What if inflation rates remain at current levels?

Roland Berger Institute

December 2021

Roland Berger

Inflation rates are surging on both sides of the Atlantic
Economists disagree on whether this is a transitory phenomenon

Inflation rates in the US as well as in Europe are at their highest levels in years after the economies rebounded from the coronavirus shock.

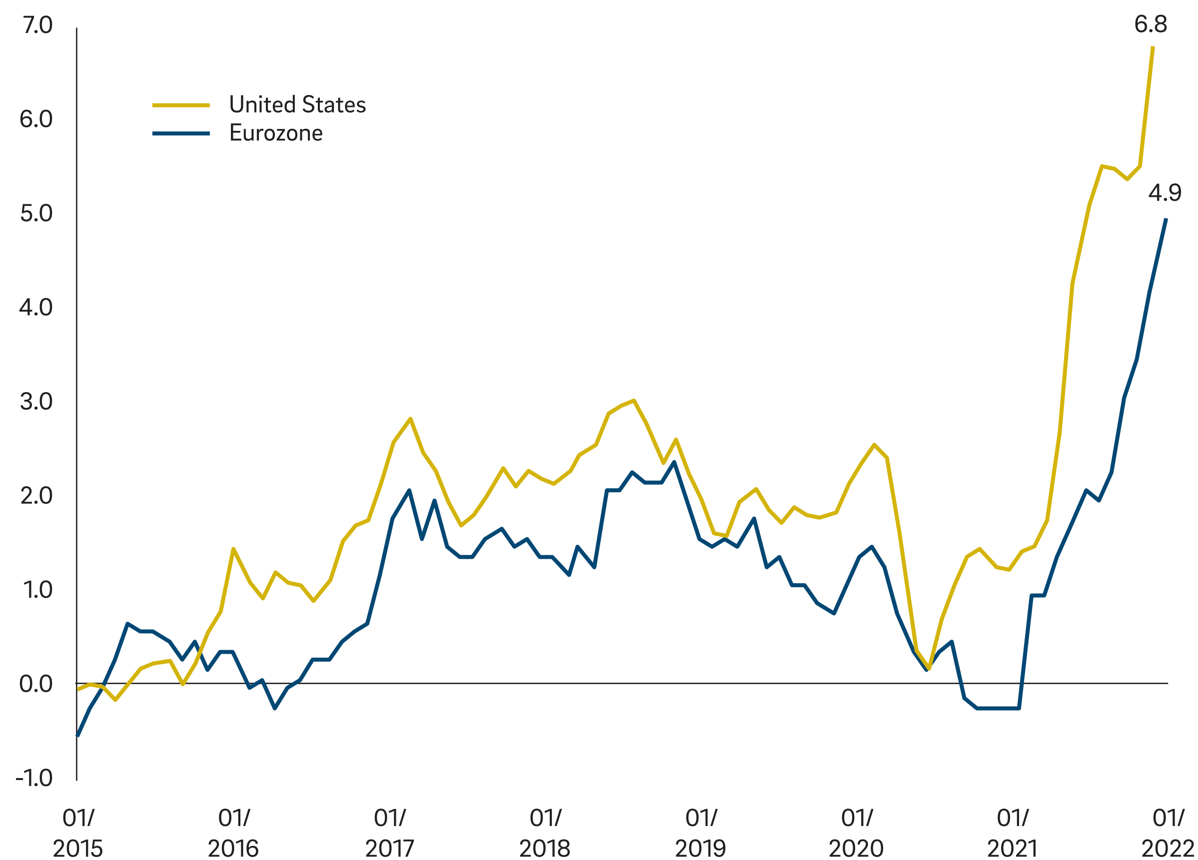
A variety of reasons are currently coinciding to fuel inflation: In addition to statistical base effects due to low inflation in 2020 as a result of the pandemic, rising energy prices and, above all, the recovery in overall economic demand, which is significantly higher than the available supply capacities, are causing prices to rise.

In addition, huge monetary and fiscal policy efforts are underway to keep the impact of the pandemic on the economy and society under control.

Opinions differ on whether inflation will be transitory. While some experts believe that inflation rates will return to the central banks' symmetric 2% target as early as next year, others assume that a decade of higher inflation rates is on the horizon.

Due to this uncertainty, we're asking: What if inflation rates remain at current levels?

