Global Macro Research - Insight

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Has the global economy entered a structurally more volatile inflation regime?

Whatever the near-term path of inflation, increasingly frequent negative supply shocks mean the global economy has likely entered a new regime of structurally higher inflation volatility. This would likely push up risk premia and challenge standard portfolio diversification strategies.

Key Takeaways

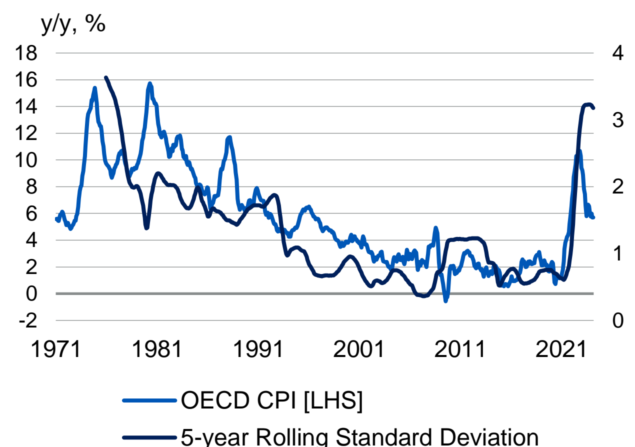
- We think the longer-term inflation regime will be one of structurally higher inflation volatility, and central banks more frequently needing to bring inflation back to target from above rather than below.
- This is because, in contrast to the period from 1990 to the start of the pandemic, the global economy is more likely to be hit by negative supply-side shocks. These push growth down and inflation up, creating a difficult trade-off for policymakers.
- In particular, the geopolitical environment is becoming more challenging, aspects of globalisation are heading into reverse, climate change may put upwards pressure on food and energy prices, and scientific consensus suggests future pandemic risks have increased.
- Moreover, greater political interference, the large increase in government debt, and a growing focus on central banks' ESG goals, may hinder central banks' ability to focus on price stability.
- Higher inflation volatility may push up discount rates, as investors require higher expected returns to compensate for more uncertainty about the future.
- Supply shocks – even positive ones of the sort that may come from AI – tend to be associated with a positive bond/equity correlation, making portfolio diversification more challenging.

Higher inflation volatility is here to stay

Following the post-pandemic overshoot, inflation declined rapidly almost everywhere over the second half of 2023. The start of 2024 has seen a number of stronger prints, re-igniting concerns about a "difficult last mile" of bringing inflation back to target.

Regardless of cyclical questions about the course of inflation, we think the longer-term regime will be one of higher inflation volatility (see Figure 1).

Figure 1: Inflation volatility remains high even as inflation is now falling



Source: Haver, abrdn, April 2024

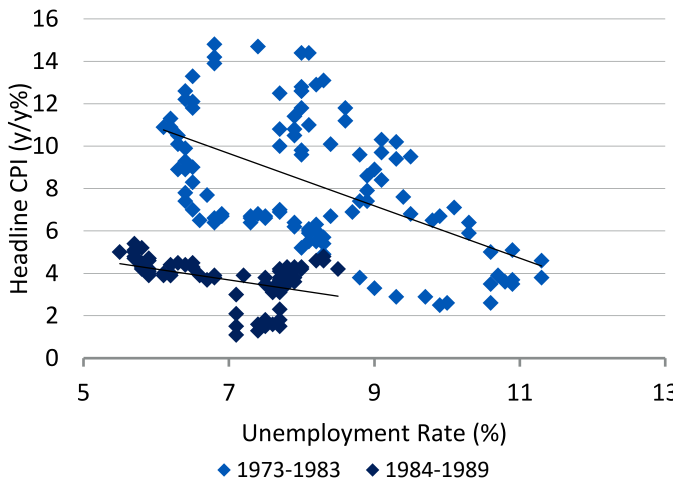
Inflation has gone through regime changes before

Inflation has tended to move in regimes over long periods of time. These are determined by the nature of shocks hitting the economy, and the policy institutions that mediate these shocks.

The 1970s was a regime of high and volatile inflation. The global economy was hit by a series of oil price shocks, while the post-Bretton Woods system of monetary policy was unable to provide a credible nominal anchor that grounded inflation expectations.

