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Inflationary pressures: elevated near-term but will they prove more persistent?

Abstract

Inflation spikes have been observed in the global economy in 1H2021 in the aftermath of the Covid-19 pandemic and related support measures. These are mostly caused by fiscal and monetary laxity, supply chain disturbances, pent-up demand, base effects; each factor has a different time horizon. While inflation is a global concern, inflationary risks are far greater in the US than in the Eurozone. The baseline scenario is that inflation spikes are transitory; yet, they may last longer than earlier expected, with a risk to be embedded into inflation expectations. Advanced economies are still far from unwinding Central Banks' crisis-fighting measures; central bankers are committed to tolerating higher inflation until they are convinced economic recovery is sustained. The key to a sustained rise in inflation pressures is labor market developments, any labor shortages and/or wages increases in particular. The eventual rise of interest rates, while still a distant prospect, raises debt serviceability issues; in this respect, indebted EA countries should make the most of the current low interest rate environment (issue/extend long maturities, fix rates).

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1. Introduction-Synopsis of main views

Inflation has been rising in recent months in most developed -and many developing- economies. Large spikes observed in headline inflation are mostly attributed to higher energy prices, transitory supply/demand imbalances upon reopening of the economies after prolonged lockdown periods, and pent-up demand. Yet, underlying causes of inflation are related to unprecedented monetary laxity due to Covid-19 pandemic (including central bank balance sheet expansion), supply side bottlenecks, and fiscal policy stimuli. The main question concerning policy makers and market participants alike is whether these higher than earlier expected spikes in inflation will prove temporary or more persistent. All the above mentioned factors that potentially contribute to rising inflationary pressures have different timing of manifestation. Supply side bottlenecks will probably take a little longer to be addressed until production increases to meet increased demand from the reopening of the economy. Monetary laxity, in theory, is a factor more quickly reversed as central bankers can act swiftly by reducing the money supply injected into the economy upon warning signs of overheating and core price and wage pressures. Yet, in the dilemma between early withdrawal of support measures to prevent an inflation spike and waiting until they are convinced that the economic recovery is sustained, most Central Banks (CBs) have indicated they may choose the latter. Therefore, whether the higher than earlier expected spike in inflation will prove temporary or more persisting is a major concern. While in advanced economies we are still far from the beginning of the unwinding of CBs, the effect price increases in certain goods and assets are already having on the recovery warrant a scrutiny.

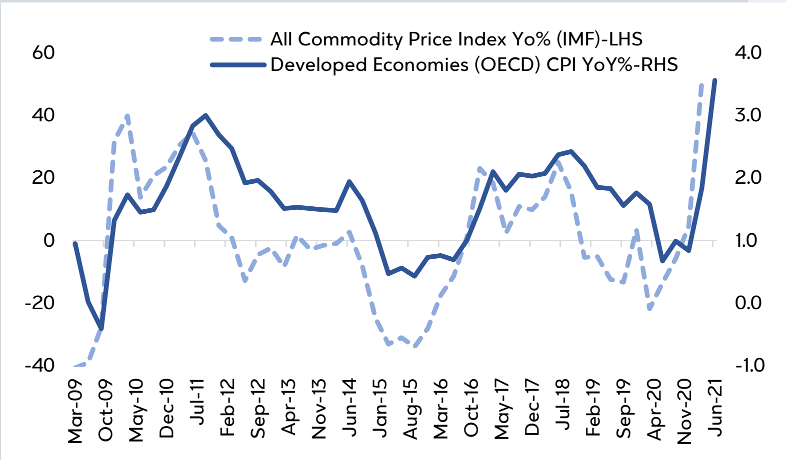
The baseline view is that rising price pressures are mostly driven by both higher energy prices - as they recover from last year's sharp decline - and factors related to the economic reopening (supply/demand imbalances, supply chain bottlenecks) and thus they will prove transitory. We have to accept though, that these pressures may last longer than earlier expected, due to certain supply constraints, such as the global semiconductor shortage, a problem that is likely to persist at least until the end of this year in view of the complex production chain that requires high upfront investment. However, there is a risk that these price pressures may last long enough to be embedded in inflation expectations and result in an inflation spiral; currently this is not the case. Key to a sustained rise in inflation pressures is the labor market, meaning particular attention is due on signs of increasing tightness in labor markets (labor shortages, wages increases) to assess whether the view on the transitory nature of the inflation rebound has to be revisited.

2. Characteristics of inflation spikes

Upon lift of lockdown measures, inflation spikes were observed globally. More pronounced increases were recorded in commodities, with energy outperforming; price increases were recorded also in certain asset classes, real estate in particular. Headline inflation has been mainly a US phenomenon, while EA lags behind. In more detail, commodity prices have surged since the beginning of the Covid-19 pandemic in March 2020, with the Bloomberg Commodity Price Index having increased cumulatively about 60% since its 46-year low hit on 18 March 2020. Energy in particular has increased by 90% between April 2020 and August 2021; crude oil markets have outperformed, with Brent oil roughly having tripled its price to about $70/bbl currently from $19/bbl in 21 April 2020, its lowest level in more than two decades. Industrial metals have increased by 77% between March 2020-August 2021. Similarly, agricultural products & grains have increased by 67% compared to lows. Rising oil prices have added upward pressure to the Global Food Price Index published from the Food and Agriculture Organization of the United Nations, which has experienced a cumulative increase of ca. 35% since its 4-year low of 91pts hit on May 2020.

