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INFLATION UPDATE

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Although the worst seems to be over, Eurozone inflation is still at very high levels, more than twice as high as inflation in the U.S. But there are not just clear differences in price development between Europe, where inflation stood at 6.1%[1] in June and the USA with a rate of 3%[2], there are enormous imbalances within Europe, too. While prices in Germany, for example, have risen slightly faster recently with an inflation rate of around 6.8%[1], Spanish inflation stood at 1.6%[1] in June while in Luxembourg, it was just 1%[1]. Spectrum Markets' Head of Distribution, Micheal Hall, looks into the reasons why and asks what conclusions can be drawn about future developments.

If the last few years have taught us anything, it is that, despite ever-increasing knowledge, better technologies and methods, the reliability of forecasts has not improved in lockstep. Is that attributable to a new dynamic in global economic relationships or due to unforeseen global-scale events, such as geopolitical crises or major diseases? Events such as the Covid-19 pandemic clearly stand out by all metrics, and it's tempting to assume that the scale of an event determines its economic impact. However, as the stranding of the cargo vessel Ever Given in the Suez Canal in March 2021 showed, a comparably minor event can seriously hit the economy. In other words, interrelations are as relevant, if not more relevant. Anyone who has followed the debate over whether inflation will be transitory or persistent knows how divided even central bank boards have been in their assessments. You may argue that the amount of time that the debate has continued is proof enough of the fact that inflation is a long-term companion. If it was that easy to judge, policy responses would be just as simple to give.

Differences between the USA and Europe

As discussed above, the US Bureau of Labor Statistics reported inflation had come down to 3% at the end of June. The most obvious reason for this advance over Europe one may think of is that the Fed[3] started their rate hike cycle earlier than the ECB[4]. That may be true, but two aspects are worth looking into in this context. One is the question of whether the ECB's monetary action would have been delayed because of deviating interpretations of the causes of the inflation, or whether there has also been a delay in prices starting to rise. In the US, inflation climbed beyond the Fed's price stability target[5] of 2%[2] in March 2021. In Europe – the ECB has been committed to the same target – prices began to increase at a rate of more than 2%[1] in July of the same year. This directly leads to the second and more important aspect. If there is a mismatch in inflation coming to pass, there must be structural causes for this discrepancy, even if the origins of inflation were identical and cyclical in nature. That is, while the root cause may be the same, structural differences may lead to different developments the addressing of which, in turn, unfolds at different paces. As the ECB states, one of the most significant differences between American and European inflation is that European inflation is mainly supply-driven whereas in the US it is much more demand-driven. What we may not confuse though are cause and effect. How can the world's largest economy, which on top of everything is much more dependent on imports than Europe, be less vulnerable to supply-chain shocks? The answer is, it's not. This shows that the said difference with a view to inflation can be easily misinterpreted as it relates to the different absorption mechanisms, i.e., the effects of inflation and not its causes. In other words, the role of private consumption in the US economy or the much more dynamic labour market cause inflation to unfold faster, it being more sensitive towards central bank monetary action or fiscal policy stimulus and thus to be contained earlier.

Differences within Europe

There are different inflation rates not just across Europe but across the Eurozone, too. Accordingly, non-euro countries' local currency fluctuations – reflecting the current state of the relevant economy – add to or help reduce inflation. This can excessively aggravate an already severe inflation scenario, as can be seen in the example of the Hungarian Forint with inflation in Hungary temporarily climbing beyond 26%[6] at the beginning of this year. Or it can contribute to preserving a favourable situation, in the example of Switzerland, which reported a rate of 2.5%[7] for June. Focusing on the single-currency zone brings us closer to the main causes of inflation – the ramifications of the Covid-19-pandemic including the resulting recovery measures and the Russian invasion of Ukraine. There's a clear link between double-digit inflation rates in the Baltics and their former interconnectedness with the Russian economy both in terms of energy and food. However insignificant some economists claim the influence of energy prices on inflation to be, those countries who have done the most to reduce their dependence on Russian energy supply did best in terms of overall price increases. There is another phenomenon which can be differently relevant in European countries which I will refer to later.

