Perspectives

Will remote work disrupt the inflation narrative?

from **MacKay Shields Global Fixed Income Team**

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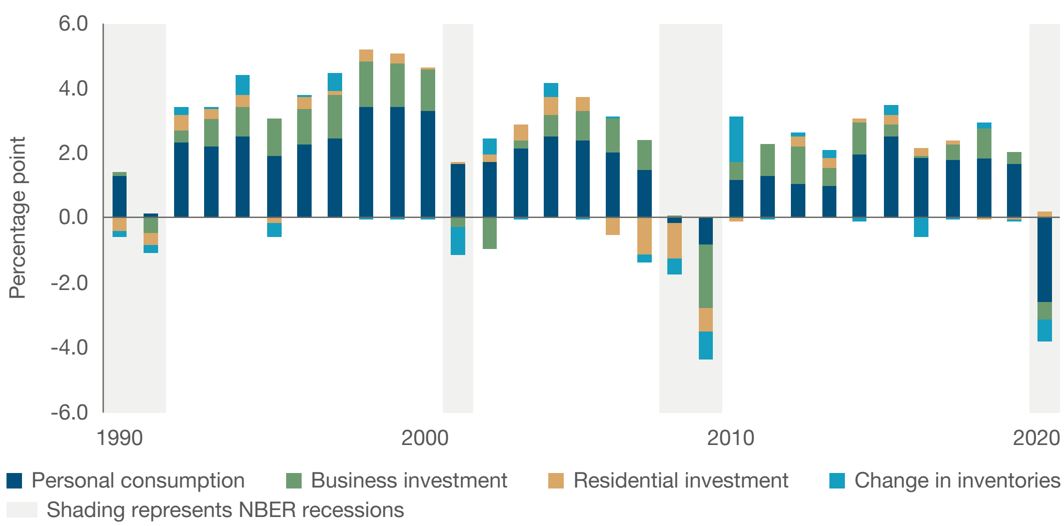
The pandemic has sped up the trend to remote work, which would otherwise have played out over many years. Like many technology-driven changes, remote work will tend to slow inflation. It may also exacerbate inequality, as not all sectors and jobs will benefit from expanded employment opportunities under the model.

Investors frequently dismiss GDP data as old news. The fourth-quarter 2020 U.S. GDP report was no exception, given expectations for a vastly improved economy in the year ahead as the pandemic fades in the rearview mirror. Still, investment trends buried in the GDP report provide clues to what the post-pandemic economy will look like.

Business investment was remarkably resilient in 2020, subtracting only half a percentage point from overall economic growth **(Figure 1)**. That's a modest decline given the economy's deep contraction. The pattern for the past 50 years suggests that the significant drop in consumer spending seen in 2020 would be accompanied by an investment spending decline taking 1.0 to 1.5 percentage points from GDP growth.

Figure 1: Contributions to annual GDP growth by sources of private domestic demand



Source: Bureau of Economic Analysis, MacKay Shields. As of 12/31/20.

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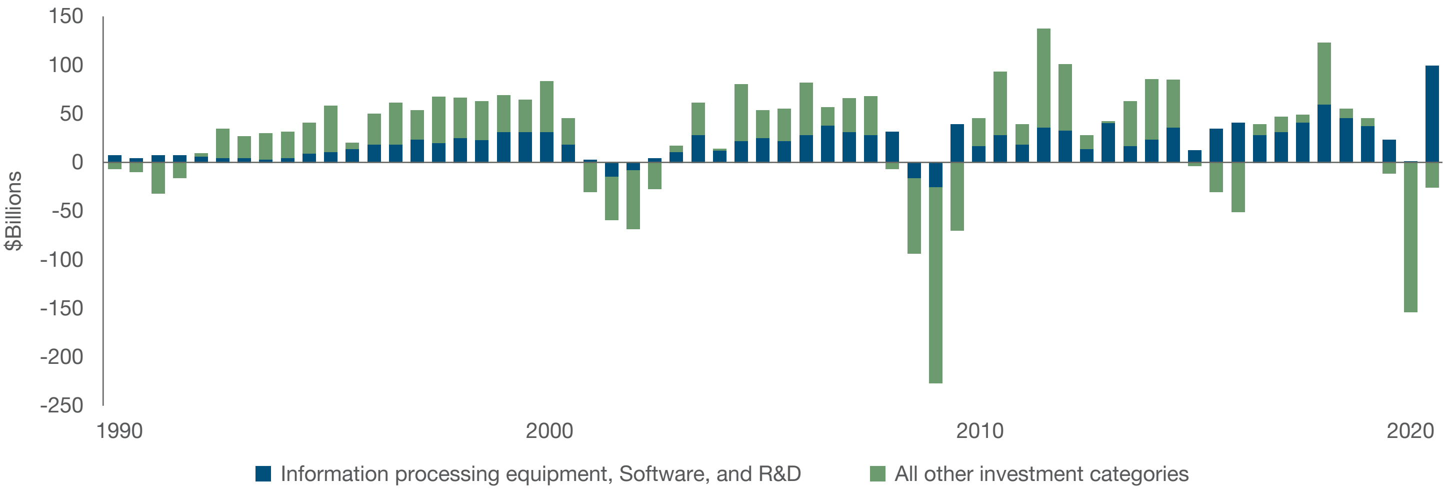
Figure 2: Business investment spending by category



Annualized data in half-year increments
Source: Bureau of Economic Analysis, Mackay Shields. As of 12/31/20.