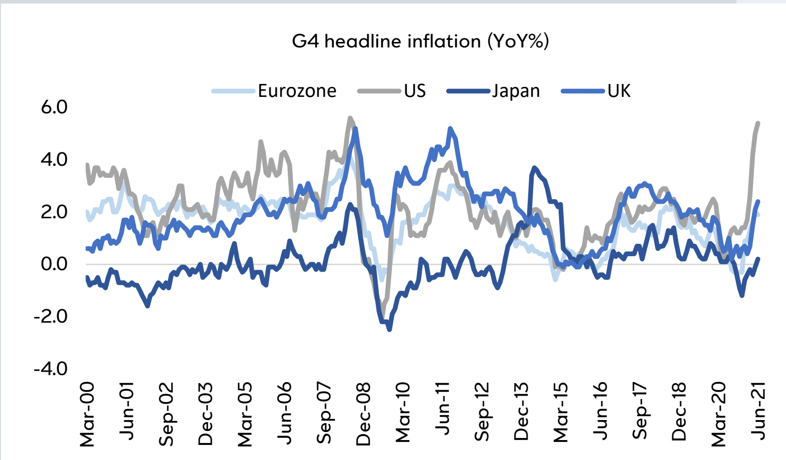
Housing prices, according to OECD data, have been rising since the onset of the pandemic (+ 9.5%YoY in the first quarter of 2021, the highest rate in the last 30 years or so, above the long-term average of 7.3%). Among main developed countries, the US and the UK recorded comparatively higher price growth rates in 2021, 12.6% and 9.0%, respectively, compared to 5.8%YoY in the Eurozone and just + 3.3%YoY in Japan.

Figure 1: Rising commodity prices add to increased inflation pressures



Source: Bloomberg, IMF, Eurobank Research

Figure 2: CPI inflation in US meaningfully higher



Source: Bloomberg, Eurobank Research

Table 1: Headline CPI Market consensus and official forecasts

Bloomberg Consensus	2020	2021	2022
World	-3.2	3.4	3.0
US	1.2	3.8	2.7
EA	0.3	1.9	1.4
IMF (July 2021)			
World	-3.2	6.0	4.9
US	-3.5	7.0	4.9
EA	-6.5	4.6	4.3

3. US: inflation on an uptrend

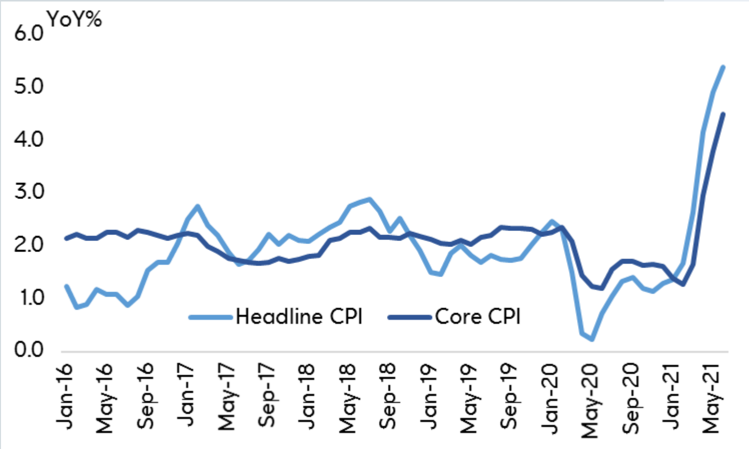
Inflation is a global concern given the fiscal and monetary policy boost in several countries around the world, rising commodity prices and the imbalances between supply and demand as the economies gradually open. However, the inflation jump in the US has been so far spectacular. Hence, given the country's big impact on the global economy and the USD's importance in financial markets as the world's reserve currency, rising inflationary pressures have been recognized as a predominant risk to the global economy. The fact that inflationary risks are far greater in the US than in the Eurozone is related to the unprecedented fiscal measures adopted in the US to contain the Covid-19 pandemic, which amount to around $5trn or 25% of GDP[1], compared to ~10% of GDP in the Eurozone. In addition, the economic recovery in the US is expected to be among the quickest and strongest in the advanced economies space. According to our projections, US real GDP growth is expected at 6.8% in 2021 (market consensus at +6.5%)[2]. With the economic slack likely to be reduced more quickly, further upward pressure on prices is likely. Upward wage pressure due to labor shortages could potentially lead to more sustained price increases in the US in the medium term.

US inflation has been on an uptrend since the turn of the year, accelerating significantly over the past couple of months. Headline CPI surprised to the upside in June (+0.9%MoM) after a sharp rise in both April and May (+0.8% and 0.6%MoM, respectively), bringing the annual rate up by a further 0.4pp to 5.4% (highest since July 2008). Core PCI, which excludes food and energy prices, advanced by 0.9%MoM in June following a 0.7% increase in May, rising by 4.5% on an annual basis, which is the highest rate since November 1991. The recent price acceleration was largely attributed to sectors that are mostly sensitive to the reopening of the economy such as transportation services (airline fares +2.7%MoM/+24.6%YoY in June). In addition, supply bottlenecks, particularly in semiconductors, have moved demand towards used car and trucks (+10.5%MoM/+45.2%YoY in June). Rising price pressures appear to be, to a large extent, transitory

[1] Without including the infrastructure packages.
[2] US growth compares to the UK's; our projection for +6.7% increase in 2021 vs market consensus of 6.8%.

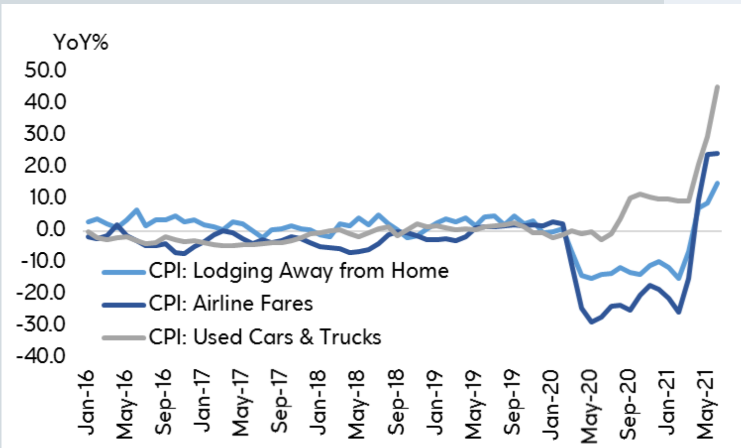
as restrictions on the services sector are gradually eased across many states. Yet, there are also some signs of upside pressures in core prices (Rent and Owners' Equivalent Rent-OER) that could prevail once the temporary pandemic-related drivers diminish.