INFLATION RATES
[yoy, %]



Source: OECD; Roland Berger

One reason for temporarily higher inflation rates is the base effect
A statistical effect due to a catch-up of consumer prices this year

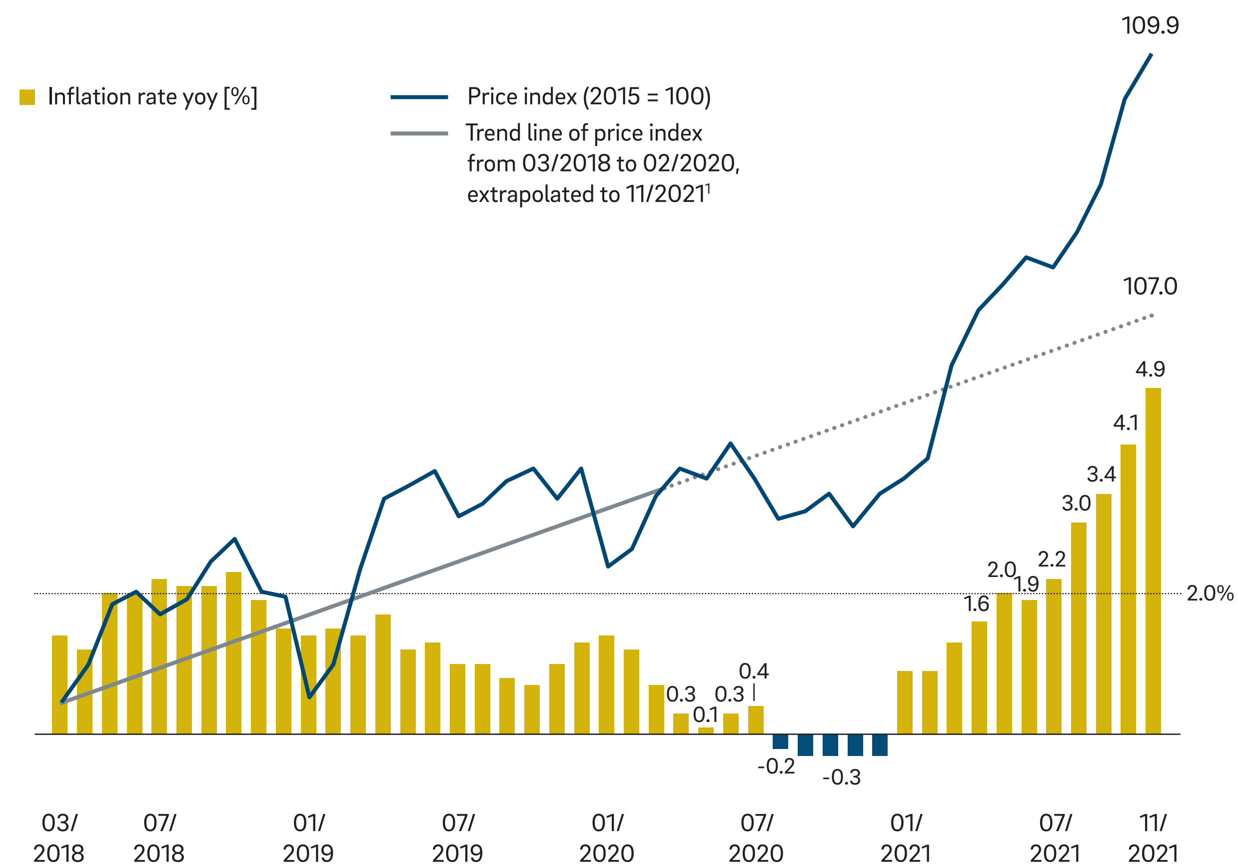
During the first year of the COVID-19 pandemic, inflation rates were consistently low, and we even experienced months of deflation.

Since summer 2021, the euro area (EA) has seen high inflation rates, which are now reaching new record levels.

Nonetheless, due to the relatively low levels of prices in 2020, comparisons of today's prices to 2020's prices might lead to a distorted picture of reality.

Until July 2021, the deviation of the measured price index from the trend line was not a cause for concern. However, the increasingly widening gap between the measured and extrapolated price indices has caught the attention of leading economists.

