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ECONOMIC INSIGHT

Speculating on the "new normal" in the post-pandemic global economy

Everyone is making plans for the "new normal." But what will that look like?

When the pandemic started, we imagined an economy that could be stopped and then simply restarted, perhaps six months later. Now, we are approaching two years in semi-lockdown and the economy has evolved in many important ways. Restarting it is not like starting a train where everything is connected and must follow, perfectly spaced. It is more like getting a group of young children to play their appropriate positions in a soccer game.

As it turns out, restarting an economy is far harder than stopping it. Think about the refrigerator in your kitchen. It may be assembled in Mexico, the U.S. or in Canada, but it has components from many more countries than that. Those pieces are embedded in a complex inventory system, a global supply chain that is only as strong as its weakest link. If the factory that makes the plastic drawers for fruits and vegetables must close for four weeks due to the COVID-19 pandemic, or the factory that makes the computer chip that reminds you to change the air filter closes a couple of weeks later, those parts simply do not arrive when needed (if at all).

The refrigerator assembly operation builds some partial fridges and stacks them in inventory, but then it shuts down too. Suddenly, all the freighters show up with orders for parts placed long ago and the ports cannot handle the volume. In other words, we get congestion – a traffic jam – very similar to what you could encounter on your (pre-pandemic) daily commute because of an accident on the expressway. A short delay is nothing, but if you miss a key meeting that morning and your colleague steps up in your place, you might miss out on that big promotion you were counting on. Apparently minor hiccups become potentially life-altering.

There is more than one factory in the world that can make plastic bins for refrigerators, of course. Some are more expensive than others and there are quality variances. But there are legal contracts out there that hold the supply chain together and limit how quickly a purchaser can pivot to a new supplier. In addition, the other factories are encountering similar issues anyway. These supply systems cannot be turned on a dime. Meanwhile, a favourite activity for homeowners during the pandemic was to renovate their kitchens, replacing the refrigerator in the process. The result of high demand and a stalled supply chain is that refrigerators have become scarce, competition is reduced and the price of refrigerators has increased. Refrigerators are only one example.

Anecdotally, inflation has taken off as a result of supply chain disruptions across a wide range of products. Notwithstanding public statements that inflation is expected to be transitory, people are wondering if inflation will be permanently higher as a consequence. News feeds are filled with inflation angst, as one specific item after another is discovered to carry a much higher price than before. Some of the higher prices are for inputs that will spread throughout the economy. The inflation angst is reinforced by news that wages are rising, too, because of worker shortages.

As with all things in economics, there is some truth to all of this. However, the economy is far more complicated than it seems at first blush. If the price of a refrigerator rises by 5% because the manufacturer moves to a domestic supplier to obtain a more reliable supply of plastic bins, what would cause the price to go up a further 5% the following year? If the underlying logistics problems are solved, where would the pressure for another up-cycle in prices come from? A higher price for an item is not the same as ongoing price inflation, which repeats year after year. We have every reason to believe that, as the traffic jams in the global supply chain ease, competitive forces between suppliers will return, and prices will eventually stop rising. Indeed, because suppliers compete for this business, those prices are likely to fall back down to previous levels when stresses in the system have been relieved.

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Furthermore, people have renovated their kitchens and bought many goods during the pandemic, while hardly buying any clothing or restaurant meals or hotel rooms or airfares. As economies reopen on the back of vaccination rates and vaccination passport systems, household demand will shift away from household goods to clothing and previously restricted services, like travel. This shift will relieve pressure on the global system of goods production and shift it to airports and restaurants.

Also, a lot of prices fell during the pandemic. Prices for hotel rooms, airfares, oil and gasoline, and many other goods declined. That was not deflation, nor is it inflation when those prices start to return to more normal levels, which energy prices have done, with a vengeance. In Canada, the level of the total consumer price index is about 4% higher than it was before the pandemic. Excluding energy products, which are notoriously volatile and therefore usually omitted to discern the trend in inflation, the index is just over 3% higher. This is the cumulative rise in prices over some 20 months, not 12 months. Because prices fell before rising again, the average 12-month inflation trend has not really gone significantly above 2% since the pandemic began. It may still do so, but probably only while these supply chain stresses sort themselves out.

The uncertainty around future inflation is as high as it has been since the 1970s, given that there are so many forces pulling inflation in opposite directions. Demand has remained strong, supplies have encountered constraints, labour force participation is in flux, while companies are deploying new cost-saving technology everywhere. The net effect of all these forces will be a challenge to judge, but the situation seems to be well in hand, so far. If a policy mistake is made in the months ahead and inflation does get a foothold in the global economy, central banks have more than enough tools to restore a low-inflation environment in subsequent years; interest rates would simply be raised sufficiently to slow the economy and relieve the inflation pressures. In economic parlance, calling a rise in inflation "temporary" implies a judgment that inflation will return to normal, more or less by itself. But that temporary rise could still last a year or more, simply because of the way inflation rates are usually calculated.

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In other respects, life has surely changed forever. Working from home has worked well for wide swaths of businesses, and new hybrid work arrangements appear to be becoming the norm. Consequently, there will be far fewer commuters into downtown cores on any given workday. There will be adverse implications for secondary businesses that rely on foot traffic in downtown cores, from coffee shops to bars and restaurants to dry cleaners.

At the same time, companies have found it necessary to move quickly to develop more efficient customer-facing systems, many based on AI, to cope with the pandemic. This accelerated deployment of new technology will speed up the displacement of some workers, while creating new jobs for workers versed in systems development and maintenance. Moreover, governments have stepped up their greening of the economy, with implications for workers in high-emissions sectors.

In other words, the "K-shaped economy" that emerged during the pandemic will continue in the years ahead, with the economy and jobs growing rapidly in some sectors and stagnating or contracting in others. Meanwhile, the pandemic revealed that the most essential workers in our daily lives are also the least well paid. Workers and firms alike have come to this realization and pockets of wage pressures are emerging. Some workers have already migrated to better-paying jobs in the top part of the K, while others have been taking advantage of the shutdowns to upgrade their education with the intention of doing so. Still others may have decided that the risks associated with customer-facing roles merit higher wages. This was especially true when government assistance programs put a floor under incomes. The result of this unusual combination has been widespread labour shortages, and a shift in market power from employer to employee. The aging of the workforce will cause this power shift to continue for the foreseeable future.

The bottom line? The economy is experiencing several major shifts all at once and no one can truly appreciate how things will look once the dust settles. At this time, we can only speculate on what the "new normal" will look like. Some of what we are observing will ultimately prove temporary (such as inflationary pressures), but much (including hybrid and remote working) will surely be permanent. The main takeaway for companies should be that business uncertainty will remain elevated in the years ahead. Accordingly, the active management of a wider range of business risks will be of growing importance to corporate performance.

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