Figure 3: US Headline and Core CPI Inflation



Source: BLS, Refinitiv Datastream, Eurobank Research

Figure 4: US CPI Subindices



Source: BLS, Refinitiv Datastream, Eurobank Research

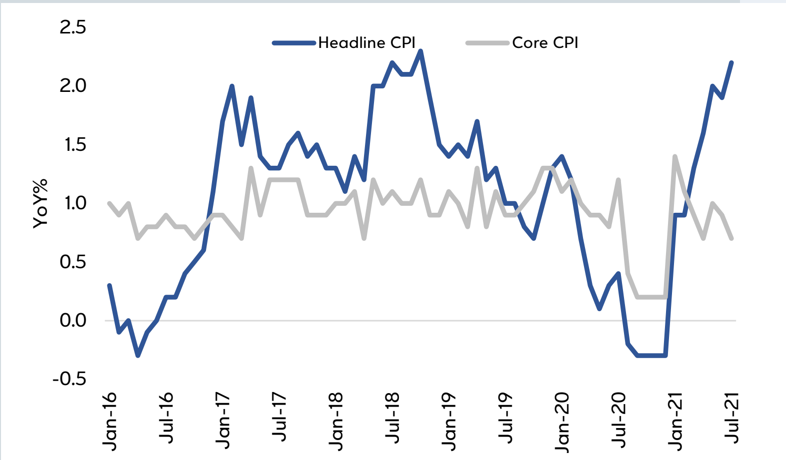
Overall, market consensus expectation is for US annual CPI inflation to remain strong in the remainder of the year, though receding gradually in H2 2021 as the economy returns back to normalcy and supply distortions, as well as base effects, gradually dissipate, after having peaked at around 4.6%YoY in Q2. Building PPI pressures as well as rising import prices and shipping costs are expected to keep core goods prices firm in the following months. Core PCE, the Fed's preferred inflation gauge, should run well above the Central Bank's 2.0% symmetric target in the short-term, expected to decelerate modestly towards 3.0%YoY in the second half of the year after having peaked at around 3.2%YoY in Q2.

4. Eurozone: headline CPI likely to remain in an upward path by year-end before falling back in 2022

According to the most recent data, the EA headline CPI increased from June's 1.9%YoY to 2.2% in July (flash estimate), the highest since October 2018, due to favorable base effects stemming from energy prices and a temporary VAT rate cut in Germany in H2 2020 (from 1.9% to 1.6%). Excluding the volatile prices of energy, food, alcohol and tobacco, the inflation rate edged lower to 0.7%YoY, from 0.9%YoY in the prior month, driven by changes in HICP weights at the start of the year and a technicality related to the delayed 2020 summer sales for clothing and footwear in a number of major Eurozone countries due to the pandemic. Looking ahead, we expect an acceleration in underlying inflation in the remaining months of the year, mostly due to associated supply/demand imbalances as the economy reopens and the positive effect of the German VAT rate cut that could potentially push headline inflation close to (or even slightly higher) 3.0%YoY by the end of the year. However, for the time being, we expect this increase to be transitory and inflation to move again below 2.0% in early 2022, mainly on the back of soft wage pressures and fading support from pent-up demand. The above forecasts are in line with the ECB's updated projections (10 June) which showed a 1.9% (+0.4pp) 2021 mid-point and a gradual decline to 1.5% (+0.3pp) in 2022, while the Central Bank kept its 2023 forecast unchanged at 1.4%, strengthening its message for only temporary pressures on inflation. These trends are compatible with projections for a softer and slower economic rebound in the Eurozone compared to most advanced economies (in line with the IMF's latest projections in July, we expect 2021 GDP growth at +4.6% in the Eurozone compared to +5.6% for advanced economies). Restrictive measures have been more stringent in most member states, thereby triggering a sharper decline in demand and more labor market slack. In the Eurozone there is no evidence of sustained upward pressures on wages as labor shortages seem less acute.