IMPACT OF BASE EFFECTS ON THE AVERAGE INFLATION RATE IN THE EURO AREA



[1] The trend line is calculated as the CAGR of price index between March 2018 and February 2020 and extrapolated until November 2021

Source: European Commission; Roland Berger

Energy prices have risen rapidly, partly driven by increasing carbon prices

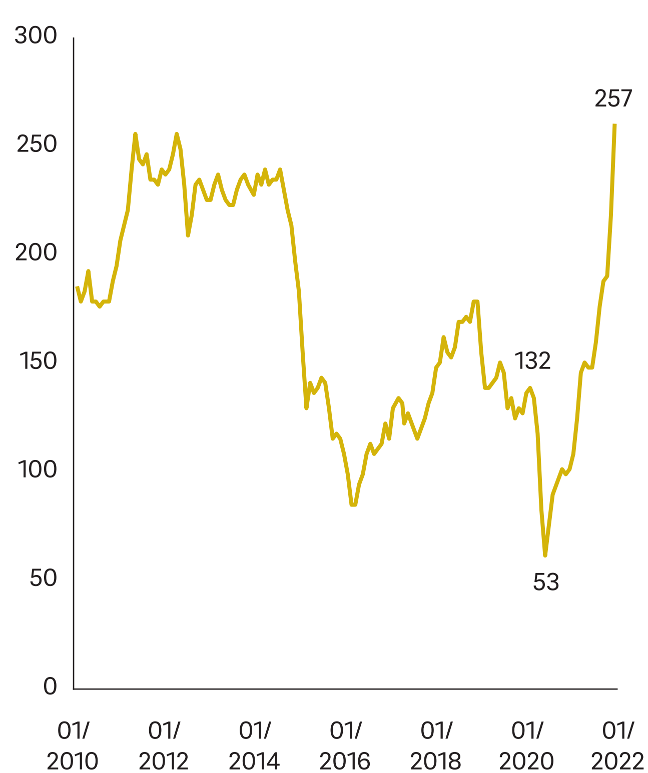
Starting from exceptionally low levels in 2020 driven by low demand for energy in the wake of factory closures and lockdowns, energy prices rose extremely quickly due to an economic recovery in 2021.

Historically, however, there were even higher energy prices before the global financial crisis. For example, a barrel of Brent cost just over USD 80 in November 2021, which is still well below the peak price in July 2008 of more than USD 147.

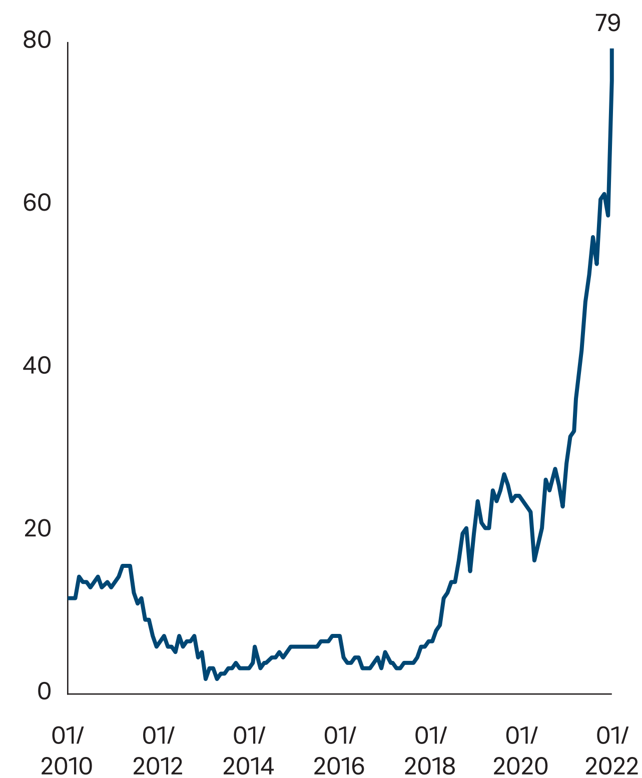
New regulatory price surcharges, such as taxes and CO_2 charges, have now been added to the bill and are placing a heavy burden on energy prices. For example, one ton of CO_2 now already costs more than EUR 70 under the European Union's Emission Trade System ETS, which further increases prices for end consumers.

With increasing efforts surrounding the energy transition, it can be assumed that energy prices tend to be more volatile in the future and that CO_2 prices will rise in the future.

