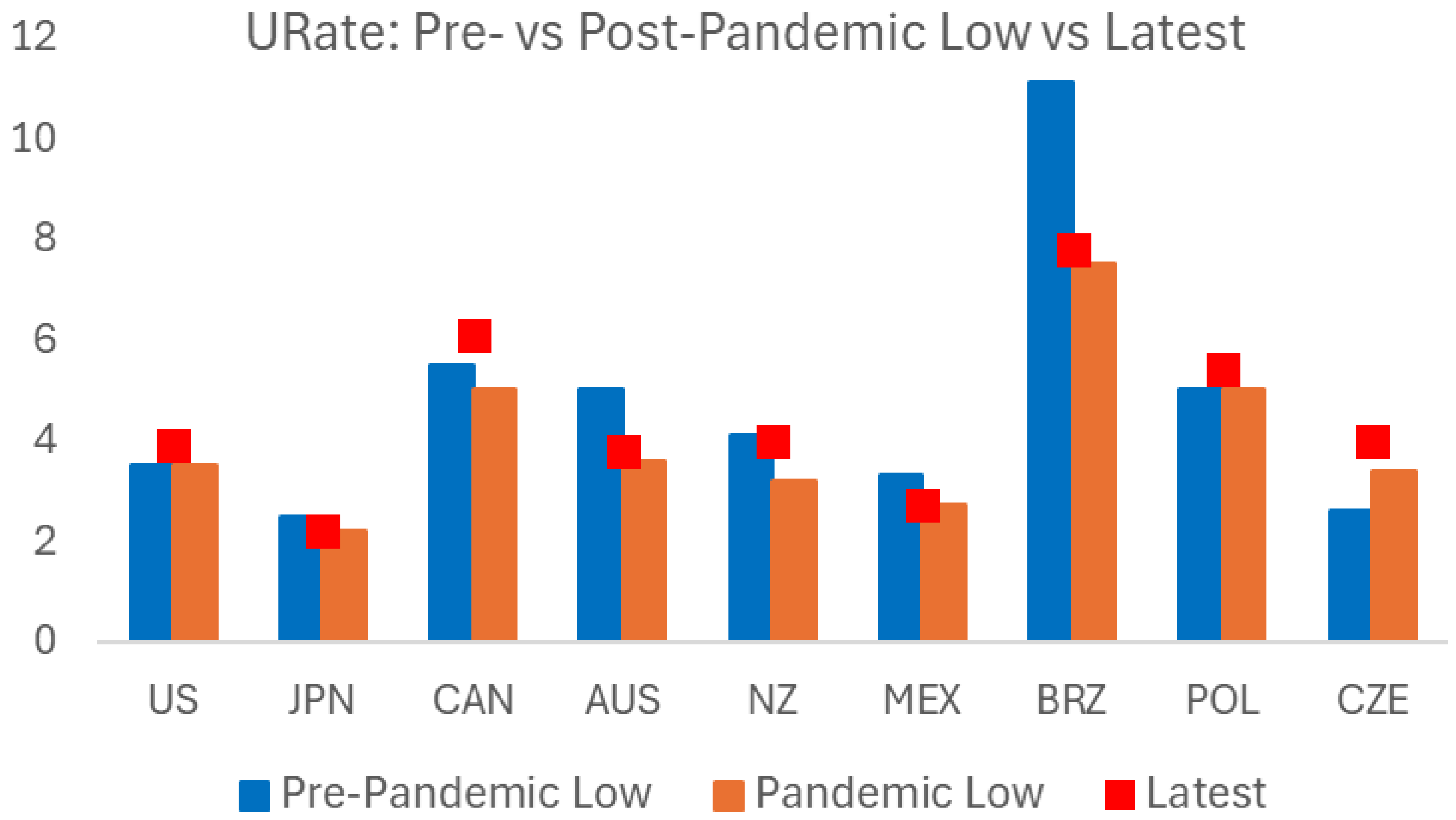
Question 4 (Guido Tabellini, IGIER): If the aged save more, then the pressure on interest rates will be to go down. If real interest rates fall and per capita GDP stays steady, why worry about debt and inflation?

Question 5 (EVERYONE): Why didn't it happen in Japan?

Source: National sources, Haver Analytics, Talking Heads Macro

Why are Labour Markets STILL So Tight?
What Lessons Do They Hold?

Why Are Labour Markets Still Tight?



Source: National sources, Haver Analytics, Talking Heads Macro

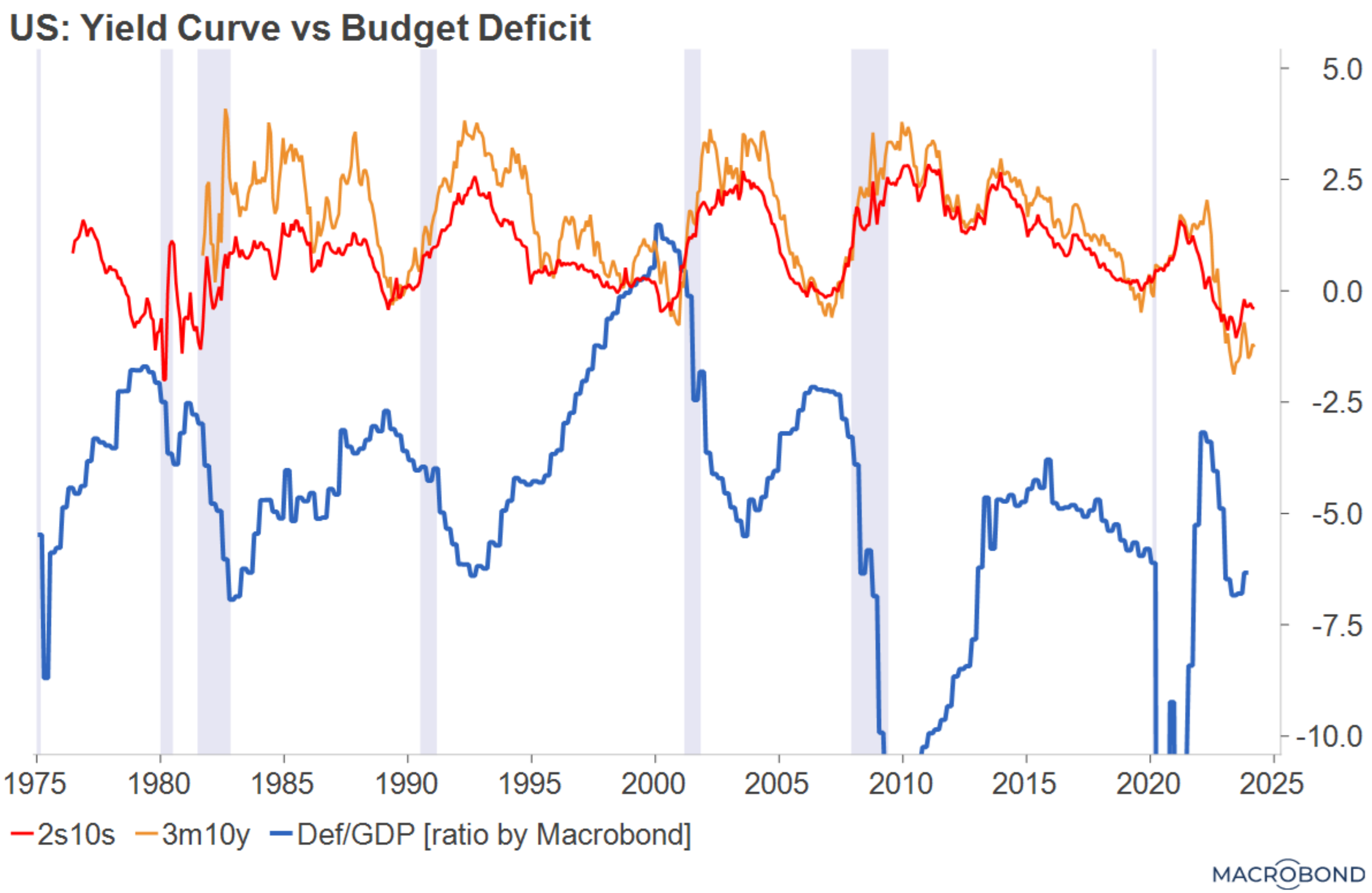
The US is Different – With a Primary Deficit of 14% of GDP over 3 Years

