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IN RESPONSE TO INFLATION, WE MUST BE BOLD AND OPTIMISTIC!

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Inflation should ease considerably in Europe starting in September. Does that mean we should expect it to swiftly return to where it was before the pandemic, and stay there? Probably not.

After being denied, played down, and then considered only "transitory", inflation is undeniably back. And even though expectations are for it to ease to 2.0–2.5% in the next 18 months, based on the prices of inflation-linked assets, the alternative scenario – one of inflation that's here to stay – is entirely possible.

This view is based on shifts we're seeing in structural trends in the areas of demographics, global trade, and prices at online retailers. While these trends had fuelled a decades-long period of disinflation, they're now showing tangible signs of turning around. For instance, today's consumers want to transition from an economy based purely on efficiency to one where more consideration is given to ethics; this will further support an inflationary trend that looks set to last, albeit with ups and downs. We're clearly seeing in the US that – for the first time in decades – wages are also a factor driving inflation, underscoring the possibility that it will last. Wage growth had been a non-issue for a long time but is now suddenly back in the game, and will likely be with us for a while.

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It would be a mistake to think inflation can be warded off indefinitely given the structural factors reviving it. We need to swap our disinflationary mindset for one better suited to the new landscape that's taking shape, whether we like it or not. Going forward, wages will pick up, mitigating the decline in households' real incomes; production sites will be repatriated to reduce countries' dependence on foreign energy and manufacturing; and economic agents will increasingly look to balance business ethics with economic efficiency in order to avoid compounding the exogenous inflationary forces. We hope that the drop in inflation likely to occur in the coming months won't blind market participants to the very palpable shifts already taking place.

Mitigating the decline in real incomes

Wages in the US are up 6% on average while inflation seems to have peaked at 8.5%. Given that inflation looks set to head back downwards, this will result in a welcome increase in real incomes, at a time when US workers are in a strong bargaining position.

In Europe, however, wages are up just 1.5% whereas inflation is running at around 7.5%. Governments have rolled out various measures to help fill this gap – such as "energy checks", "rebates at the pump", and possibly food subsidies for the most disadvantaged – but such measures can never be more than temporary. They increase households' dependence on government support and impede natural adjustments by masking the genuine impact of prices.

By preventing household incomes from at least partially closing the gap with inflation, policymakers are almost guaranteeing that European consumers will take to the streets. Governments need to nip this issue in the bud and make it easier for businesses to bump up wages. After all, one advantage of nominal GDP growth is that, to some extent, it automatically lowers the public debt-to-GDP ratio. If policymakers don't shake off the disinflationary mindset they've had over the past few decades, they could trigger a deep recession, obstruct any kind of lasting price stability (whose causes are mostly external), and amplify public debt levels. A triple whammy!

Bringing back European manufacturing

The next step will be for European countries to address their energy, manufacturing, and military dependence – a dependence thrown into light by the pandemic and the war in Ukraine. That will entail bringing production sites back on European soil, with the upshot of

PROMOTIONAL MATERIAL

creating opportunities for restoring lost manufacturing industries where needed. France is a prime candidate for this kind of reshoring, especially since its nuclear power facilities give it a major competitive advantage, even more so if those facilities were expanded and modernised. Countries no longer have the option of trying to become or even remain a manufacturing powerhouse without securing their own energy supply. It's time for them to step up to the plate.

What's more, manufacturing jobs are well-paid owing to the skills they require and the growing productivity experienced by manufacturers. Odd jobs in the services sector, like as delivery drivers, are certainly useful but are also starting to show their limitations. Today's inflationary climate makes it more important than ever for businesses to step up their efforts on boosting productivity, which can be possible through a modernised manufacturing industry.

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Reshoring can be a way to orient households' savings towards investments that would be profitable even in times of sustained inflation, thus aligning their interests with those of the government. That would be a big change from the past ten years when financial repression meant savers were financing public debt in return for negative interest.

An additional, virtuous method for linking incomes to inflation would be to encourage schemes that give employees a share of their companies' profits. Several large companies have recently introduced new employee stock-ownership plans, for example. If these schemes include at least some degree of incentives and protection, they can help align the interests of employees and companies on a broad scale – along with the alignment between savers' and governments' interests mentioned earlier – and provide a virtuous way of offsetting the decline in real incomes.

Combining ethics with efficiency

The third step on the path to making this potentially enduring bout of inflation a positive experience for the economy involves reconciling the desire for ethical practices with the need for efficiency. This step, complementary to the two others, will require bringing economics back into the equation, since the quest for a more principled economy shouldn't distract us too much from the reality on the ground.

This applies to geopolitics just as much as energy supplies. How much energy is available, and where, depends on physical factors that we can't ignore. Are engineers and entrepreneurs being sufficiently consulted on policy decisions regarding the pace of the energy transition? In view of the challenges we're currently facing, the pace chosen by policymakers is clearly too fast, which is further driving up inflation and could trigger imbalances between energy supply and demand. Wouldn't we be better off resuming oil and gas exploration in regions and under conditions that would secure our future and the future of generations to come?

If policymakers and economic agents once again base their most "impactful" decisions on real-world facts, the phase we're now going through could be an auspicious one – with a little imagination and bold thinking – and could usher in an era of more widely shared prosperity. We could be at the dawn of something similar to the Trente Glorieuses in France, which was a 30-year period of rapid economic expansion between 1950 and 1980 in a generally inflationary climate.

Those three vibrant decades coincided with the post-war reconstruction and led to the emergence of a large middle class. Today, another kind of reconstruction is needed – one of building back up the domestic manufacturing base – to address the three types of dependence revealed by the pandemic and the war in Ukraine. Whereas much of today's middle class has been weakened by structural deflationary trends in past years, we now have an opportunity to restore a positive dynamic to the economy and give the middle class a more enviable position by introducing updated compensation schemes, employee stock-ownership plans, and creative, virtuous savings vehicles. This could help undo the deep-rooted sclerosis caused by the long period of wage stagnation, excessively low inflation, and negative interest rates.

The new inflationary paradigm that we're likely facing will make fund managers' jobs more complicated. But the return of inflation also means the return of the business cycle, after a 12-year hiatus during which active fund managers lost their investment compass. A regular, symmetric business cycle will engender alternating periods of outperformance between stocks and bonds, growth stocks and cyclical stocks, corporate bonds and sovereign bonds, and the US dollar and gold.

Because active investment approaches are based on quickly identifying inflexion points in the business cycle, this new, more cyclical era will restore active fund managers to their former glory. We now need to help investors close the door on the generic ETFs and other passive investment products that had attracted savers during the long acyclic period which is now coming to an end.

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