GLOBAL ENERGY PRICE INDEX
[INDEX 2016 = 100][1]



CARBON PRICE UNDER ETS[2]
[EUR]



[1] The index covers prices of Coal, Crude Oil, Natural Gas and Propane. Figures represent benchmark prices, which are representative of the global market. They are determined by the largest exporter of a given commodity. Prices are period averages in nominal US dollars.
[2] EU Emissions Trading System

Source: St. Louis FRED; Bloomberg; Roland Berger

As economies recover from the pandemic, companies have trouble meeting rising demand due to supply constraints

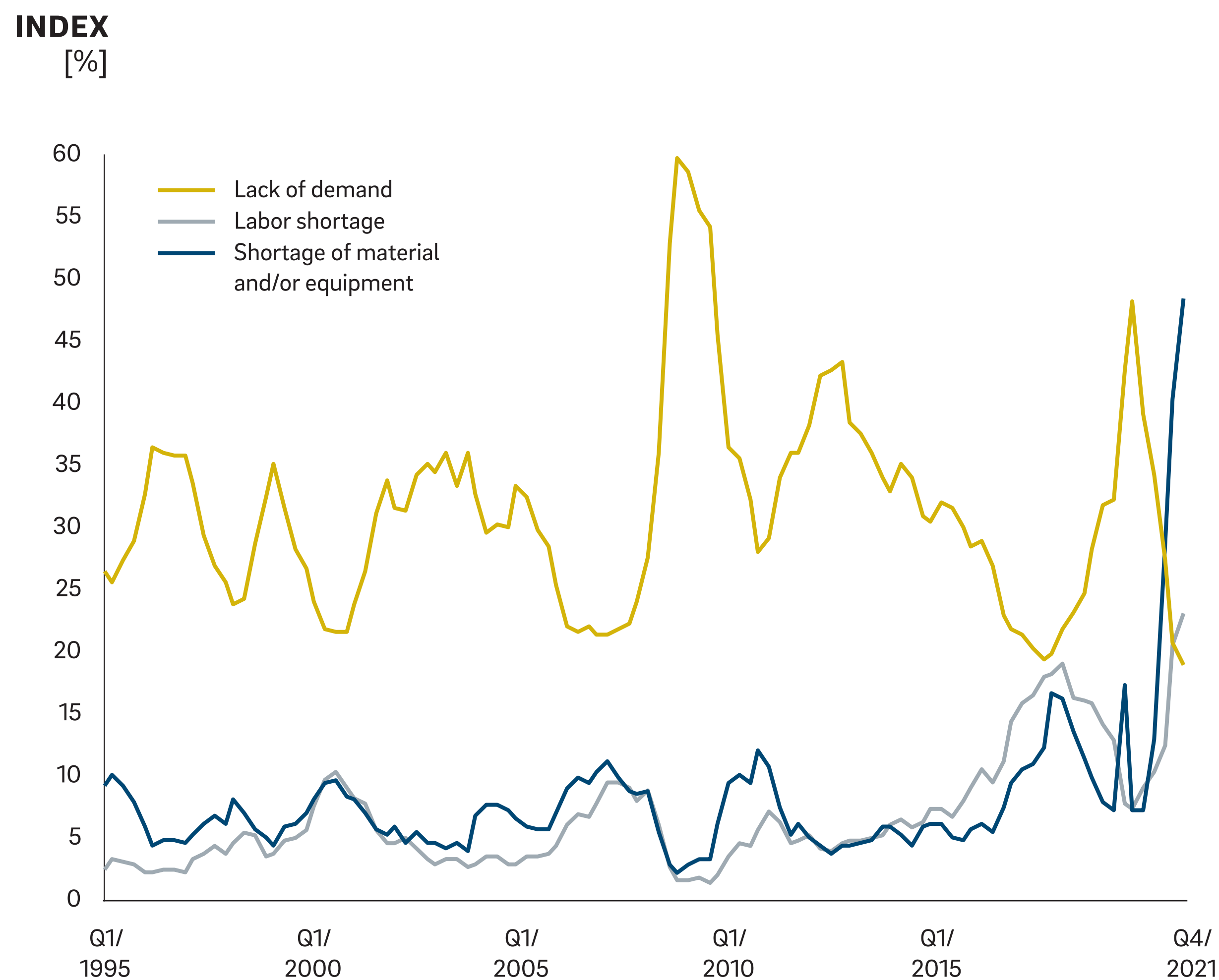
With the onset of the COVID-19 pandemic, demand for industry products plummeted as lockdown measures in various countries led to factory closures.