Policy Mix:
Monetary tightening has been offset by a higher near-term *r** (fiscal policy + post-crisis low rate, long duration borrowing)

Policy Offsets:
Tighter credit conditions (MP) vs greater transfers and interest incomes (FP, MP)

Lower capex (MP) vs IRA (FP)

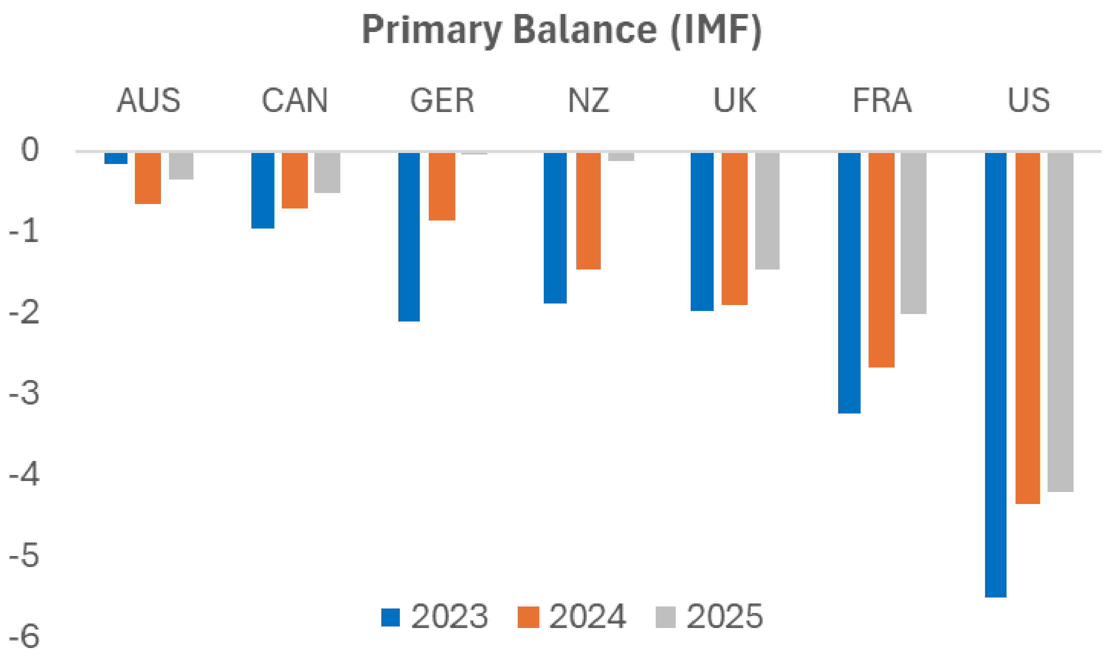
Lower existing homes (MP) but higher new homes sales

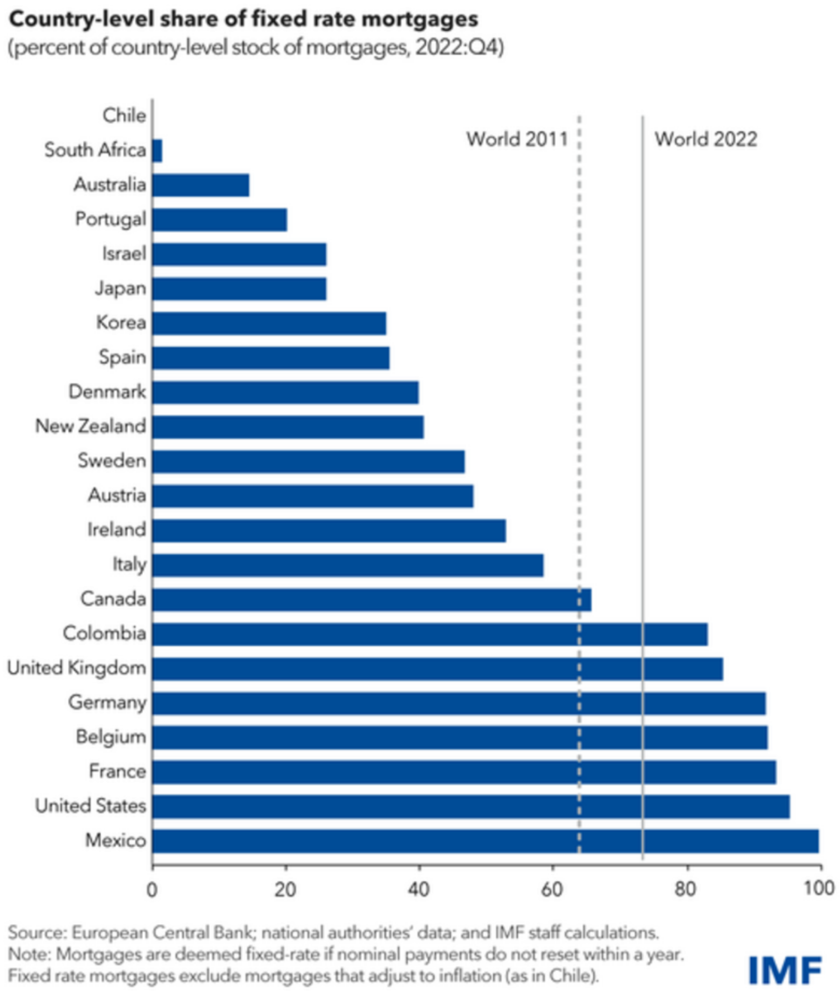


Source: National sources, Haver Analytics, Talking Heads Macro

The Cross Section Can't Explain Why Are Labour Markets Tight Globally

Labour markets have remained tight where near-term *r** is higher (high deficits, post-GFC low-rate borrowing) or lower, and where central banks have tightened earlier, or later, and by more or less in real terms.





Source: National sources, Haver Analytics, Talking Heads Macro

Labour Hoarding is Part of the Answer – But Not the Whole Answer

Greene (BoE):
Hoarding explains L mkt tighteness

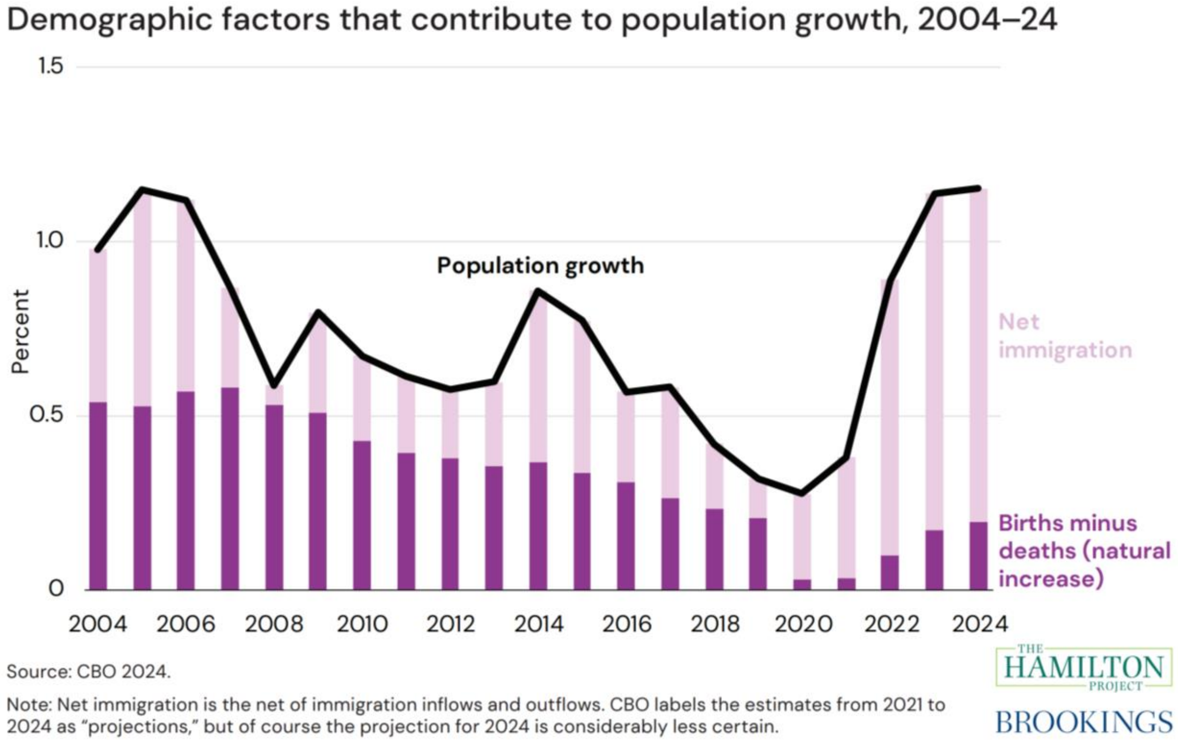
Hoarding is due to a high cost or rehiring:
- Experience of shortages
- Wage growth still high