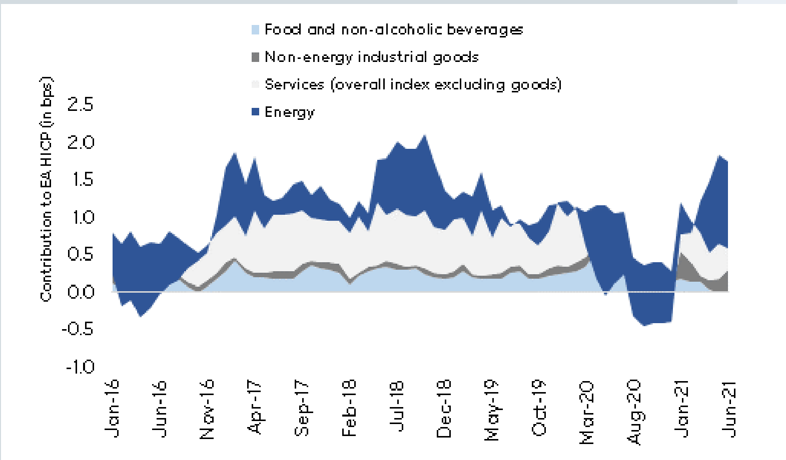
Sub-target inflation projections should keep ECB monetary policy accommodative for longer, a view that was further supported by the outcome of the Central Bank's policy strategy review. Key changes included a shift to a symmetric 2% annual HICP inflation target over the medium term, suggesting that negative and positive deviations of inflation from the target are equally undesirable. Since 2003, the ECB had adopted an annual inflation target "below, but close to, 2%". The ECB actually increased slightly the target itself by removing the implicit asymmetry suggested by the aim for inflation to be "below 2%". Hence, ECB indicated tolerance for potential modest overshooting for a while, when policy was earlier constrained by the lower bound on nominal interest rates, as is currently the case. As such, the risk of premature tightening amid higher inflation has been undoubtedly reduced, while the prospect of higher interest rates has been pushed further into the future, making an end to the ECB's highly accommodative stance even more distant. As part of the strategy review, the ECB also announced an ambitious action plan to include climate change considerations in monetary policy strategy. Furthermore, the ECB explicitly recommended the inclusion of the cost of owner-occupied housing (OOH) in the HICP basket (a decision that rests with Eurostat), as is already the case in the US, to better represent the inflation relevant for households (around two-thirds of households in the EA live in an owner-occupied property). Such a measure is not readily available by Eurostat and will likely take years to materialize, not least because of data quality issues. As announced, in the meantime the ECB "will take into account inflation measures that include initial estimates of the cost of owner-occupied housing in its wider set of supplementary inflation indicators". However, the inclusion of the OOH will not change significantly the inflation picture. Judging by previous ECB work, it is estimated that the headline and core inflation would have been pushed higher by an average of 0.1pp and c. 0.2pp per year, respectively, over the last decade.

Figure 5: Headline CPI rose to a more than 2-yr high of 2.2%YoY in July 2021



Source: Eurostat, Eurobank Research

Figure 6: Energy prices contribute strongly to higher headline inflation

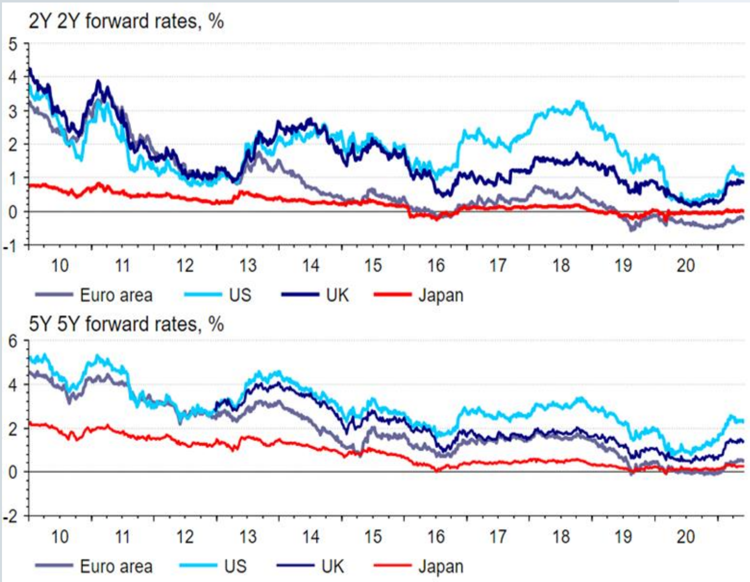


Source: Eurostat, Eurobank Research

5. **Have inflation expectations peaked?**

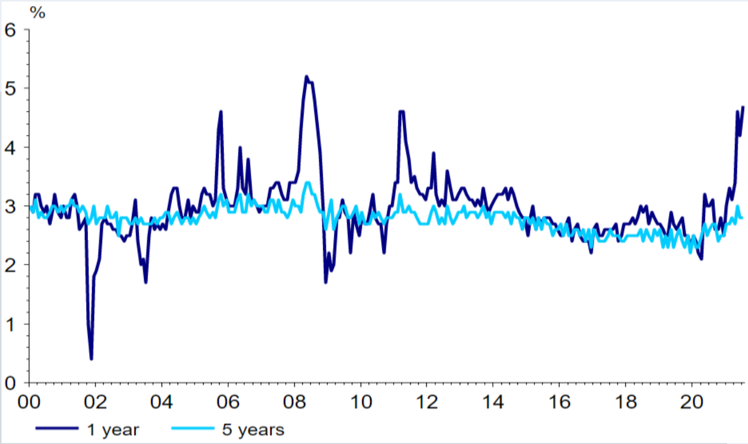
Inflation expectations are an important factor for the course of inflation in the medium term as they shape the behaviour of economic agents in the price setting process and thus the likelihood of transitory price pressures becoming more permanent. Increases in inflation expectations have been significantly stronger in advanced economies and particularly in the US, where 5y5y forward rates surged to their highest level since mid-2019. The unprecedented policy support that leads the US economic recovery, coupled with higher commodity prices partly due to supply chain shortages, have raised inflation concerns remarkably. Consumer surveys provided further evidence for the uptrend in expected prices, with University of Michigan consumer inflation expectations surging around 10-yr highs in the past three months. 5y inflation expectations increased to 3.0% in May, the largest monthly increase in about 30 years, before pulling back modestly to 2.8% in June and July, while 1y expectations rose to 4.7% in July from 4.2% in June, the highest reading in 13 years. The large gap between 1y and 5y expectations might suggest that households consider recent price pressures to be transitory. However, the fact that longer-term expectations are also elevated suggests agents are contemplating the possibility of recent pressures becoming entrenched. Meanwhile, falling supply chain considerations, the rhetoric by government officials which highlights the transitory factors that drive inflation higher, and the hawkish tilt of the June FOMC meeting, have all resulted in a pullback in US inflation expectations, with 5y breakeven falling from its recent high in mid-May by about 20bp to around 2.3% currently.

