Retirement Income
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Higher Rates Won’t Quell This Kind of Inflation: BlackRock

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'Central banks should live with supply-driven inflation, rather than destroy demand and economic activity – provided inflation expectations remain anchored,' write Elga Bartsch and Nicholas Fawcett of BlackRock's Macro Research team.

We are in a new and unusual market regime, underpinned by a new macro landscape where inflation is shaped by supply constraints. Limits on supply have driven the surge in inflation over the past year: a profound change from the decades-long dominance of demand drivers.

This fundamentally changes how we should think about the macro environment and the market implications. The key to understanding the muted response of central banks to inflation is not the timeframe but its cause: supply. Much of the 2021 debate overlooked this.

Two broad types of supply constraint are at play in the economic restart. First, it is easier to bring back demand than production, which is constrained by the weakest link in the supply chain. But another important constraint is the reallocation across sectors due to Covid restrictions: consumer spending has shifted massively towards goods and away from contact-intense services.

This has meant severe bottlenecks in some places and spare capacity in others. Prices tend to rise faster in response to bottlenecks than they tend to fall in response to spare capacity, so this has pushed inflation higher, even though overall economic activity has not fully recovered. Developments at the sector level are shaping the macro picture.

The restart gives a glimpse of how the transition to net-zero emissions will play out: it will be akin to a drawn-out restart. Economy-wide supply limits will bind as energy costs rise. Big shifts across sectors will create supply bottlenecks. Both will add to inflation, as in the restart. A gradual, orderly transition is the least inflationary path, in our view. Whether or not carbon emissions are reduced, we believe climate change will increase inflation.

A rewiring of globalization and population aging in China are reducing the supply of cheap imports from China to developed markets. This will raise costs and force resources to be reallocated in those markets, making supply constraints more common. In addition, geopolitical risks threaten to disrupt energy supply.

A world shaped by supply constraints will bring more macro volatility. Monetary policy cannot stabilize both inflation and growth: it has to choose between them. This is a marked shift in the macro landscape. When inflation was driven by demand, stabilizing inflation also stabilized growth – there was no trade-off.

Central banks should live with supply-driven inflation, rather than destroy demand and economic activity – provided inflation expectations remain anchored. When inflation is the result of sectoral reallocation, accommodating it yields better outcomes, as recent research (Guerrieri et al, 2021) shows. Insisting on stabilizing inflation would lead to an over-tightening of monetary policy, more demand destroyed and a slowing down of the needed sectoral reallocation. Given the persistence of supply constraints over many years, delivering the best outcome might require further adjustments to central banks' inflation-targeting frameworks.

We expect the sum total of rate hikes in this cycle to be low. Central banks will take their foot off the gas to remove stimulus – but they shouldn't go further to fight inflation, in our view. Yet we expect negative bond returns as, faced with inflation volatility in this environment, investors question – as they have in recent weeks – the perceived safety of holding longer-term government bonds at historically low yield levels.

The primary risk we see is that central banks hit the brakes by raising rates to restrictive levels. As in recent weeks, we can expect markets to price some of this at points, as they adapt to the new macro landscape. But if central banks do go ahead and hit the brakes, they will likely learn that the damage to growth to get inflation down is too great and will be forced to reverse course – flattening or even inverting yield curves.