Shortages will be a **structural** issue because of demography

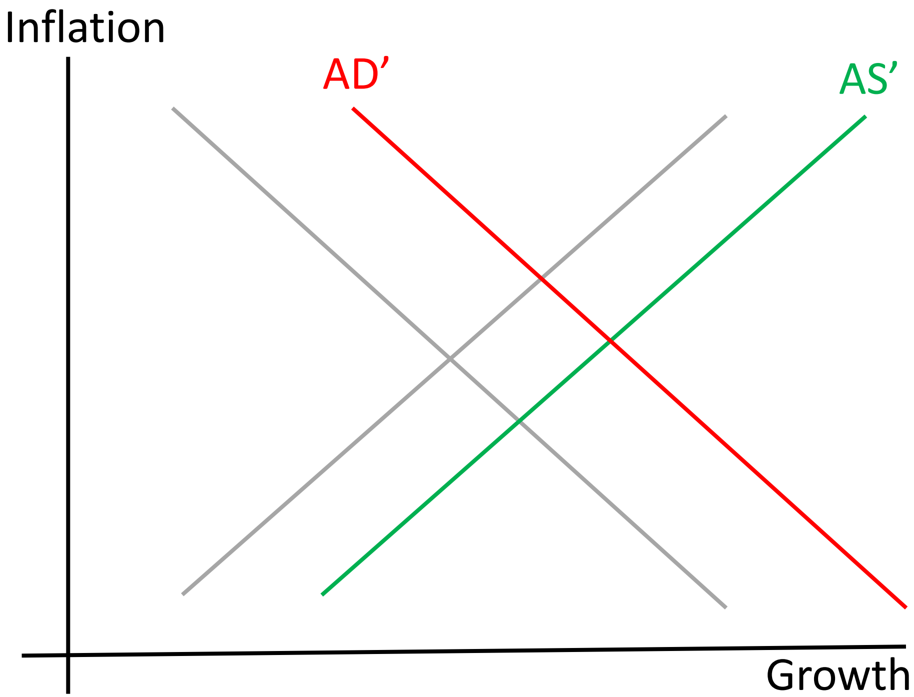
Source: National sources, Haver Analytics, Talking Heads Macro

Immigration: A Shift In, or a Movement Along, the Supply Curve?

Timing and Breadth
CAN, US, SWE, UK, EA, AUS, NZ
Hiring matches the inflows
And all at the SAME time – coincidence?



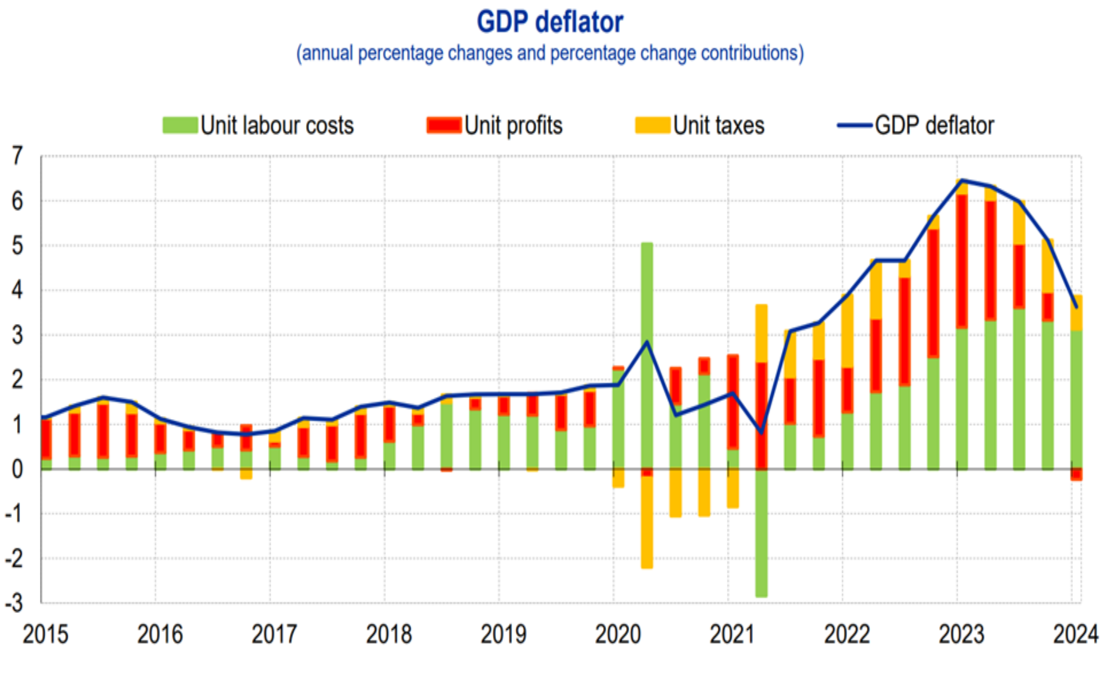
Participation rates have risen in
US, SWE, EA, AUS, NZ (Flat CAN, Lower UK)
That cannot be a coincidence
Most likely, a movement ALONG the AS curve



Source: National sources, Haver Analytics, Talking Heads Macro

2. The Other Side of 'Greedflation': Real Wages Still Underwater

Unit profits 'created' inflation – but real wages growth has only recently turned positive – the level of real wages is still underwater.



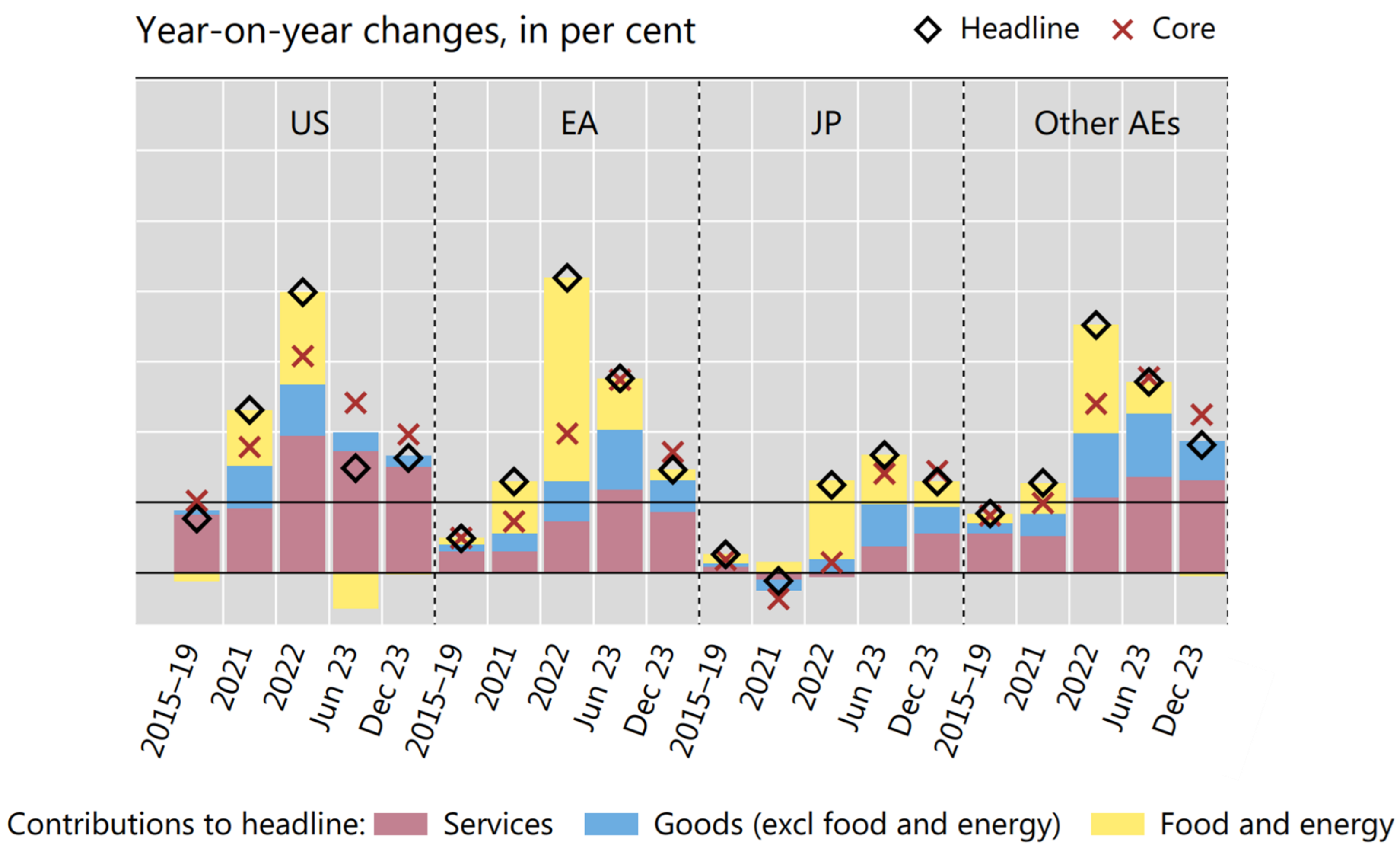
Sources: Eurostat and ECB calculations.
Notes: Unit taxes refer to unit net indirect taxes defined as indirect taxes minus subsidies.
Latest observation: 2024 Q1.

