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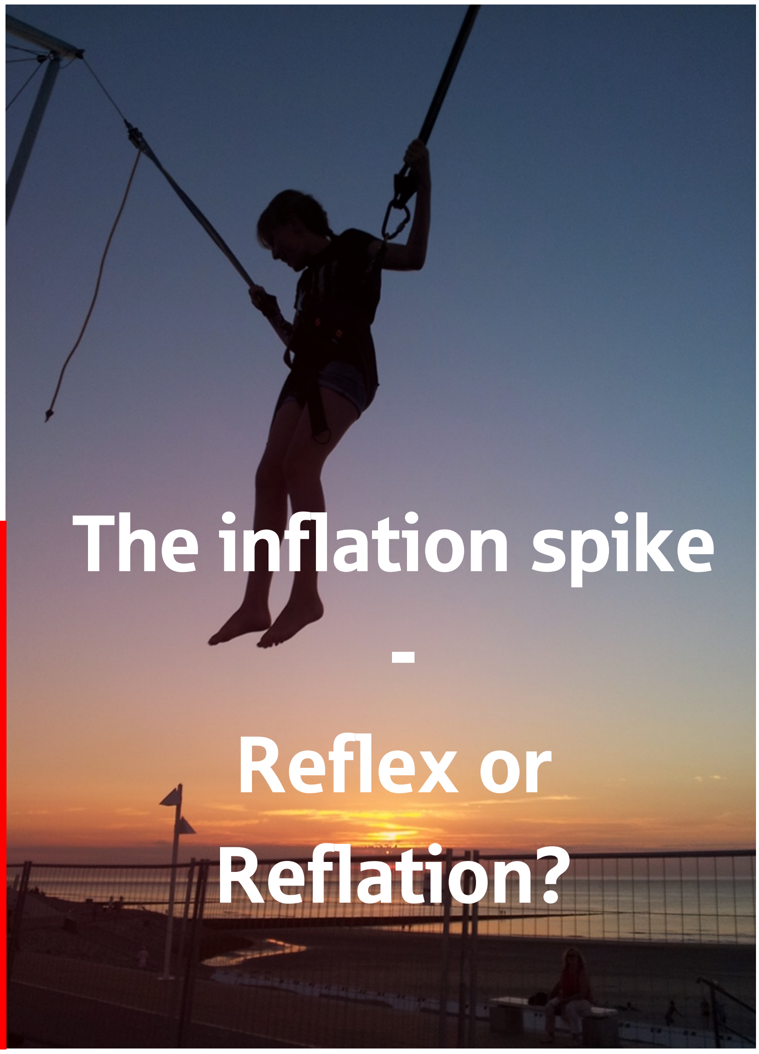

The inflation spike - Reflex or Reflation?

6th July 2021

A shift in perspective has taken place with regard to the topic of inflation. Where, in the past, it was mainly too low rates of price increases that were regarded as a problem, the current inflation spike is now causing concern. Is the recent upward shift in inflation dynamics already a harbinger of a systematically steeper price path? To a large extent, the price swings observed so far have been reflex-like ("knee-jerk") countermovements. In part, these are an expression of a normalisation of prices after a year in which downside pressure was put on inflation by the pandemic crisis; in part, these reflexes are due to supply bottlenecks, which should disappear as the situation progresses.

- At the moment, strongly surging - and, in some cases, already elevated - rates of price increases are unsettling. Going forward, however, moderate - and, once again, more reliable - price trends can be expected.
- The reversion to a higher inflation trajectory, or a "reflation" scenario, is neither inevitable nor to be ruled out. What is certain is that the price movements witnessed to date are not to be classified as evidence of such dangers.
- Timely and careful monitoring of price risks is a prerequisite for effective inflation control. Successes on this front can be gauged from whether or not inflation expectations are well-anchored. The current upward bias in inflation expectations does show, however, that at least the risk of a possible upward shift in the inflation trend has become greater.

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The 2021 surge in inflation

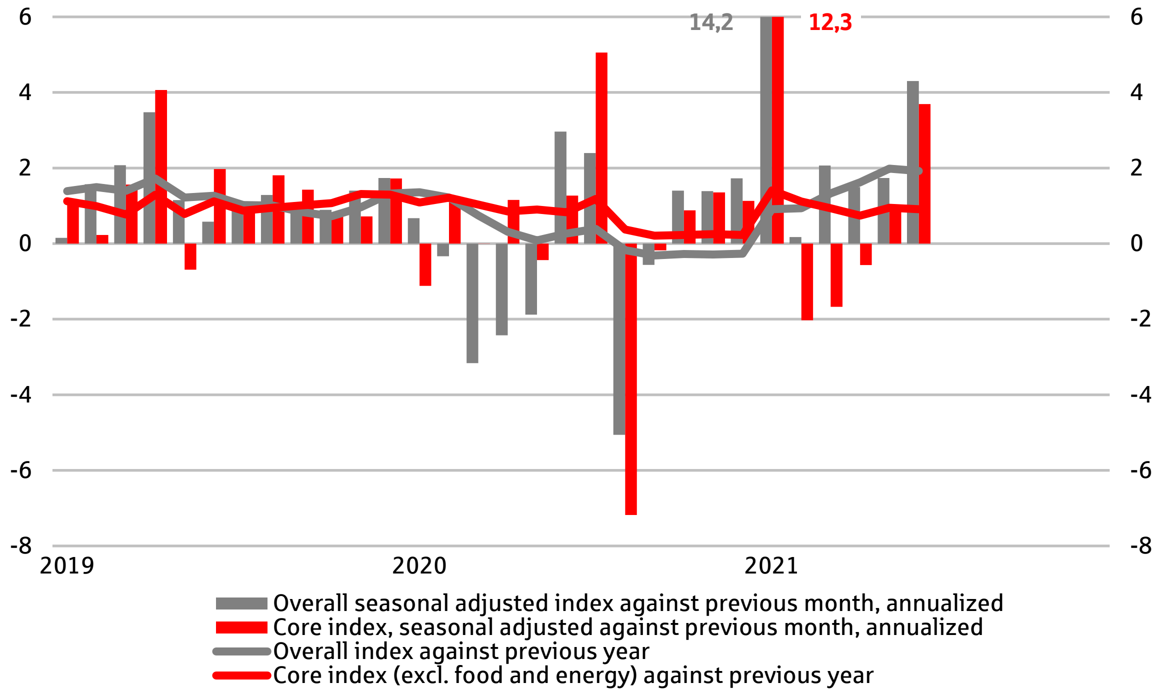
Inflation has surged - even more sharply than expected