Figure 7: Inflation Expectations



Source: Refinitiv Datastream, Fathom Consulting

Figure 8: US Consumer Inflation Expectations,
University of Michigan



Source: Refinitiv Datastream, Fathom Consulting, University of Michigan, Eurobank Research

6. Risks for higher inflation near-term I: commodity prices are surging

Commodity prices have increased significantly in the post-pandemic period, leading, in combination with the strength of demand for goods and a squeeze on transport capacity, to significantly higher freight rates along major international routes. The rise in commodity prices (up by 20% cumulatively since major economies started to reopen, according to IMF data) has been fairly broad-based, with metals leading the way higher (up by a total 44% since the end of the lockdown). While industrial metals price increases feed into manufacturing cost, thereby causing second-round effects, food prices are important for perceived price levels, especially in developing countries where food comprises a large part of consumer's basket. In the past, price increases in main nutrition goods have caused geostrategic frictions and social upheaval.

Commodity prices have been boosted by several factors, including:

- *China's impressive economic recovery from the pandemic*, particularly driven by a boost to infrastructure investment, which underpinned strong demand for metals. The momentum is likely to continue as China's 14th Five-Year Plan focuses on R&D spending and manufacturing investment. Furthermore, strong demand from China, as the economic recovery has been gaining momentum and broadening out to consumer spending, also favored agricultural commodity markets; dry conditions in South America contributed too. Grains led the way higher, especially soybeans and corn.
- *Western governments' plan to increase their spending on infrastructure, mostly related to climate change policy* (i.e., green policies- rise of net zero carbon emissions) and electrification (government mandates and targets for electric vehicle market penetration). This has been a particular support for battery-related materials such as lithium & cobalt, and materials used for the construction of electricity networks such as copper, while this strong source of demand for those particular commodities is likely to persist in the coming months.

- *The strong upswing in global manufacturing industry after the initial impact of the pandemic*. Factories were able to re-open fairly quickly after the initial shock of the pandemic. In addition, lockdowns forced
- people to spend more time at home, encouraging them to spend more on household goods, including computer equipment, furniture and home gyms. Strong stay-home demand for consumer electronics during the pandemic (PCs, tablets, game consoles), has also been a major reason behind the global semiconductor shortage that has hit the auto sector particularly hard.
- *Global monetary accommodation/supportive fiscal policies:* Gold prices have an inverse relationship with interest rates while expansive fiscal policies (deterioration in the budget balance) favor the safe-haven appeal of the precious metal. The positive momentum for gold is likely to prevail short-term, on the view that global monetary accommodation and supportive fiscal policies will remain in place for the foreseeable future to ensure that the economic recovery remains on track, regardless of how the vaccination rollouts progress.

The FAO Food Price Index (FFPI), which captures the international price of commonly-traded food commodities, reported in May its biggest monthly gain since October 2010 (+4.8%MoM/39.7%YoY), before reversing part of its gains in June (declined by 2.5%MoM but still remaining 33.9% up on an annual basis). The decline in June was the first reported following an uptrend for the past twelve months that drove the index in May to its highest level since September 2011. This upturn was mainly attributed to a surge in prices for oils, sugar and cereals. Taking a more thorough look into the specific categories, the FAO Vegetable Oil Price Index advanced amid a combination of slow production growth in Southeast Asian countries and prospects of firm global demand. Furthermore, the respective Sugar Price Index also gained as there were harvest delays and reduced crop worries in Brazil, which is the world's largest sugar exporter, due to prolonged dry weather conditions. Last but not least, the rise in the Cereal Price Index mirrored rising global maize prices (+90%YoY in May) due to gloomier production prospects in Brazil that weighed on already tight global supplies and strengthening demand.

According to the latest Global Food Market Outlook published in early June by the Food and Agriculture Organization of the United Nations (FAO)[3], global food markets developments over the last couple of years were characterized by fast growing global trade and rising food imports. In such an environment, international food prices are expected to remain strong in the remainder of the year and in 2022 amidst many supply and demand uncertainties. Early forecasts put the value of global agricultural trade (measured by exports) firmly on an uptrend, confirming the resilience of the sector to the Covid-19 pandemic. With the global economy projected to gather considerable pace in H2 2021, global demand for commodities, which is generally more income-elastic, could bounce exerting upward pressure on inflation dynamics.

[3] http://www.fao.org/3/cb4479en/cb4479en.pdf

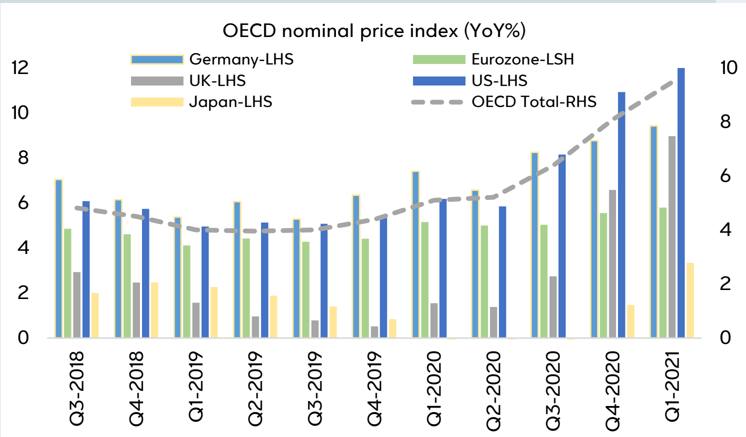
7. **Risks for higher inflation near-term II: house prices are booming**

The OECD nominal house price index was up by 9.5%YoY in Q1 2021, a rate not seen for around 30 years, and higher than the long-term average rate of 7.3% recorded in the 1980s. Data pertaining to Q22021 suggest that a further acceleration seems to be on the cards, adding to the risk for higher rents at some stage. There are several reasons that seem to be causing this unusual dynamic of sharp house price increases during the pandemic. These include:

- *Ultra-low interest rates.* People who were on the edge about buying a home have jumped into the market; most of them are first-time homebuyers or near-retirees who hasten the purchase of a retirement home while not giving up their primary residence. Additionally, the pandemic has pushed wealthier households into homeownership.
- *A shift in family spending towards housing.* According to studies on the consumer behavior during the pandemic, households are shifting their spending patterns: less for travel and vacations, eating out, entertaining; more for housing, especially if more space is needed to work/study from home.
- *Bottlenecks and other supply constraints*. Shortages of building materials, lack of labor, lack of land.
- *Shifting housing preferences.* Increased preference for more space as the pandemic forced people to spend more time at home. The pandemic also reduced the attractiveness of urban amenities due to social distancing measures. These simultaneous pressures have seen people moving from city-centre flats to rural and non-metropolitan areas, opting for bigger homes with extra space to accommodate simultaneously work and school.
- *Fewer houses for sale.* Potential sellers do not want to risk infection with buyers wandering through their homes for showings.

Looking ahead, we expect a moderation in global housing prices as demand is likely to slow when post-pandemic adjustment is complete. Several people are moving back to city rental as they have to return to their office, while the perceived fear about the pandemic is gradually falling. The prospect of higher interest rates as some major CBs are gradually preparing the ground for policy normalization, is also likely to magnify the expected slowdown.

Figure 9: Booming house prices



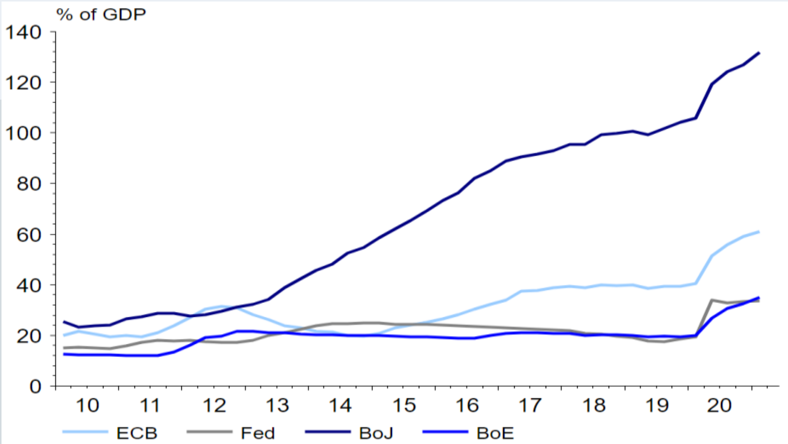
Source: OECD, Eurobank Research

8. Risks for higher inflation medium-term III: accommodative monetary policy and fiscal expansion

Central banks have responded to the recession brought about from the pandemic with an ultra accommodative monetary policy mix, including zero interest rates and expansion of their balance sheets (Quantitative Easing, see Figure 10). As a result, market interest rates are at historically low levels, encouraging excess borrowing and higher debt levels. It seems that it will take some time before monetary policy laxity is reversed, given central bankers' willingness to tolerate higher inflation in the short-term in order to ensure that the economic recovery remains on track (according to 3M Eurodollar Futures, the Fed is expected to stay put on interest rates by late 2022, while the ECB is not likely to hike rates before early 2025). While there is a risk of CBs failing to recognize inflation spirals before it is too late, central bankers seem determined to prioritise dealing with the opposite risk, namely that of destruction of productive fabric and cliff effects from premature withdrawal of support measures.

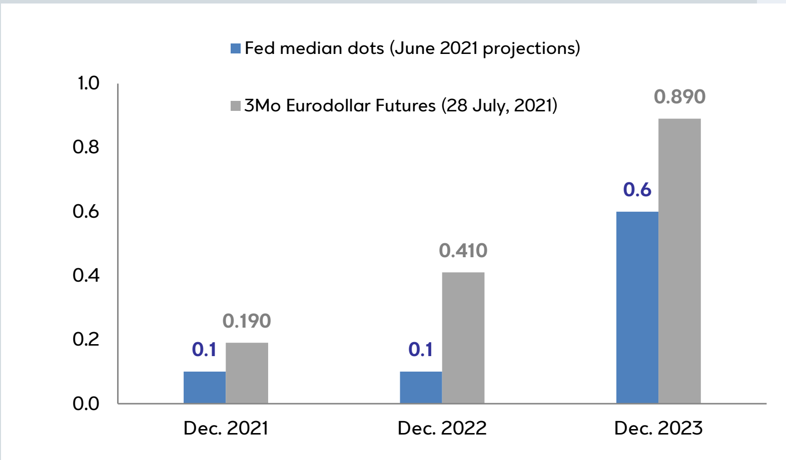
Accommodative monetary policy also serves the additional purpose of facilitating the serviceability of public (and private) debt, which was substantially increased during the pandemic due to fiscal support measures. According to the IMF's Fiscal Policies Database updated in July (as of June 5th, 2021), key fiscal policy measures adopted by the US government in response to the Covid-19 pandemic amounted to ca. $5.3trn or ~25% of GDP, while the respective number for the European Union is around €1.2trn or ~10% of GDP. The unprecedented measures have resulted in an increase in the general government gross debt-to-GDP ratios, especially in the US with a cumulative annual increase of ca. 19bps to 127% in 2020, while the respective number for the EU was 93% from 91.6% in 2019. Among the EA countries, Greece has experienced the biggest debt-to-GDP increase in 2020 (+28bps to 213%), followed by Cyprus (+24bps to 118%), Spain (+22bps to 117%) and Italy (+21bps to 156%). Once the economies are on a steady track and wage pressures are building, interest rate hikes would begin, which in turn could bring debt sustainability issues on the fore for the most heavily indebted countries. All countries should pursue a decisive and coordinated economic policy that allows a rapid economic recovery through productive investment and promotion of structural reforms which enhance long term growth. Yet, governments of the most indebted euro area countries should, in addition, make the most of the current low interest rate environment to issue debt with the longest possible maturities or extend official public debt maturity, thereby allowing for a long period of very low debt servicing costs. Higher inflation could reduce the value of the existing debt stock. However, in that case, the market would adjust its yields accordingly, as investors would demand higher interest on future debt. Although the Central Bank's job is to keep inflation in check and not to keep yields under control, policymakers should strike a balance between the two opposite causes. The optimum policy mix should include pro-growth policies to increase the serviceability of debt.