Figure 4. Wage and price inflation since 2019Q1, quarter-over-quarter annualized percent changes

Sources: National statistics and authors' calculations.

Source: National sources, Haver Analytics, Talking Heads Macro

3. Has China 'Rescued' The Global Economy Again? For How Long?



Source: Amatyakul, Igan, Lombardi, BIS, April 2024, "Sectoral price dynamics in the last mile of post-Covid disinflation"

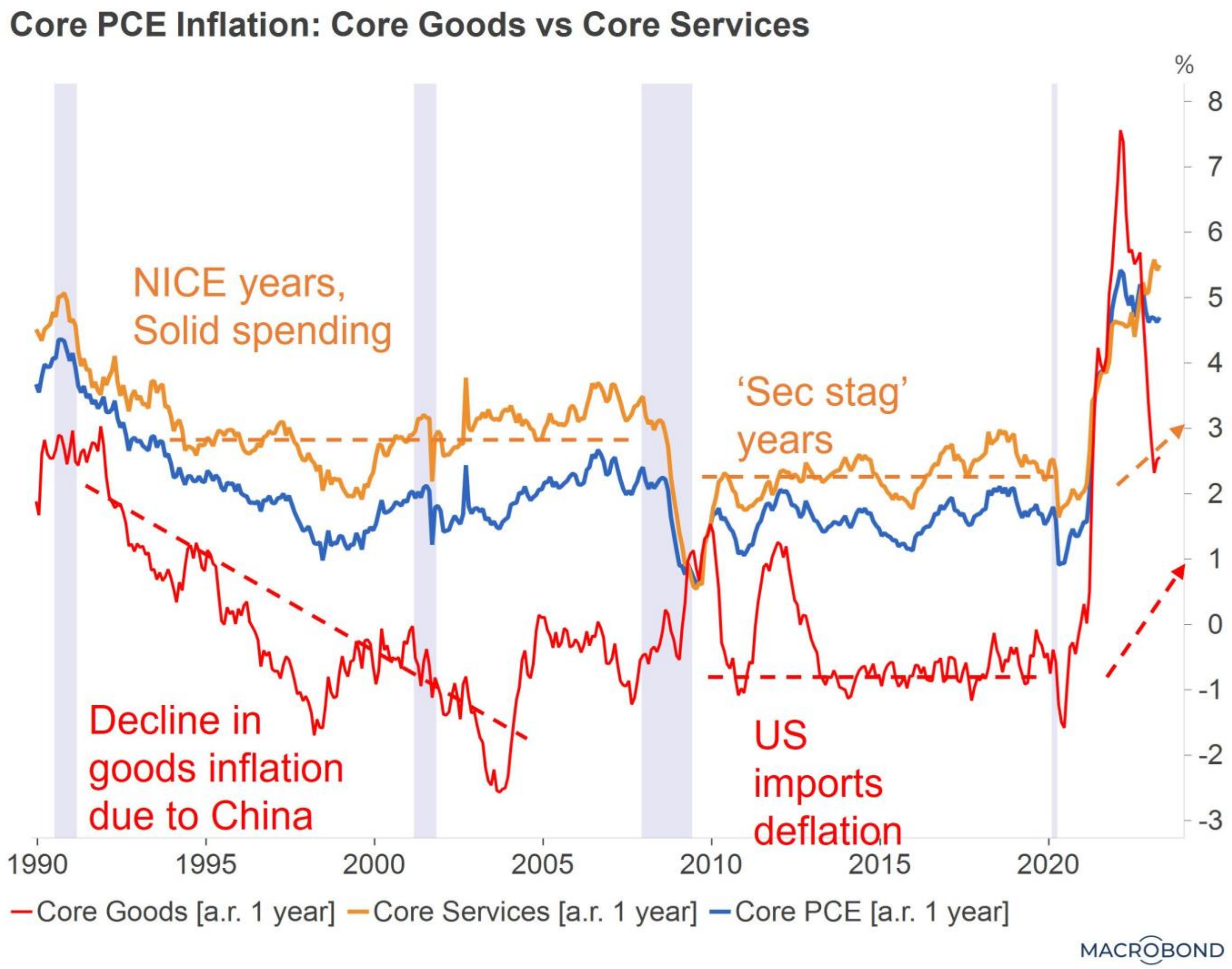
Two Phillips Curves

The Phillips curve for goods inflation is Made in China

- Outlook for deflation in China will determine goods inflation
- Pre-GFC: Rightward shift in AS
- Post-Covid: Leftward shift in AD

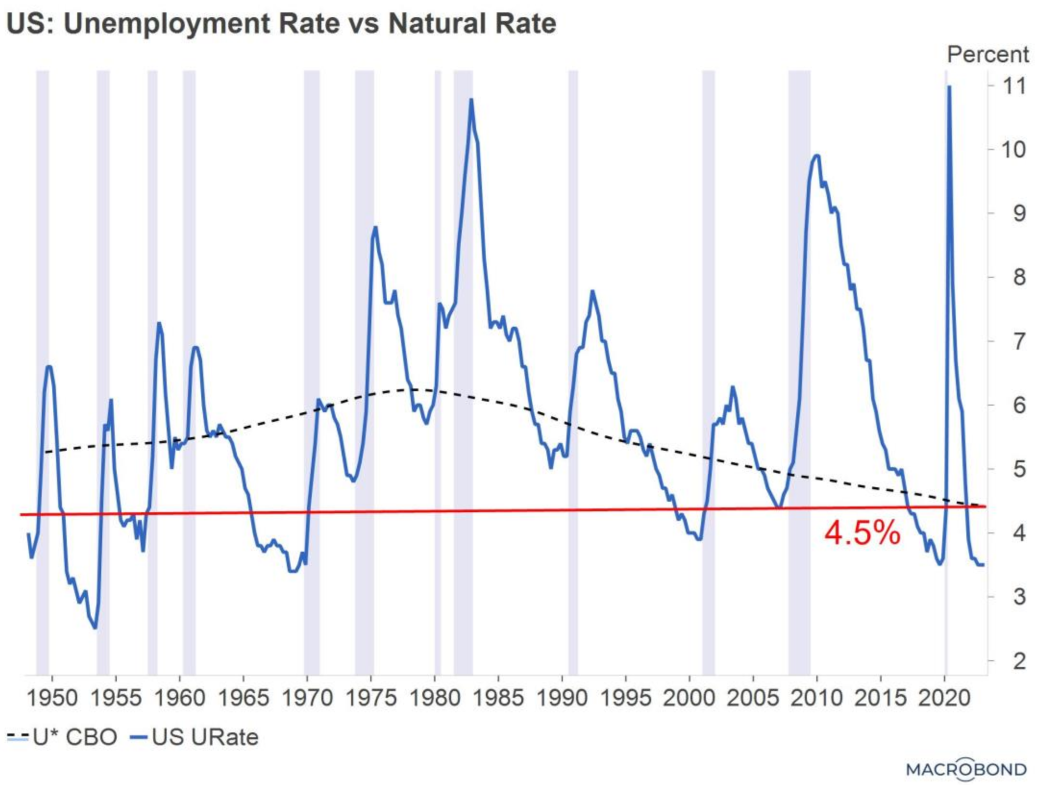
The Phillips curve for services inflation is driven by the US labour market

