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Turning point of the Inflation

Inflation becomes a drag on the economy

Dr. Michael Heise on Global Economics
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An almost global increase in consumer prices will make 2022 very unpleasant for consumers in many countries. Here in Germany and in the EMU, consumer prices are already more than 7% higher than in the previous year and threaten to rise further if energy raw materials remain at their current high levels or even rise further, as would be expected in the event of an energy import freeze from Russia.

The additional expenditure on imported energy and other raw materials, as well as agricultural products, is a huge drag on private consumption. The additional burdens flow away and are not available for the consumption of other goods. Less affluent households are particularly affected, with heating and electricity costs and food accounting for a high share of monthly spending. Contractionary effects can also be expected on the supply side of the economy. This is because the higher production costs resulting from the expensive use of energy and raw materials will reduce companies' profits and thus their ability to invest. In particularly energy-intensive sectors, losses may be imminent.

Economy on a knife edge

The risk of a recession in the developed economies is high. Whether a recession can be avoided depends first and foremost on the development of energy and raw material prices. A positive scenario for the economy would be an early decline in energy and raw material prices - at least to the level before the outbreak of the war in Ukraine.

Such a "normalization" would cause consumer inflation rates to fall significantly again. This would also limit the economic setbacks in the Western industrialized countries.

However, the development of energy and commodity prices is currently extremely uncertain and probably inextricably linked to the political scenarios in the Ukraine-Russia conflict. A rapid decline is just as conceivable as a further increase due to a lack of success in negotiations and continued fighting. In the event of a supply freeze of Russian energy to Western European countries, further price jumps are likely. The ECB, for example, is still rather cautious about this risk in an unfavorable (severe) scenario with significantly weaker growth but at the same time significantly higher inflation. In this scenario, consumer price inflation in 2022 is not 5.1%, as in the base scenario, but 7.1%, on an annual average. Over a period of two or three years, energy and commodity prices then return to normal, which also reduces inflationary pressure at the consumer level.

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A decline in the current upward price trend would also be expected if the global supply bottlenecks for supplies were overcome. This hope was raised in the past winter months, when the supply bottlenecks and long delivery times worldwide eased somewhat. However, new pressures have since arisen. Restrictions on trade with Ukraine and Russia have already led to interruptions in production. Although these countries are not particularly important for global trade in industrial goods, disruptions to energy trade or raw material exports can also severely impair the functioning of global supply chains. In this respect, the continuing war in Ukraine also means continuing inflationary pressure in the Western world. In addition, upstream supplies from China continue to be interrupted due to widespread lockdowns as part of the pandemic response. China's handling of the pandemic, which remains difficult to assess, remains another critical problem for the functioning of international supply chains.

Inflation likely to become reinforced

There is a high risk that the previous inflationary impetus will become entrenched over a longer period. For example, in view of the tight labor markets in many places, significant secondary effects can be expected via higher wages. This has already occurred in the USA and is to be expected in Europe. At any rate, this would be in line with the historical experience that rising consumer price inflation also slows down wage increases in Europe with a lag of about one year. A firming of inflation is also likely due to the already elevated inflation expectations. Based on prices on the financial markets, short- and longer-term inflation expectations can be derived for both the USA and the EMU which are well above the target values of the central banks. Financial contracts in the EMU show inflation expectations of around 6% in the one-year range and values of around 3% over the next five to ten years.

The very strong increase in the money supply over the past two years, which has far outstripped growth in nominal GDP, is also likely to give market participants reason to expect higher inflation. There is more money in circulation than would actually be needed to finance the total transactions of private households and companies. If this surplus cash is reduced, and this is likely to happen, it will boost demand and the price-increasing tendencies in the economy.

The so-called financial repression will not be over soon

Could government fiscal policy take the pressure off prices? At best, this is likely for a short period of time, when state energy taxes and levies are reduced. In the medium term, fiscal policy will not contribute to deflation. First, the prices of energy-intensive products are likely to be increased in the long term via higher taxes, such as the CO2 tax. Second, fiscal policy is likely to continue to support the development of demand and capacity utilization through deficit-financed spending policies instead of dampening inflation, for example, through tax increases. Especially in times of rapid monetary devaluation, tax increases are completely unattractive politically.

From a fiscal policy point of view, some inflation is quite beneficial and tolerable, because it helps to devalue the high debt burdens in real terms and allow tax revenues to rise through inflation alone. The combination of low interest rates and some inflation is a much more convenient way to reduce debt than raising taxes or cutting spending. Currently, the difference between yields on ten-year government bonds and the annual average inflation rate in Germany is around 4.5%. Even if the real interest rate is likely to rise slightly in the future, there will still be a substantial real loss for investors in safe government securities. The so-called financial repression will not be over any time soon.

Monetary policy must act

For the ECB's monetary policy, the situation is becoming increasingly difficult due to the drastic increase in energy and commodity prices. The Ukraine war is fueling inflation and threatens to slow economic growth to zero. Nevertheless, the ECB should push ahead with the exit from its very expansionary monetary policy in order to prevent inflation from becoming dangerously entrenched over longer periods of time. After all, in the long term, price level stability is a crucial prerequisite for adequate and stable growth.

In the difficult balancing act of monetary policy, it might be helpful to rethink the planned sequence of "normalization". So far, the ECB has announced that it will first end its bond-buying programs before considering interest rate steps. However, in the current situation, it might make sense to first raise negative deposit rates and the key interest rate in order to dampen the growth of the money supply in circulation and support the external value of the euro, and only then, if the situation allows, to end bond purchases and reduce the balance sheet. This would tend to keep long-term capital market yields under control, which is particularly important for economic activity and investment in the economy.

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Conclusion

There are many indications that we are experiencing a turnaround in inflation. The currently very high price level increases will decline again in the coming quarters as the drastic energy and raw material price increases subside and the Corona-related procurement and supply bottlenecks ease. In the medium term, however, inflation will remain significantly higher than has been observed in recent years and decades. Higher wage settlements, extremely dynamic money supply developments and an expansionary fiscal policy overall will keep upward pressure on prices.

Monetary policy will know how to prevent inflation from accelerating further, but the tightening of policy will slow down economic activity. For the financial markets, this suggests that volatility will remain high. Investments that are to some extent protected against inflation, such as equities, shareholdings or real estate, will continue to be in demand, but will also show significant price fluctuations.

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Rating system of the absolute valuation	
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