However, economies recovered from the initial shock more quickly than expected – although the recovery was not equally rapid everywhere, which is why many companies, particularly in advanced economies, are reporting a shortage of intermediate goods.

But that's not all: The pandemic has led to massive distortions in the labor market. In the US, 4.4 million people voluntary quit their jobs in September 2020 alone – most of them already with a new job in prospect that may offer them better pay or conditions.

The shortage on the labor market combined with sharply rising inflation may lead to employees demanding higher pay for their work, which thus increases companies' input costs. A wage-price spiral could be triggered.

Promised investments under the European Green Deal will also continue to drive strong aggregate demand going forward, with supply presumably able to adjust to this.



Source: European Commission; Roland Berger

Central banks have been hugely increasing money supply in order to stabilize economies after the financial crisis of 2008

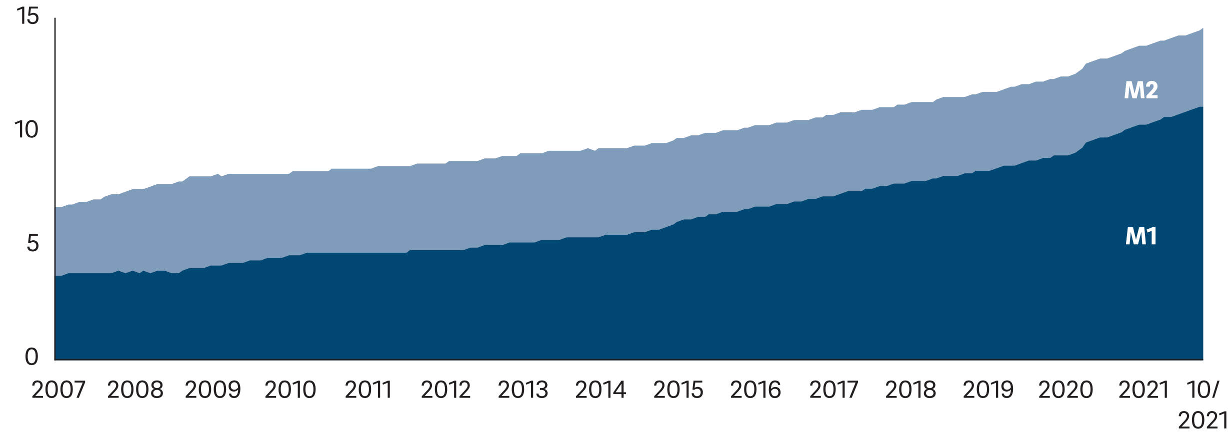
Central banks have been reacting to the economic fallout from the pandemic with even looser monetary policy.

Driven by monetary intervention, higher credit lending in both the eurozone and the US has led to an increase in M1 and M2 money supply, which indicates the amount of relatively liquid forms of money in the economy.

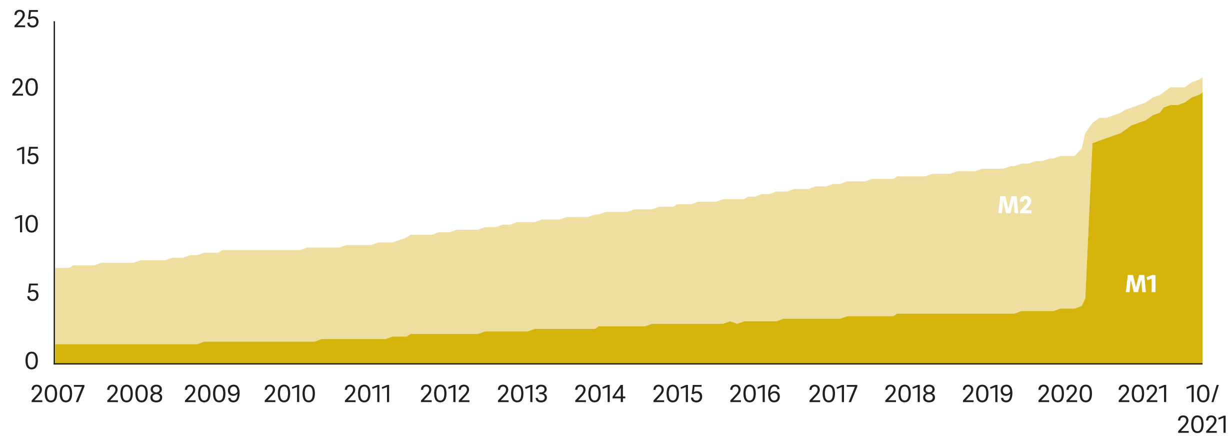
Due to new regulations in the US, there has been a significant shift of money supply from M2 to M1.