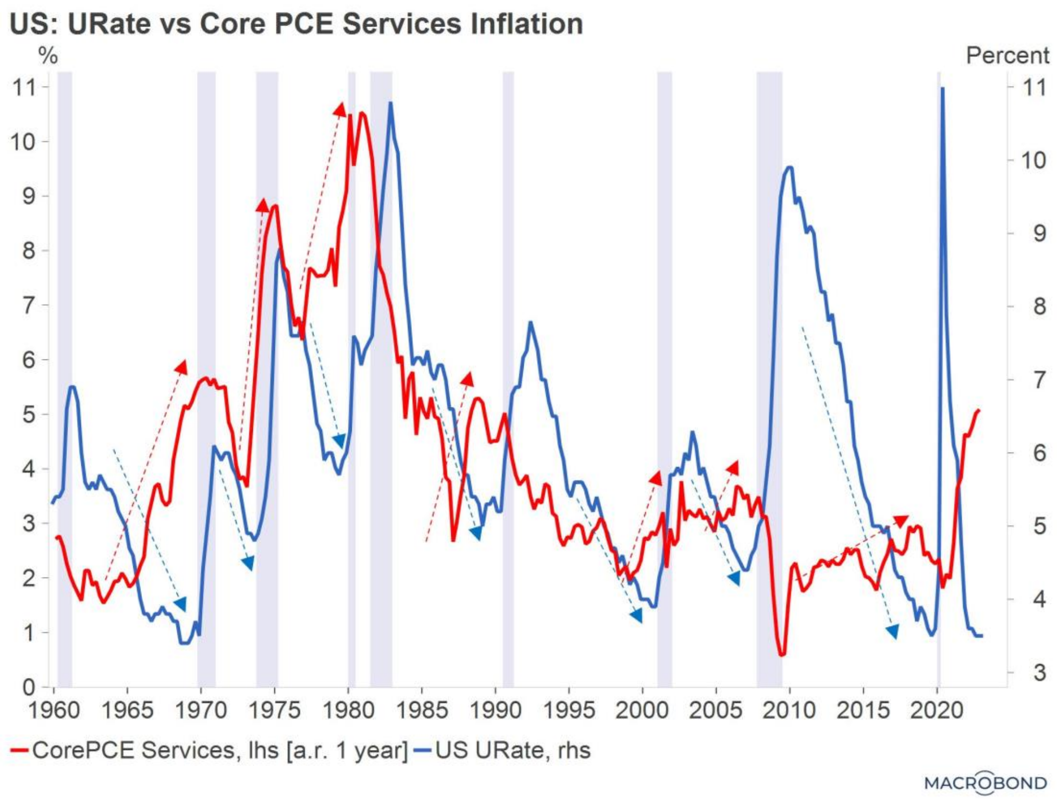
- Core PCE ex-housing is 56% of the core index and some 55-60% of that sub-index depends on wages.
- The exception is the financial sector.



Source: National sources, Haver Analytics, Talking Heads Macro

Central Banks are Taking Risks With the Domestic Phillips Curve





Source: National sources, Haver Analytics, Talking Heads Macro

What Are Labour Markets Telling Us?

Labour markets will tighten much faster in future cycles. Loosening them will require greater economic slack in the future.

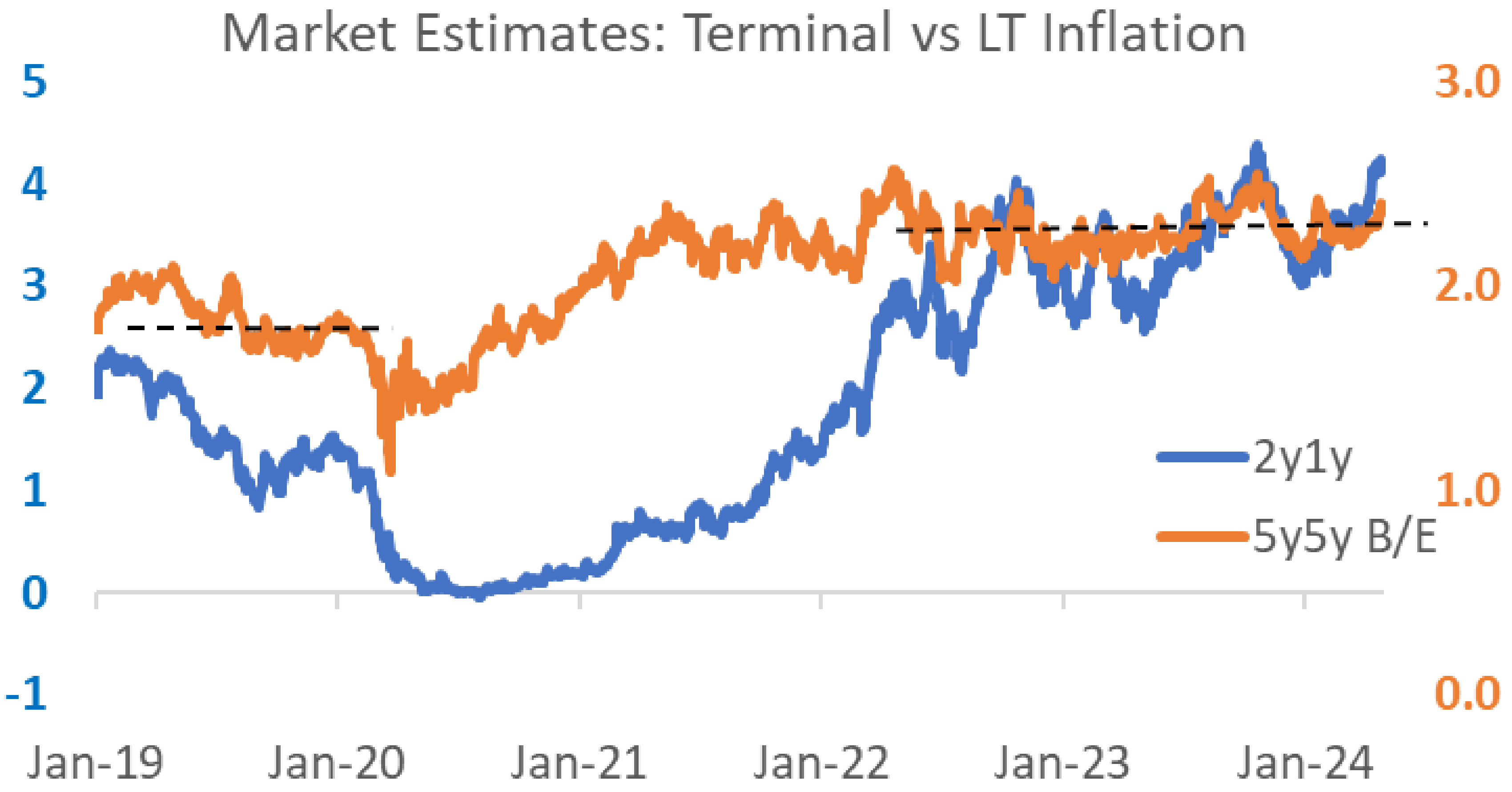
However, demography will drive a wedge between both components of the Debt/GDP ratio. There are thus financial stability limits to how much economic weakness markets will tolerate when it comes to **financing debt**.

Without the structural disinflation forces of demography/China, labour markets and **services inflation** are likely to dominate cycles.

In a slow-motion repeat of the Truss administration, central banks will have to increase their balance sheets to absorb some of the fiscal issuance, while using the short-term rate to affect domestic demand. The result? A sustained increase in both real interest rates and inflation.