Figure 10: Central Bank Balance Sheets, Total Assets



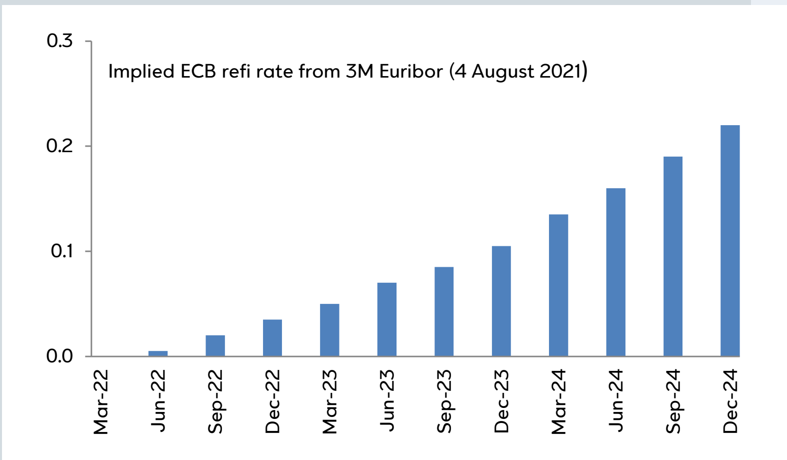
Source: Bloomberg, Refinitiv Datastream, Fathom Consulting, Eurobank Research

Figure 11: Fed funds rates are expected to remain unchanged by late 2022



Source: Bloomberg, Eurobank Research

Figure 12: Ultra accommodative ECB policy for a prolonged period

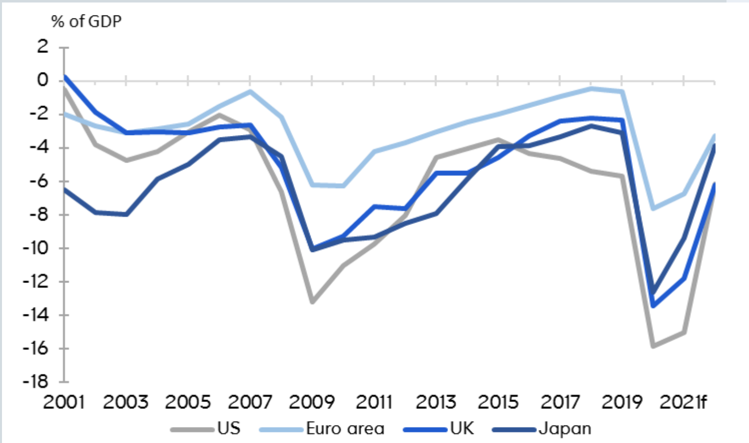


Source: Bloomberg, Eurobank Research

9. **Risks for sustained high inflation medium-term IV: Unprecedented fiscal boost and substantial excess savings**

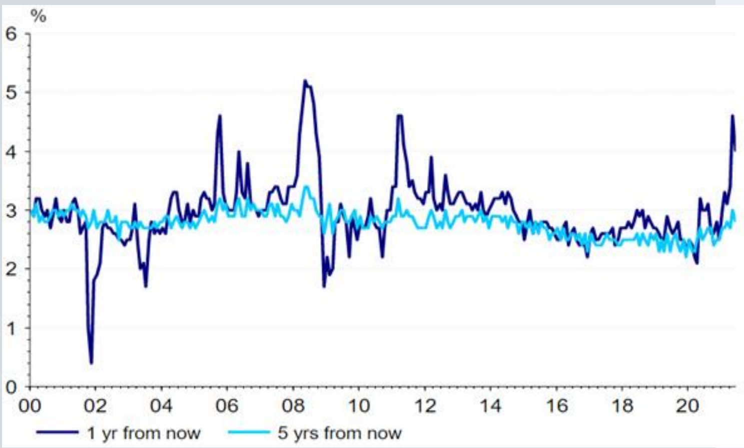
Households across major advanced economies have built up precautionary savings over the past year, partly due to unavailability of certain consumption options and need to protect themselves from increased uncertainty. However, this trend was reinforced by extraordinary fiscal support measures adopted to limit the economic damage caused by the pandemic. Since the onset of the Covid-19 crisis, personal net worth has risen significantly, with savings in excess of end-19 levels having surged by about 8.0-10.0% of GDP in the US (~$1.8trn) and the UK (~£220bn), and around 5.0% of GDP in the euro area (€600bn). A crucial factor regarding the future trajectory of inflation is how households will ultimate use these savings. The proportion of the pandemic savings that will be spent and the actual speed of the savings' unwinding will determine the path of consumer spending and the extent to which the release of pent-up demand could boost further inflationary pressures

