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Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.

Global Risk Watch Newsletter

The Consequences of "stagnant prices", etc.

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1. Overview Macroeconomic and Financial Risks (Trends & Topics)

 # The Consequences of "stagnant prices" (Tsuyoshi Oyama, Partner/Head of Center for Risk Management Strategy (CRMS) at Deloitte Touche Tohmatsu LLC/Deloitte Asia Pacific Risk and Capital Management Leader)

The stock market remains as strong as ever despite some sporadic uneasiness emerging like the sign of major correction. Also, 3Q GDP growth in the US, EU and even Japan outperformed their potential growth rates by a large margin. In China while the gradual deceleration of GDP growth continues, the growth rate itself remains robust thanks to strong consumer spending as well as investments into infrastructure and labour saving devices. In this environment, one of the largest contributors to the current goldilocks situation in asset markets could be the lack of any signal that prices are about to rise. In the US and EU, just when we would expect to see consumer prices pick up, they are in fact on a decelerating trend. In Japan, core CPI finally rose to 0.7% but once energy costs are taken out of the mix core CPI trends flat. In fact there are worries that in next year prices will once again begin to tumble.

So, how should we think about current low prices and yet still buoyant economy? It's certainly not a bad thing that a tightening labour market is accompanied by stagnant price rise and low interest rates, and consequent strong stock prices. The problem is instead whether or not this situation can actually continue over the long term. A strong economy, low interest rates/prices, and a high stock values are simply not things which normally coexist. Usually, a strong economy invites a tight labour market which pushes wages higher. This in turn puts upward pressure on prices. Expectations of inflation and monetary tightening from central banks leads to rate rises which finally marks a turning point for the economy in question. Most developed economies can pass the first critical test of the above domino effect – namely they succeeded in boosting leading to a tight labour market. However, they will struggle to pass the second major one: a tight labour market leading to rising wages.

For example, if globalization and technological innovation precipitate a shift from high to low wages, no matter how tight the labour market gets wages may not raise commensurately. In other words, a large section of the middle tranche of the private sector wage pyramid shifts towards the lower tranche, resulting in the rapidly expanding bottom tranche. While this phenomenon may temporarily invite a strong market and low prices, the shift of labour from high wages to lower ones ultimately has to stop somewhere.

As well, in the case that the owners of capital rather than labourers themselves who enjoy the lion’s share of the fruits of technological innovation and its increased efficiency, it may be possible for a strong economy and low prices to coexist temporarily. We have also recently observed the view that the success of superstar companies like Apple, Facebook, and Microsoft are inviting cuts into labour’s share of income, implying that the remarkable growth of these companies has not resulted in the creation of “new demand” based upon their innovations. Rather, they have just stolen “existing demand” from other less efficient companies.

If it is really the case, the current situation cannot continue indefinitely. It is instead more natural to think that at some point either prices will rise or that the economic situation and corporate earnings will worsen because of stagnation in demand. The big question is when such a thing will eventually occur.