Source: National sources, Haver Analytics, Talking Heads Macro

Inflation in the Next Cycle is More Dangerous Than it is Today



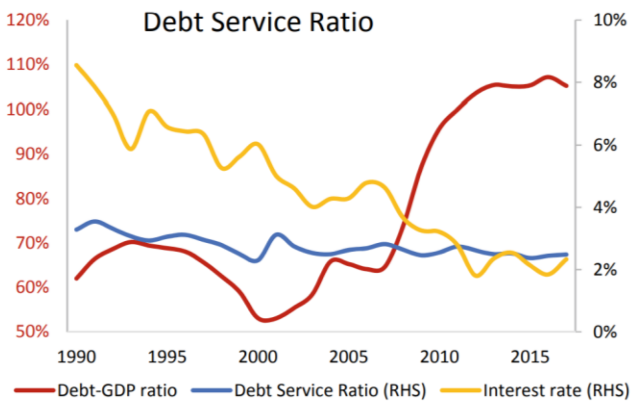
Source: National sources, Haver Analytics, Talking Heads Macro

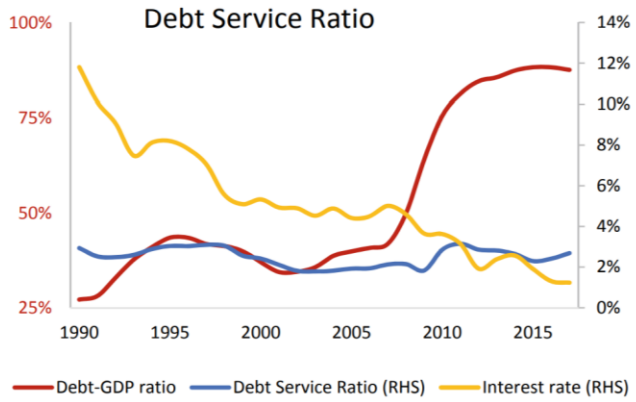
Appendix 1:
Is the US Different From Everywhere Else?

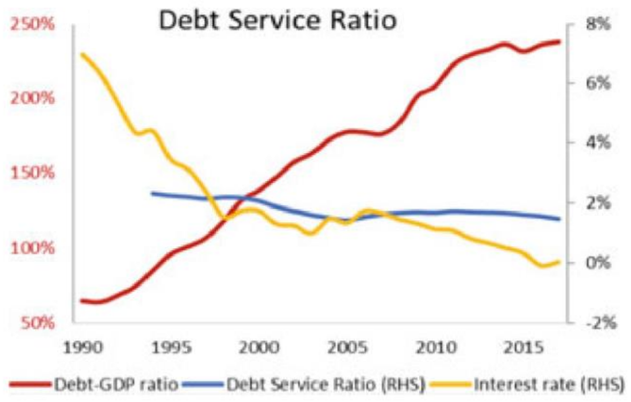
Appendix 2:
Why Didn't It Happen in Japan?

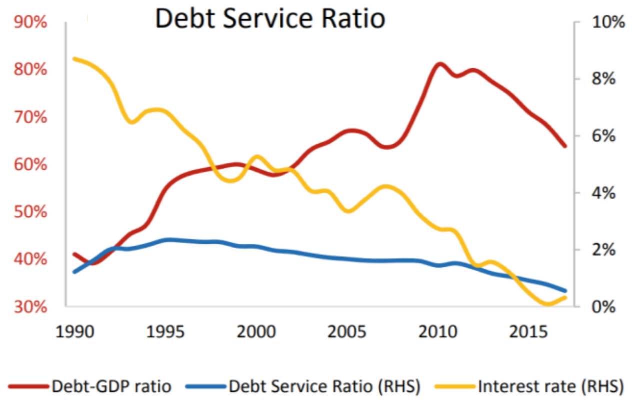
Why Didn’t It Happen in Japan?

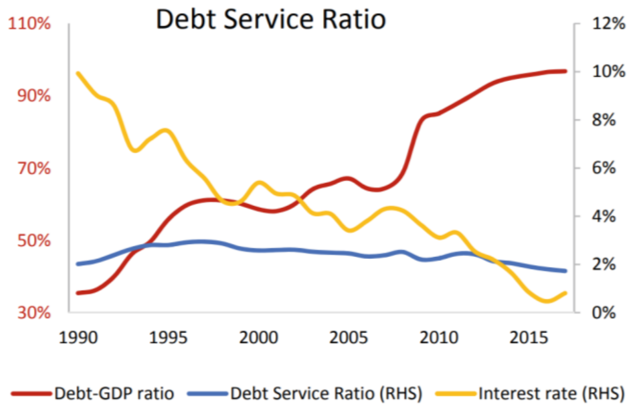
Japan was neither unique, nor resistant to global disinflation and the trend of falling interest rates