The "core inflation" dilemma

Core inflation has recently come to the centre of attention of economists when trying to assess the more "sticky" components of inflation or how "stubborn" inflation is. The concept is to deduct energy and food from the basket of goods used to compute consumer price inflation. In contrast to the so called "headline inflation" which covers all goods in the basket, by excluding the volatility of food and fuel items it aims at returning a more reliable picture of price trends. Its plausibility is sometimes called into question in the public debate as consumer protection groups or politicians argue that for the people it doesn't matter which theoretic cluster a certain component of rising prices is attributable to as, after all, for them the nominal increase is all that matters.

While this sounds understandable, for policymakers it is important to find out to what degree prices are actually rising in the first place. Furthermore, they need to understand what the drivers of rising prices really are, how they are connected and which monetary action to take. Interestingly, it doesn't make a big difference whether headline or core inflation is referred to when looking at long-term historic averages. However, headline inflation fluctuates so much more strongly around a mean that it doesn't provide much insight into the periods under observation by central banks. How significant these fluctuations can be is illustrated by the three-month-on-three-month annualised inflation rate based on seasonally adjusted data the ECB observes in order to capture turning points in inflation momentum. As the central bank stated in its March meeting minutes, headline inflation, according to this metric had fallen from around 11% in November 2022 to about 3% in February 2023 – a development entirely due to the slowing energy inflation.

Within the core inflation rate, the ECB also monitors and compares energy-sensitive and non-energy-sensitive sectors in order to assess the indirect impacts of the energy and food constituents on core inflation.

How stubborn will inflation be?

As discussed, the ECB analyses a lot of different aspects in order to determine what drives inflation and how persistent it is likely to be. Where it must fail, or at least get close to its limits, is the quantification of the effects attributable to irrational or opportunistic behaviour.

In theory, there is demand-pull-effect inflation which occurs when the aggregate demand grows faster than the aggregate supply or cost-push-effect inflation which arises when production prices rise – as a result of rising commodity prices or wages. There is inflation as a consequence of money-supply-tightening and there is built-inflation when prices increase because of the pure expectation that they will rise. And the latter is increasingly the focus of central banks. They want to avoid what they call a de-anchoring of inflation expectations. According to this notion inflation expectations are anchored as long as people expect long-term inflation to remain relatively unchanged even if prices temporarily rise beyond their short-term inflation expectations. In contrast, inflation expectations are de-anchored when people's long-term inflation expectations go up considerably as a result of prices rising beyond their short-term expectations only temporarily.

This is not just an explanation for why central banks didn't react to high inflation for quite some time. It has to be seen in the context of "second-round effects" of headline inflation. As the ECB put it in their meeting minutes from March, "the evolution of profits compared with that of wages suggested that wages had had only a limited influence on inflation over the past two years and that the increase in profits had been significantly more dynamic than that in wages".

What this means is if corporates had just passed on higher costs to clients, this would have been profit-neutral. This, phenomenon is referred to as "Greedflation" or "Winflation" and although it is difficult to prove, the ECB review suggests it's actually taking place and that the degree of its continuation will have an impact on inflation.

We shouldn't underestimate other factors that may contribute to higher inflation going forward, such as a wage-price spiral once there are more rounds of pay rises, or the cost of de-globalisation as a result of jobs and production relocation to domestic markets in order to better deal with supply chain issues. However, until now these factors haven't been attributable to any meaningful event. However, "labour costs (...) are becoming a dominant driver of inflation" as the ECB said in its latest inflation outlook . In addition, prices in the services sector will have a dominant effect.

Over the course of the past twelve months, the ECB has raised rates by an unprecedented 425 basis points. According to its own statement, the ECB is seeing the first signs of these tightening operations being effective, however, it expects them to have fully unfolded by the end of this and the beginning of next year respectively.

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1 Eurostat
2 https://www.bls.gov/news.release/pdf/cpi.pdf as of June 2023
3 Federal Reserve System, the U.S. central bank
4 European Central Bank
5 Target inflation rate for both the U.S. Fed and the ECB to tolerate as most appropriate in terms of stable prices
6 https://ec.europa.eu/eurostat/documents/2995521/16965667/2-16062023-AP-DE.pdf/971fae70-c34b-a974-b7e8-205b797f15a4
7 https://www.bfs.admin.ch/bfs/en/home/statistics/prices/consumer-price-index.gnpdetail.2023-0451.html
8 https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp230707~8f8f9debc6.en.html

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