Businesses didn't drastically slash their capital expenditure programs because the economic crisis was widely viewed as temporary, and a strong policy response supported the economy and allowed corporate profits to rebound rapidly. A closer look at what happened to capex over half-year periods also shows that companies didn't trim spending across the board. In fact, spending on information processing equipment, software and research and development surged in the second half of 2020, after pausing in the first half. All other capital investments continued falling in the second half after plunging in the first **(Figure 2)**.

The abrupt shift in the type of capital investments suggests that in the second half of the year, businesses were not merely making up for weak spending in the first half. Instead, businesses appear to have stepped up investments in digital transformation in order to give their current workers greater flexibility to work remotely or to seize the cost benefits of hiring more remote workers.

This shift towards a greater share of the labor force working remotely will have profound consequences. Importantly, the shift is likely to exert disinflationary forces on the economy. The pandemic will wind up condensing into a short time frame investment in a wide range of digital transformations that would otherwise have occurred over many years. This pulls forward future productivity gains for many parts of the economy, suggesting higher trend growth, a wider output gap and less upward pressure on prices.

The disinflationary aspect of work from home also plays out in the labor market. More remote work represents a positive labor supply shock, as it allows greater flexibility to workers in terms of place and time of work, and tears down barriers to work that are based on geographic location. To put some numbers behind this, before the pandemic, there were roughly four and a half million civilians who were not in the labor force but wanted a job.[1] Many of them could not find work that matched their skills within commuting distance. Child care responsibilities, transportation issues or disability kept others from going to jobs on site. Remote work lowers the barriers to employment for many people in both groups. It can also lengthen careers for older workers who might otherwise retire. All told, by making many people more employable, remote work may allow unemployment to fall to a lower level before wage and price pressures begin to build.

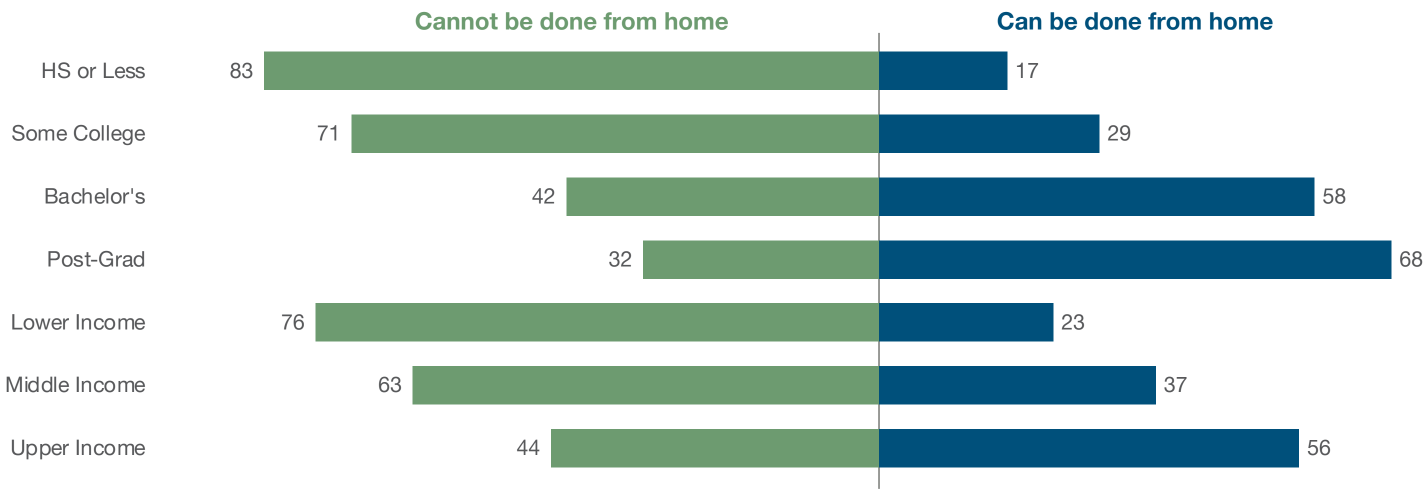
Remote work may also reduce labor costs directly, by allowing firms to recruit more workers in lower wage cities. Why hire in New York or San Francisco, if you can find suitable employees in lower-wage cities? It may also reduce companies' real estate costs: If companies encourage more employees to work from home full or part time, they won't need as much office space. These results will not apply equally across job types and sectors, but the net impact of a remote work model will be to lower labor and real estate costs for many firms.

Of course, there are negative consequences to the remote work paradigm. Downtown New York, Boston and Chicago may not remain the ghost towns they became during the worst periods of the pandemic, but their office towers may not return to full occupancy after the pandemic is over. Perhaps, like the old industrial spaces of SoHo, some of the excess office towers will eventually be repurposed as housing. In the interim, many restaurants and other businesses catering to a shrinking number of central city office workers will continue to struggle. The demand for their services are still needed, but the location of that demand will shift away from city centers.

The trend towards remote work is also likely to exacerbate inequality. Not all workers will see expanded employment opportunities as remote work takes hold. A recent Pew Research Center study, for example, suggests that less-educated and lower-income workers are disproportionately in jobs that cannot be performed remotely **(Figure 3)**.

Even before the pandemic, increased inequality of income and wealth was tilting the policy debate toward more redistributive fiscal and tax policies. If the accelerated digital transformation resulting from the pandemic increases inequality, it will likely increase public support of redistributive policies. The pendulum may swing back toward more social welfare spending and more progressive taxation of income, wealth and inheritances.

Figure 3: Percent of employed adults saying that the responsibilities of their job



Source: Pew Research Center, "How the Coronavirus Outbreak Has - and Hasn't - Changed the Way Americans Work", December 2020. Figures may not add up to 100% due to rounding.

Footnotes and references

[1] Author's calculations based on the Bureau of Labor Statistics' monthly household surveys for October – December, 2019.

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