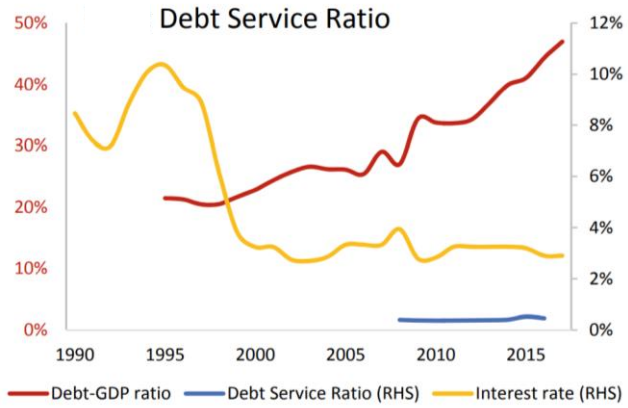










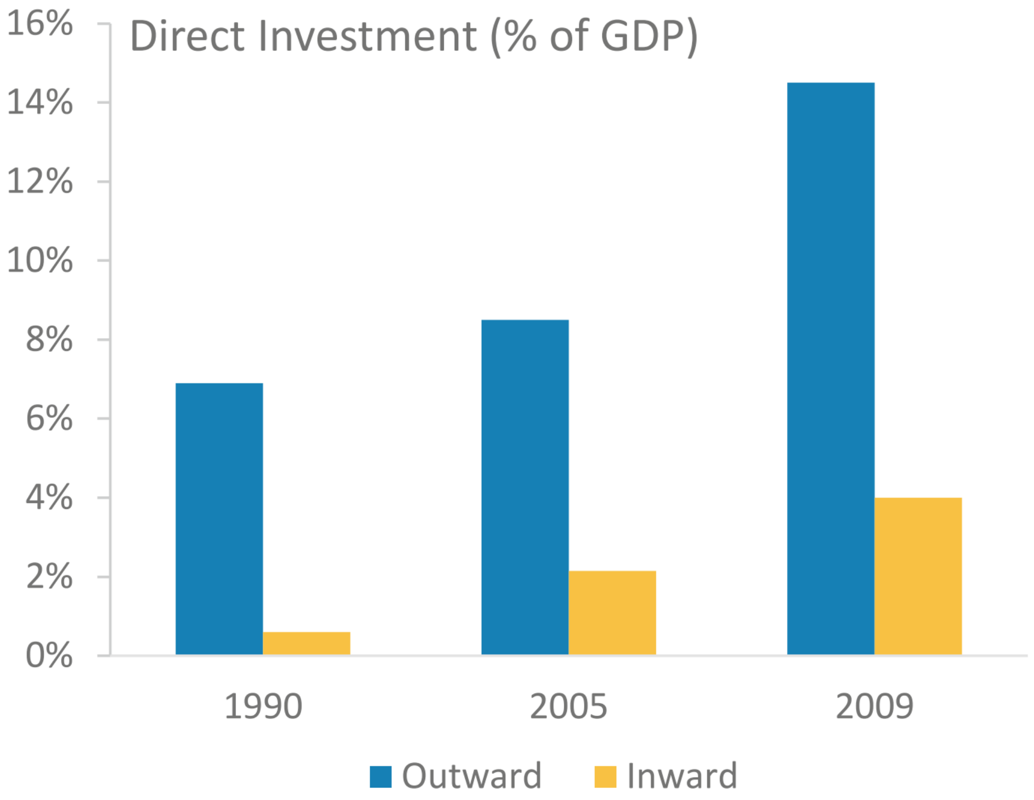


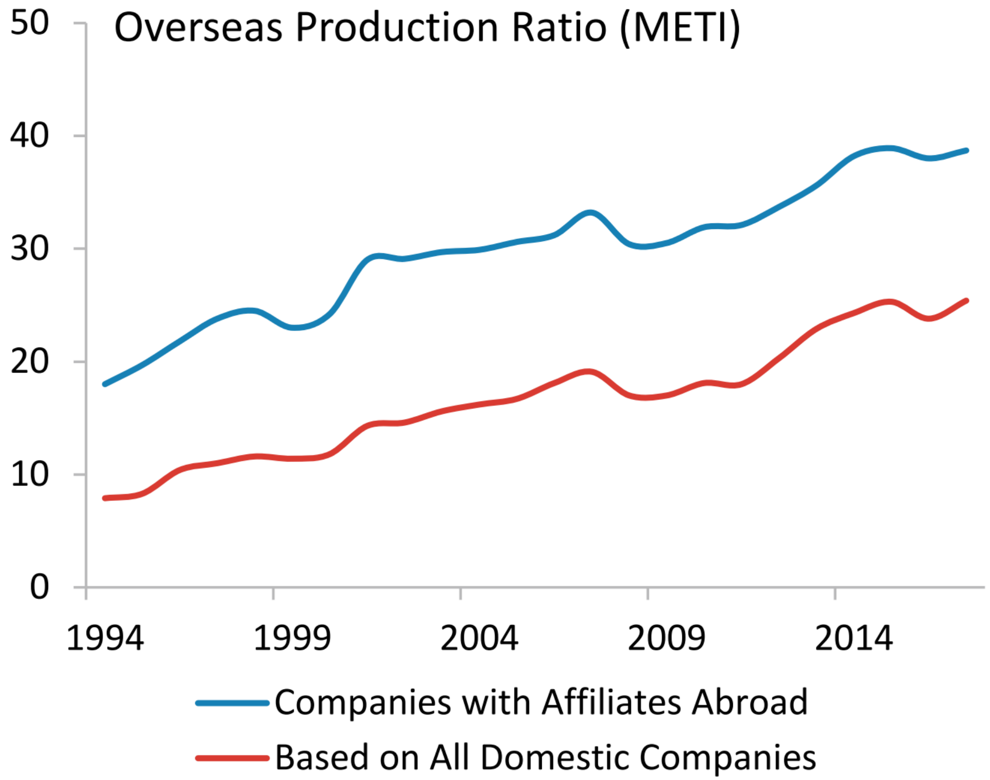
Source: Talking Heads Macro

Japan’s Outbound FDI was an ‘Escape Valve’

Without the global element, Japan demography forced to explain growth, inflation, rates

Corporates understood the global labour supply shock and used Outbound-FDI as a ‘Escape Valve’





Source: Talking Heads Macro

Appendix 2:
Will China Remain Deflationary for longer?

Deflation Deepest When Imbalances Are First Reversed

Mainstream View:
China has long Covid + property downturn due to demography starting now

Our view:
Cyclically: production better protected than consumers
Structurally:
The demographic shock and the hard landing hit policy-makers in '12-'15

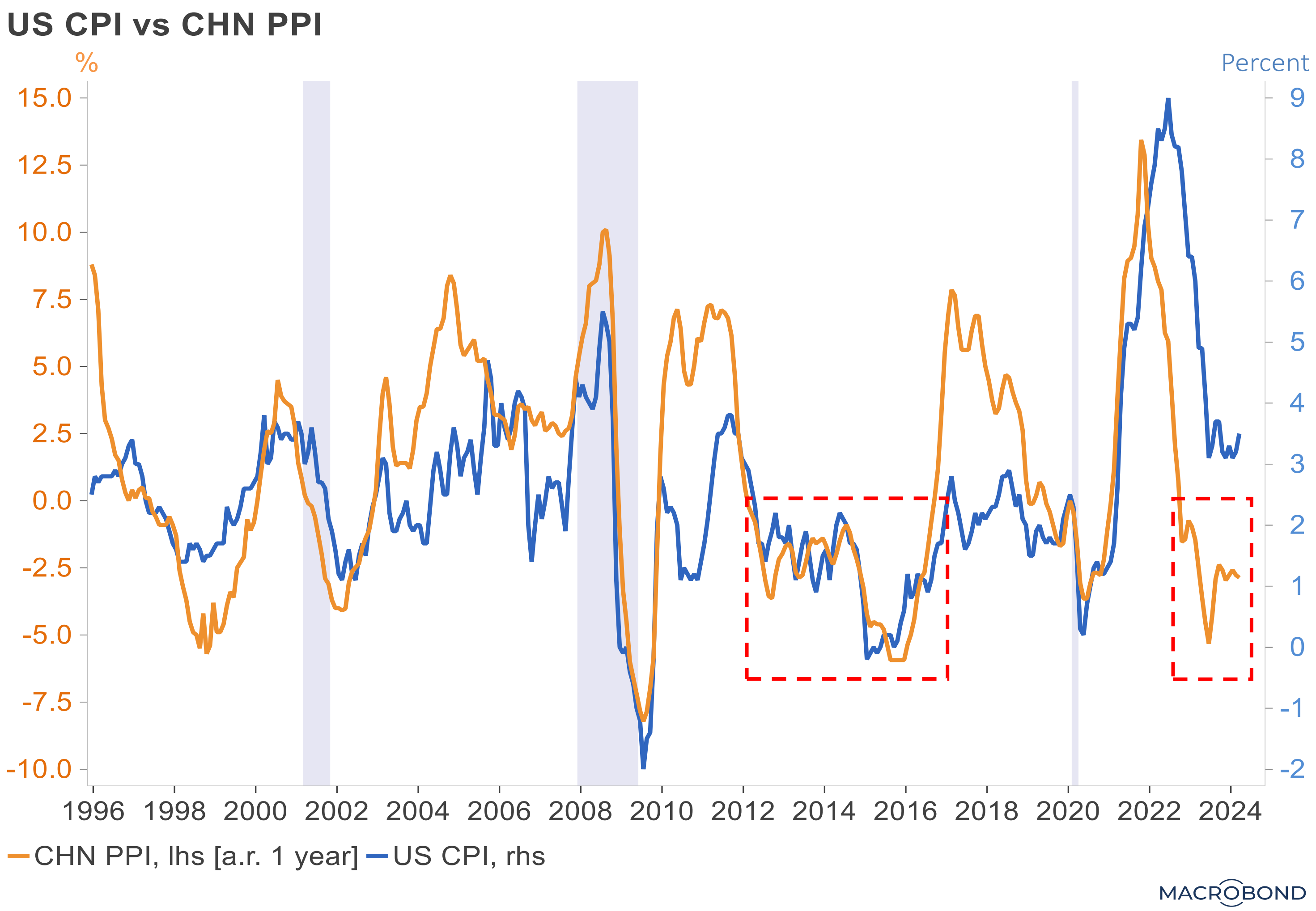
China's Deflation

	Post GFC	Post Pandemic
Starting Point	Hard vs Soft Decoupling	No desire to raise GDP growth
Policy	Massive credit surge in '09 Property bailout in '15	Massive fiscal surge in '20 Three Red Lines by the PBoC
Downturn/ Deflation Triggers	Falling ICOR amidst property + capacity surge	(i) Property, (ii) Protecting production, not consumers
Excess Capacity	Property, steel, coal, chemicals, mfg, cement	Solar (hence US friction), cyclical hit from property
Policy Response	2015 bailout reduces to avoid debt deflation due to excess capacity	Incremental. Secondary housing, box office, travel flourishing
Global Spillover	Crisis in Russia and oil markets Brazil, Norway, Canada suffered India, Turkey, Argentina did not	Germany's auto industry

Source: National sources, Haver Analytics, Talking Heads Macro

China's Deflation Is Far More Cyclical Than Structural

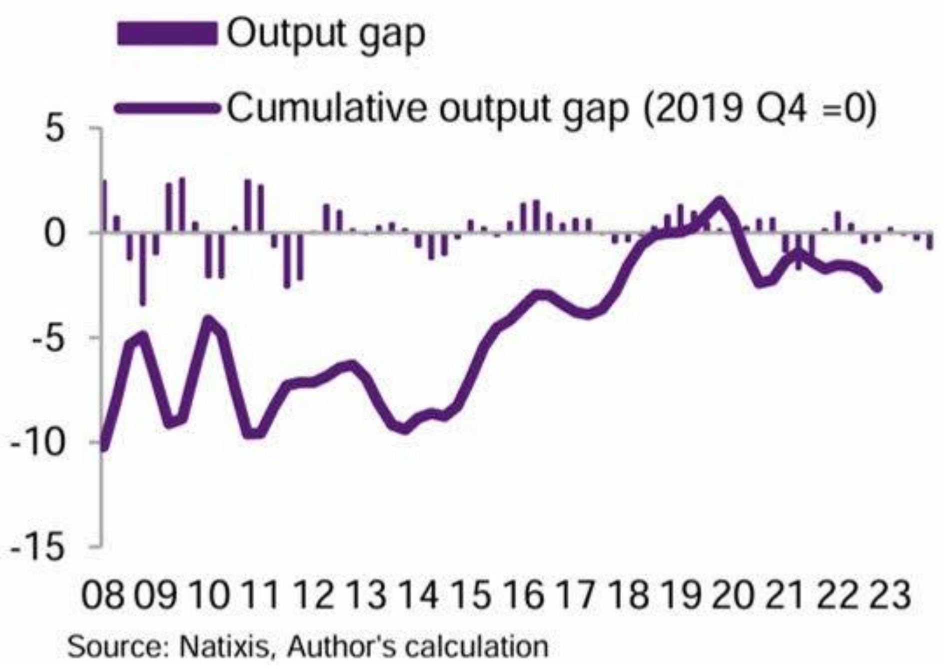
China's administration protected businesses and employment (State Council Report, May 2020) much more than households.