Figure 13: General government net lending/borrowing



Source: IMF, Refinitiv Datastream, Eurobank Research

Figure 14: Household Savings

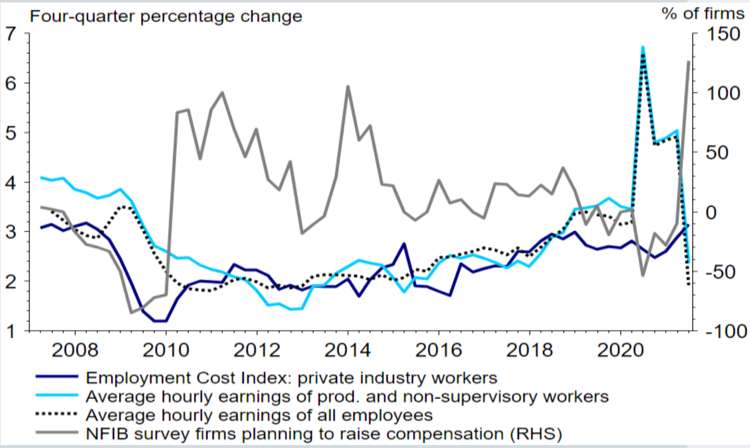


Source: IMF, Refinitiv Datastream, Eurobank Research

10. Risks for sustained high inflation medium-term V: US wage pressures

US wage gains have recently surpassed consensus estimates, adding to investors' concerns over rising inflationary risks. Although US total employment remains well below its pre-Covid-19 level, labor market shortages have added upward pressure to average hourly earnings, reinforcing fears of a potential wage-price spiral and more sustained price increases in the medium term. In theory, rising wages could give boost to disposable income, which may, in turn, increase the demand for goods and, therefore, cause prices to rise. Nevertheless, Federal Reserve Chair Jerome Powell has noted that the historical close relationship between wages and final prices has weakened remarkably in recent years. To this end, the Economic Policy Institute argues that the diluted bargaining power of typical workers in the labor market suggests that it should take very low rates of unemployment and for a very long time in order to drive wage growth higher.[4] Fed officials do recognize that pandemic-related policies such as fiscal stimulus checks and higher unemployment benefits could drive wages higher. Nevertheless, they highlight that the earnings' increases are concentrated mainly in the lower paid industries, which is desirable for the economy and does not lead to higher salaries on the whole. In any case, incoming wage growth data are currently distorted by pandemic-related factors, in the sense that there is a shift in the composition of employees that has caused the average wage to increase (low-paid workers lost their jobs, while relatively high-paid workers remained employed.[5] Hence, it will take some time before these distortions fade away and we more secure conclusions can be made about whether there is a sustained upward wage growth trajectory.

Figure 15: US Wages



Source: Refinitiv Datastream, Fathom Consulting, Eurobank Research

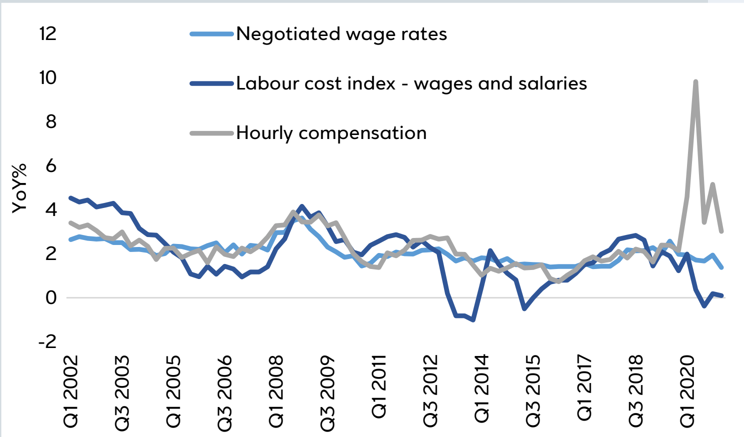
[4] https://www.epi.org/blog/inflation-sources-consequences-and-appropriate-policy-remedies/

[5] https://www.whitehouse.gov/cea/blog/2021/04/19/the-pandemics-effect-on-measured-wage-growth/

11. EA wages: No sustained upward pressures expected

In the EA, there are few signs of widespread labor shortages or pay pressures that could lead to a wage-price spiral in the coming months. Admittedly, there are some signs of labor slack in a handful of sectors as the economy gradually reopens, especially in hospitality. According to the EC's latest quarterly survey for Q2, the number of firms reporting difficulties in hiring workers to meet increased demand as Covid-19 related restrictions are gradually lifted, has increased above that in 2020. Nevertheless, it is still below pre-Covid levels, supporting the view that any upward pressure on wages as the economy recovers, is likely to prove short-lived and well contained. In fact, labor market slack is currently larger than official unemployment statistics suggest, as the labor markets in several large EA countries have been well protected by the job protection schemes. The unemployment rate stood at 7.7% in June 2021, after reaching a post-pandemic peak of 8.7% in August 2020, well below the levels seen during the global financial crisis and the EA debt crisis. What's more, the relatively slow pace of economic recovery and the process of re-integrating furloughed workers at their previous jobs when the said schemes expire (expected between September and December this year), should largely prevent the emergence of sustained upward pressures on wages or inflation.[6] Meanwhile, EA wage data have surprised to the downside lately, with negotiated wage inflation having dropped to just 1.38%YoY in Q1 2021, the lowest pace ever. Furthermore, recent pay deals in major EA countries have not resulted in significant wage increases as, under current conditions, unions seem to prioritize job security over pay rises. That is mostly because EA wages are strongly influenced by collective bargaining (in contrast to the US). Indicatively, in Germany, the IG Metall which represents 2.2 million workers and had initially demanded a 4.0% increase, agreed on a 2021 pay rise of just 2.3% from July, which will not be paid out until February. To sum up, wage inflation is the EA is expected to remain subdued as the economy recovers and moves closer to normal, supporting the view for accommodative ECB monetary policy for longer.

Figure 16: No signs of wage pressures in the EA



Source: ECB, Eurobank Research

[6] Note that services EA HICP inflation accounts for around 2/3 of the core basket and is heavily affected by wage dynamics.

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