Paul Volker's term as Federal Reserve (Fed) Chair between 1979 and 1987 showed that a committed central bank could squeeze out inflation, albeit at the cost of temporarily increasing unemployment. Having established their inflation fighting credibility, policymakers then faced a more favourable trade-off between growth and inflation (see Figure 2) as inflation expectations were better anchored.

Figure 2: Re-anchoring inflation expectations shifted the Phillips curve inwards



Source: Haver, abrdn, April 2024

From the post-Volker era through to the 2008 financial crisis, the global economy experienced a regime of low and stable inflation, amid a series of positive supply-side shocks.

Globalisation accelerated with the fall of the Soviet Union, China joining the global economy, the formation and expansion of the European single market, and a broad decline in global tariff levels. IT boosted productivity growth, and the internet increased price transparency. Meanwhile, de-unionisation reduced the bargaining power of labour and de-regulation increased the contestability of markets by lowering barriers to entry.

At the same time, an increasing number of central banks became independent and explicitly inflation-targeting, with monetary policy no longer influenced by the political cycle.

Following the global financial crisis (GFC), the economy entered a new inflation regime, characterised by systematically undershooting the inflation target. The economy suffered the after-effects of an enormous negative demand shock, and central banks struggled to raise inflation given institutional limits on how accommodative monetary policy could be set.

More negative supply shocks mean higher inflation volatility

We think the global economy has now shifted into a new regime, which will be characterised by high inflation volatility and central banks frequently needing to bring inflation to target from above rather than below. This is likely to see the mean of inflation somewhat above 2% even if the mode is 2% because central banks can in the end bring inflation down to target. But the most important feature from an economic and market perspective is likely to be higher inflation volatility.

The key reason for this is an increasing propensity to negative supply-side shocks. These are shocks that push up on inflation and down on growth. They are more difficult for central banks to navigate than demand shocks, because of the absence of the "divine coincidence" that allows the inflation and growth objectives (whether explicitly or implicitly targeted) to be met at the same time. Instead, when inflation rises but growth falls, central banks must prioritise either bringing inflation back to target or output stabilisation.

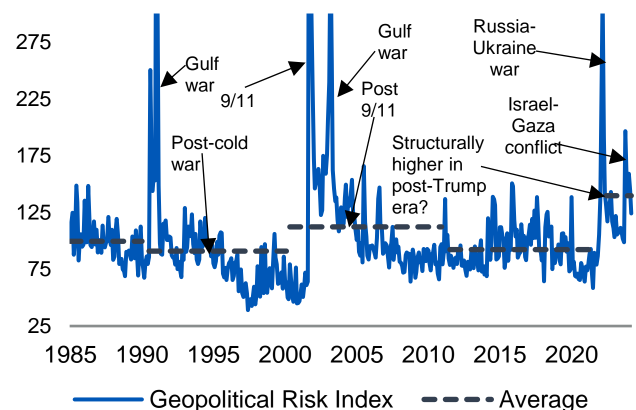
Different central banks may have different – and time-varying – preferences about how this trade-off should be handled, making it more difficult to predict how monetary policy will respond. Higher uncertainty about the path of policy may in turn exacerbate uncertainty about inflation, further increasing its volatility as expectations are less well anchored.

Increasing negative supply-side shocks may come from geopolitical volatility, climate change, and future pandemics.

1. Geopolitical challenges and stalling globalisation

Geopolitical risk may have moved structurally higher (see Figure 3) because of increasing great-power competition especially between the US and China, Russian revanchism, and the rise of non-state actors.