In the US, the money supply was further boosted by direct COVID-19 stimulus checks to American citizens – so-called helicopter money that created a higher amount of money without any countervalue, thus depreciating the value of money and increasing inflation.

MONEY SUPPLY M1 & M2 IN THE EURO AREA [EUR TRILLION]



MONEY SUPPLY M1 & M2 IN THE US [USD TRILLION]



Source: ECB; FRED; Roland Berger

How long will inflation rates stay high?
Selected assessments of central bank leaders, politicians and economists

BACK TO NORMAL IN 2022

"We still see inflation moderating in the next year, but it will take longer to decline than originally expected. If energy prices keep rising or supply constraints persist, inflation may remain higher for longer than anticipated. This could feed into higher wages and subsequently higher prices."

Christine Lagarde, President of ECB, November 15, 2021

"When labor supply normalizes and the pattern of demand normalizes, and I would expect that, if we're successful with the pandemic, to be sometime in the second half of next year, I would expect prices to go back to normal."

Janet Yellen, Treasury Secretary, US, November 14, 2021

"[The] contribution of energy to inflation is expected to fade once prices plateau during 2022. Fundamentally, the toll of the shock will depend on how central banks respond."

Rafaela Guedes Monteiro, Chief Economist and Strategy Manager, Petrobras, Brazil, November 10, 2021

"In the medium term, there is a trade-off between the cost of moving towards decarbonization targets and the long-term benefit from rebalancing the economy."

Shusong Ba, Chief China Economist, Hong Kong Exchanges and Clearing (HKEX), Hong Kong SAR, China, November 10, 2021

"The structural forces that have kept inflation low and stable worldwide since the mid-1990s – high debt burdens and increasingly skewed income and wealth distributions – remain in place."

Giulio Martini, Director, Strategic Asset Allocation, Lord, Abbett & Co., US, November 10, 2021

MORE PERSISTENT INFLATION

"The main risk for more persistent inflation comes from a potential de-anchoring of longer-term inflation expectations and/or a more structural change in the way labour markets respond. While inflation expectations have thus far remained well within their historic ranges, labour-market developments, especially in the US, have surprised by sharp wage increases amid a lack of labour supply (i.e. low participation)."

Christian Keller, Head, Economics Research, Barclays, UK, November 10, 2021

"There is a potential for higher price pressure for longer. The current situation in European and Asian electricity and gas markets is a vivid illustration of the energy trilemma of affordability, decarbonization and security of supply."

Eirik Waerness, SVP and Chief Economist, Equinor, Norway, November 10, 2021

"The risk is that inflation becomes self-fulfilling. The longer it remains elevated, the greater the risk that companies will be encouraged to increase prices further, and workers seek higher wages."

Guy Miller, Managing Director and Chief Market Strategist, Zurich Insurance Company, Switzerland, November 10, 2021