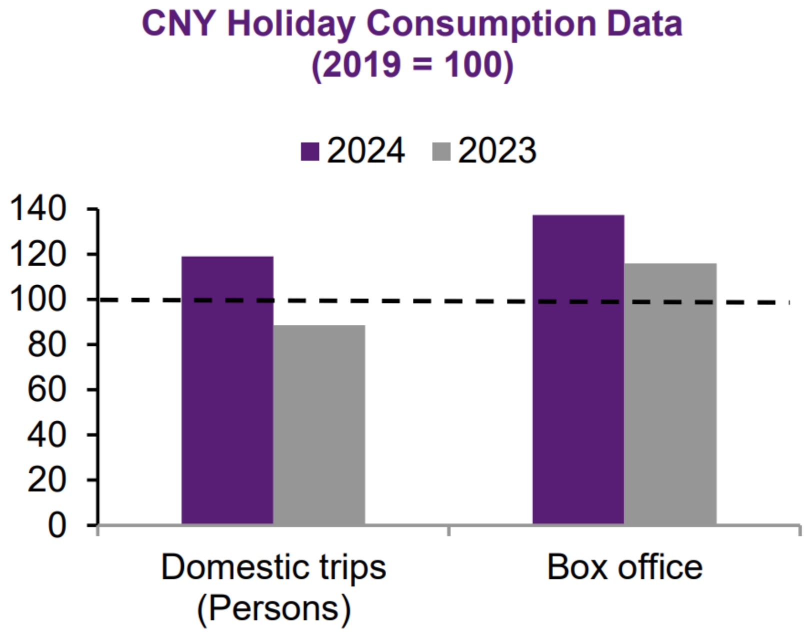
Source: National sources, Haver Analytics, Talking Heads Macro

China Excess Capacity: Greater in ’12-’15

China’s Output Gap: Much Smaller Now



China’s Consumers are Showing Confidence

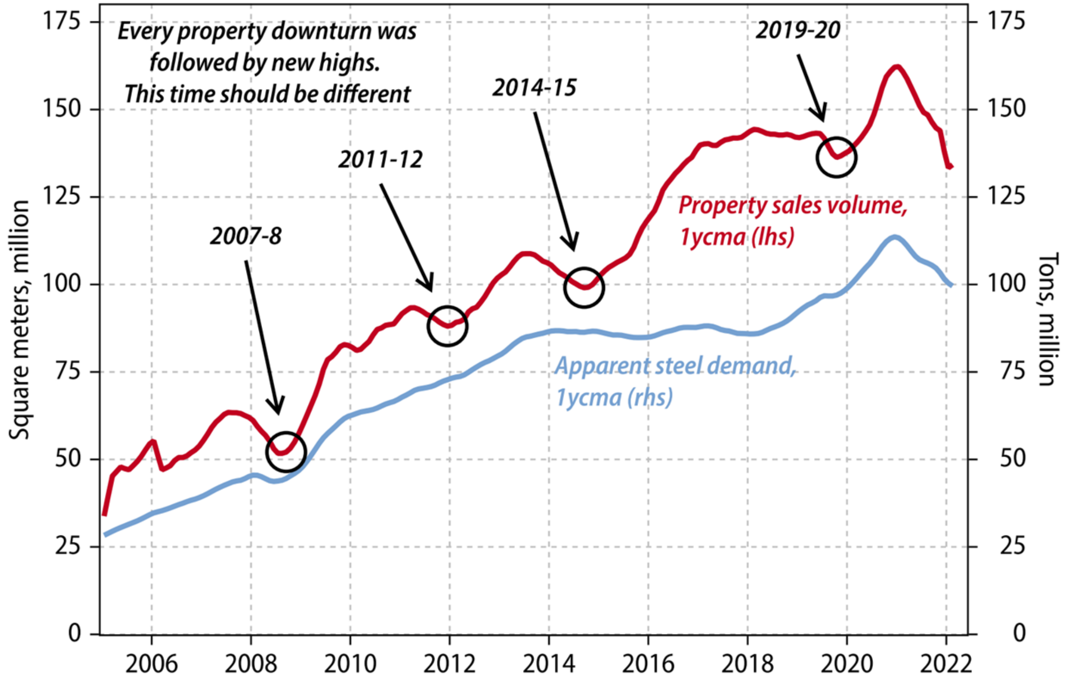


Source: Natixis, News

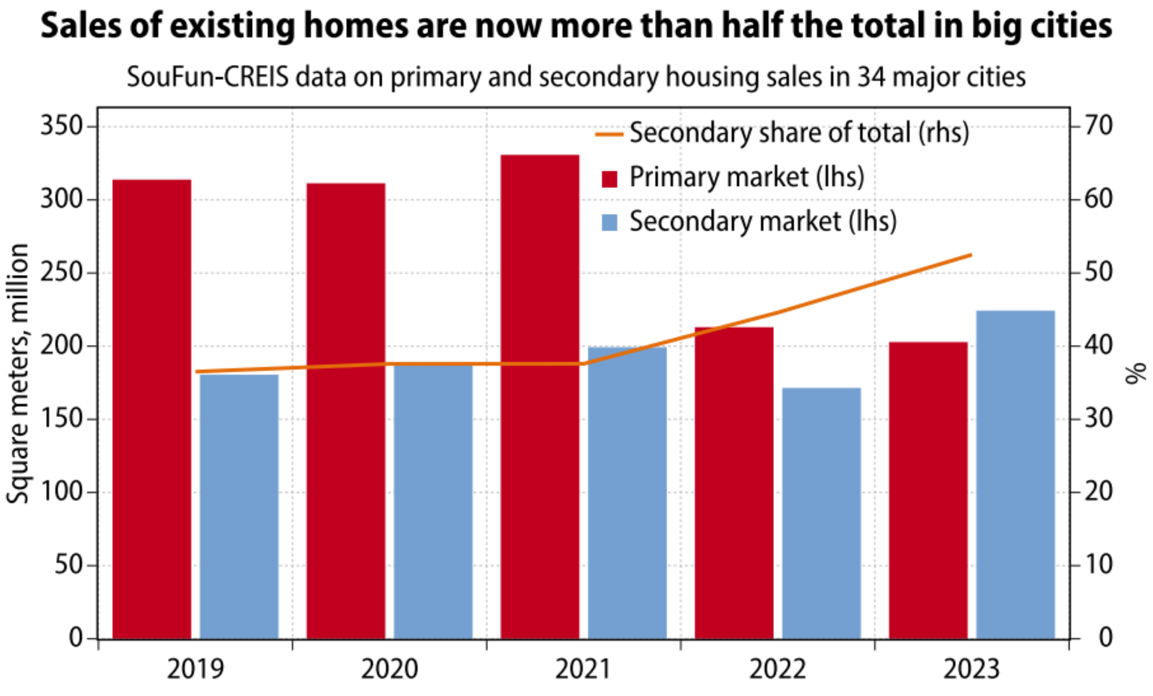
Source: Natixis, When Will China Recover From Its Cyclical Downturn?, 2024

China's Property Downturn: 2012-15 vs Now

China's Property Spillovers vs Mfg Excess Capacity



After the '3 Red Lines', Who Do You Trust?



Source: Gavekal, A Stoey of Two Housing Markets, 2024