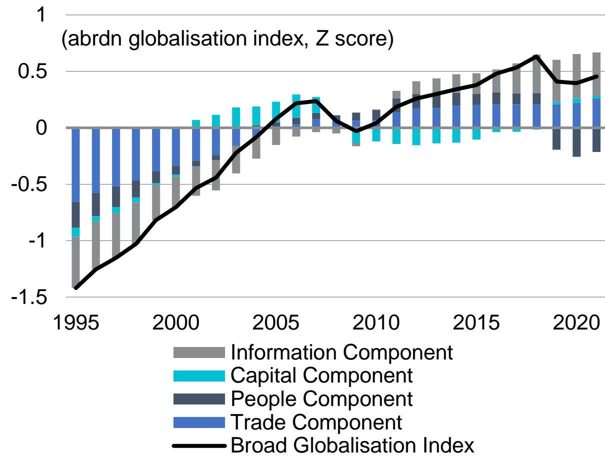
Figure 3: Geopolitical risk may be moving higher



Source: Caldara and Lacoviello (2024), abrdn, April 2024

In addition, some aspects of globalisation have stalled or gone into reverse (see Figure 4). While this process started during the GFC, the shortening and reorientation of supply chains has increased recently.

Figure 4: Some aspects of globalisation have stalled or headed into reverse



Source: Haver, abrdn, April 2024

Re-engineering supply chains for resilience is itself a response to supply-side shocks, and in time may help blunt those shocks. And building out domestic production capacity for strategic industries such as chips could even lead to global excess supply, which would push down on prices and inflation.

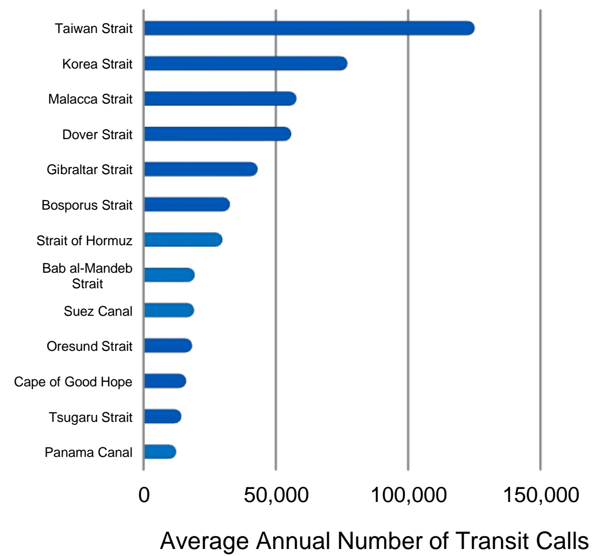
However, this process could come at the cost of efficiency and potential growth, while the period of transition is itself a negative supply shock. Excess productive capacity may also be a source of trade disputes, as countries seek to protect domestic industries from other countries "dumping" this output. This may already be happening with Chinese solar panels and electric vehicles.

Relatedly, several major supply-chain chokepoints are in geopolitically fraught parts of the world. For example, cutting-edge microchip production in Taiwan, rare earth metals from China, and maritime container freight through various contested waters (see Figure 5). Disruption to these supply routes – as occurred with Russian gas supply to Europe following the invasion of Ukraine – could have significant inflationary consequences.

At the same time, domestic politics in several important economies has taken a more populist direction over the past decade.

This may have ushered in a political economy less focused on market efficiency. For example, Brexit was a large negative supply shock arising from shifting domestic political preferences.

Figure 5: Some of the most important maritime chokepoints are in geopolitically fraught locations



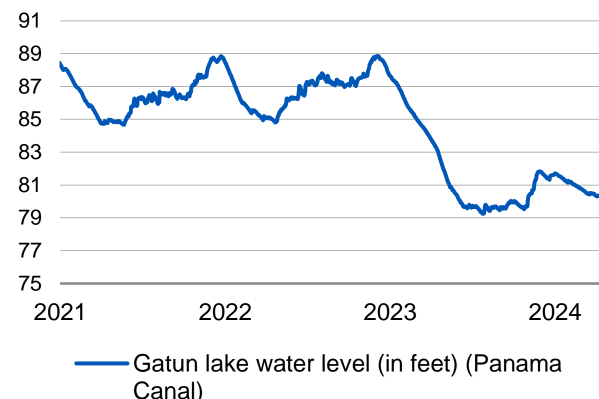
Source: Haver, abrdn, April 2024

2. Climate change

Physical climate risks, such as rising temperatures and extreme weather, including more frequent and powerful El Nino events, may cause more regular drought and reduce agricultural production. This could put upwards pressure on global food prices.