Source: European Parliament; CBS; WEF

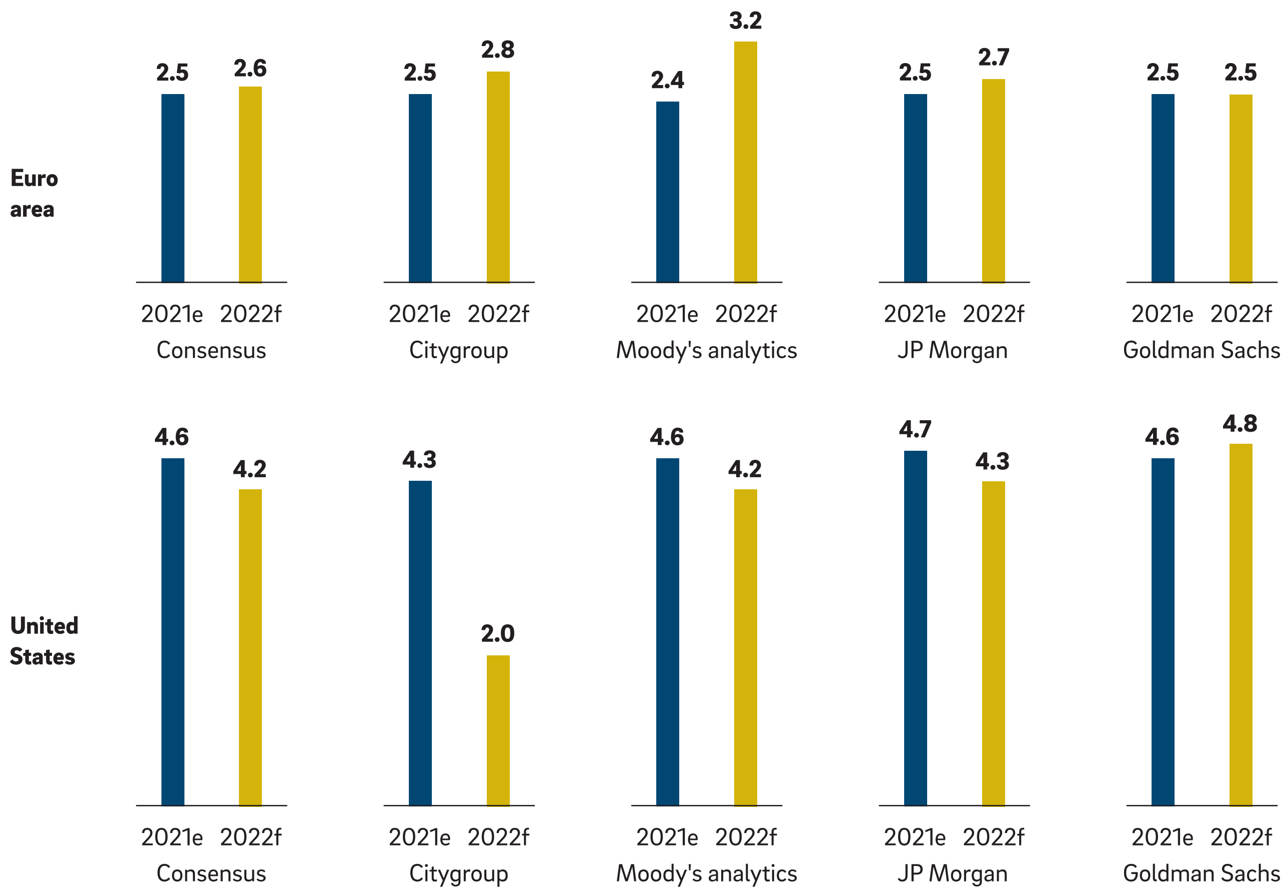
The majority of analysts' inflation expectations are close to each other
Inflation expected to remain above 2% in 2022

In the short term, the majority of observers expect inflation rates to remain above the central banks' targets of 2%.[1]

Looking at Europe, one of the reasons for the weaker inflation is that direct cash transfers to households have been less generous compared to the US.

Expectations for 2022 differ for the euro area and the US: While moderate inflation rates slightly above 2% are expected in the eurozone, inflation in the US is likely to be well above the central banks' targets.

INFLATION FORECASTS BY SELECTED INSTITUTIONS
[avg. consumer price inflation, %]



[1] For the FED, the 2% target is flexible, i.e. it must be reached on average for a certain period; the ECB sees the 2% as a symmetric target, which means negative deviations are as bad as positive deviations

Source: Consensus Analytics; Roland Berger

What if higher inflation rates are not transitory?