Droughts also appear to be leading to more frequent supply-chain disruptions in recent years, by lowering the level of certain important rivers that are crucial to manufacturing and trade flows. This includes the Rhine in Germany, the Panama Canal in Central America, and the Yangtze in China (see Figure 6).

Figure 6: Droughts are affecting the level of waterways crucial to the global economy



Source: Haver, abrdn, April 2024

Negative supply shocks may also arise from transition risks and government policy. For example, carbon taxes, especially in the presence of short-term inelastic energy demand and supply, may be inflationary.

3. Pandemics

Finally, pandemics could be a meaningful if difficult-to-predict source of negative supply shocks. Following Covid, scientific consensus seems to be that zoonotic diseases or other public health challenges such as widespread anti-biotic resistance are a growing risk.

Could AI push in the opposite direction?

On the other hand, the artificial intelligence (AI) revolution could be a large positive supply-side shock that pushes growth higher and inflation lower. Over the medium term, central banks might find it easier to hit their inflation targets because higher productivity growth would increase equilibrium interest rates and give policymakers more space to adjust policy before running into lower-bound constraints.

That said, while we don't want to imply that all future supply-side shocks will be negative, the majority of them probably will be.

The institutional framework may also be shifting

The institutional setup of central banks may also be shifting in a direction that, at the margin, hinders their ability to deliver price stability.

The inflation overshoot of the pandemic has increased political pressure on some central banks and reduced de-facto independence. Moreover, the large rise in government debt in response to the pandemic may have increased the risk of fiscal dominance, with central banks under pressure to prioritise government financing needs over price stability.

The potential re-election of Donald Trump could increase political pressure on the US Fed specifically. During his first term Trump was outspoken on monetary policy and he may attempt to shift it in ways that help him politically.

Finally, some central banks are increasingly concerned with ESG objectives. While we have argued that, in certain cases, this is appropriate given the stakes, adding objectives to central bank mandates increases the risk that price stability will be deprioritised when objectives come into conflict.

The risk premium is likely to rise

What does this mean for markets? Higher inflation volatility means investors should be less confident about the real value of future cash-flow streams that any particular investment will deliver.

To compensate for this increased uncertainty, expected returns may need to be higher – all else equal – to incentivise investment projects. In other words, discount rates would be higher, putting downward pressure on asset prices as they adjust to deliver a higher risk premium.

Diversification may become more difficult

Moreover, a preponderance of supply shocks over demand shocks could shift the correlation structure between bonds and equities that existed for much of the last 30 years.

Because demand shocks push growth and inflation in the same direction, they tend to push bond and equity prices in different directions: risk assets and bond yields will typically rise when the economy is strong and decline when it is weak.

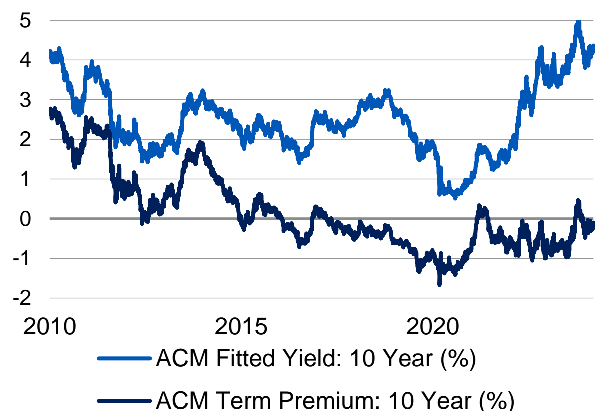
This negative correlation has diversification benefits when constructing a portfolio. In a portfolio of bonds and equities, one asset will tend to perform well when the other part is performing poorly. This is the logic behind 60/40 equity/bond portfolios.

However, supply-side shocks push growth and inflation in different directions and so tend to push bond and equity prices in the same direction.

Positive correlation between bonds and equities undermines standard portfolio diversification and may require a wider range of asset classes to be held to deliver desired portfolio characteristics.

The combination of higher inflation volatility pushing up risk premia in general, and the fact that bonds would be less attractive as a portfolio hedge, means that the bond term premia may have to increase further to incentivise investors to hold duration risk (see Figure 7).

Figure 7: The bond term premium may increase in response to higher inflation volatility



Source: Haver, abrdn, April 2024

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