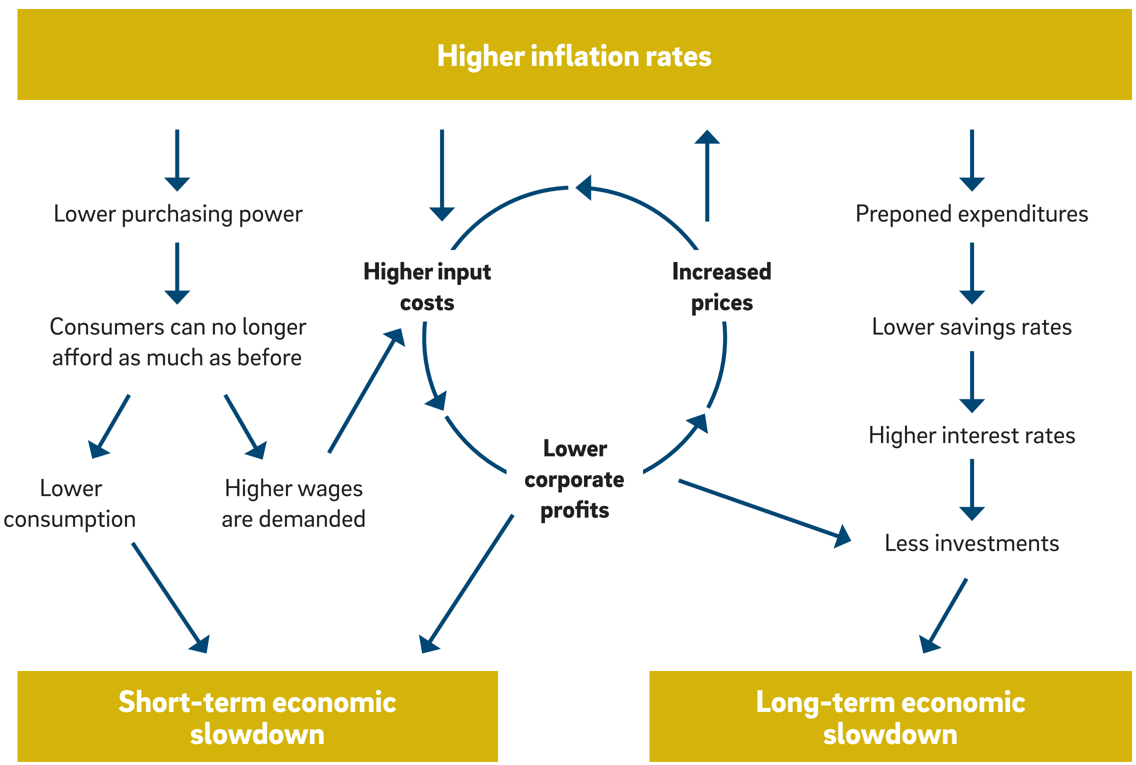
Higher inflation rates, both in the long and short term, mostly have a cooling effect on the economy.

Higher prices decrease the purchasing power of consumers, leading to less consumption. This causes both a short-term economic slowdown and demands for higher wages.

Higher wages and increased input prices induce higher production costs and therefore lower corporate profits. In order to restore initial levels of profits, companies increase prices for their final goods.

Price increases lead to preponed expenditures and consequently to lower savings rates. In theory, the declining savings rate means that banks have to raise their interest rates if they want to avoid an outflow of their deposits. Increasing interest rates, which are also the textbook response to rising inflation rates, would then in turn have a long-term impact on the level of investment.

SCHEMATIC FRAMEWORK



Source: Roland Berger

Will inflation rates remain at current levels?
Our take

We tend to concur with the experts who view current inflation levels of 4% and more as transitory.

However, we expect inflation rates in the coming years to be above the average of the past years, which saw unusually low levels of inflation.

WILL INFLATION RATES REMAIN AT THEIR CURRENT LEVELS?

Source: Roland Berger

Authors

Steffen Geering
+49 211 4389-2194
steffen.geering@rolandberger.com

Christian Krys
+49 211 4389-2917
christian.krys@rolandberger.com

David Born
+49 69 29924-6500
david.born@rolandberger.com

About us

ROLAND BERGER is the only management consultancy of European heritage with a strong international footprint. As an independent firm, solely owned by our Partners, we operate 50 offices in all major markets. Our 2400 employees offer a unique combination of an analytical approach and an empathic attitude. Driven by our values of entrepreneurship, excellence and empathy, we at Roland Berger are convinced that the world needs a new sustainable paradigm that takes the entire value cycle into account and enables us to meet the profound challenges of today and tomorrow.

We welcome your questions, comments and suggestions
WWW.ROLANDBERGER.COM

Cover Getty Images

PUBLISHER

ROLAND BERGER GMBH
Sederanger 1
80538 Munich
Germany
+49 89 9230-0
www.rolandberger.com