The past few months have been marked by a significant increase in inflation. In some places, the usual objective of two percent has already been exceeded. In principle, this development had already been predicted; however, the actual pace of the acceleration in inflation over the first half of the present year has clearly outstripped expectations.

A big bang already materialised at the start of the year

The Harmonised Index of Consumer Prices (HICP) for the euro area sprang the first surprise, jumping by a whopping 1.2 percentage points to 0.9 percent right at the beginning of the year. On this front, the customary drop in prices after the Christmas holidays was completely absent - on a seasonally-adjusted basis, the January 2021 reading, 1.1 percent month-on-month, was indeed the highest monthly price increase observed since the introduction of the euro[1].

Euro Area: Inflation trend
in %



Source: Eurostat, ECB

Special influences that were foreseeable

The special influences aiding and abetting the significant increase in inflation which we are witnessing have already been described many times and will therefore only be briefly summarised here. First and foremost, mention has to be made here of the expiry of the reduced VAT rates which applied over the second half of 2020, and of the simulta-neous expansion of CO_2 pricing in Germany. Over the course of the first

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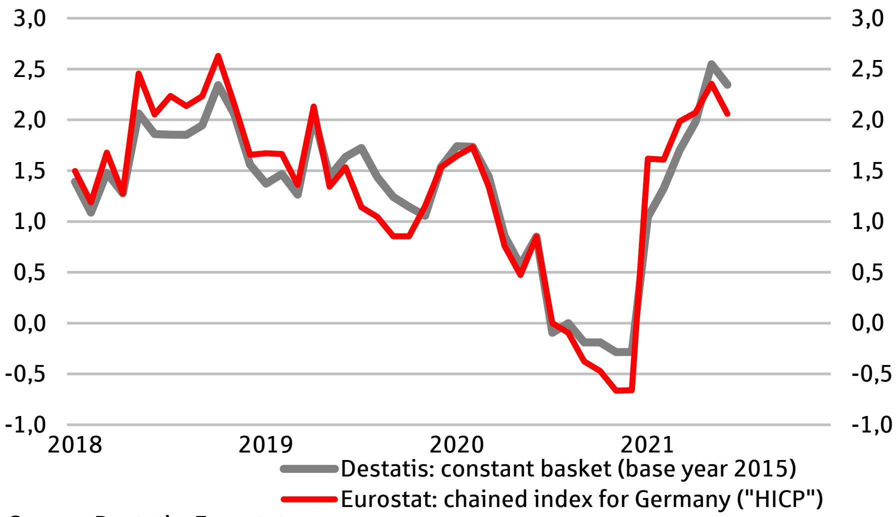
[1] The previous month-on-month peak reading was 0.7 percent at the time of the euro cash changeover in January 2002. The above seasonally-adjusted inflation figures are based on ECB calculations. In order to be directly comparable with inflation rates, the monthly changes in the chart have been annualised.

half of the year, strong base effects have likewise come into play, relating primarily to the very pronounced temporary decline in energy prices in spring 2020. In principle, however, they were also due in a weaker form to the fact that the previous-year baseline had now also moved lower because the pandemic had decimated demand in the relevant consumer sectors at the time.

The HICP will be more susceptible to capricious movements during 2021

The strong fluctuations in the inflation trend at the beginning of the year were furthermore caused by methodological factors pertaining to the HICP. From the turn of the year onwards, all price adjustments in the Harmonised Index of Consumer Prices have been subjected to updated HICP weights, the intention here being to reflect current household consumption patterns as far as possible.[2] Under the conditions of the pandemic, the basket of goods underlying the HICP was shaken up particularly vigorously this time round. Individual components characterised by pronounced seasonal fluctuations lost considerably in importance, so that firstly their footprint in the overall index diminished and secondly their intra-year pattern changed. Accordingly, price volatility around the time of the main travel periods has receded into the background this year. In keeping with this, the price jump at the beginning of the year was followed by countervailing dampening influences in the run-up to Easter.[3]

Comparison: National and harmonized inflation in Germany
against previous year in %



Source: Destatis, Eurostat

[2] Since basket weights change every year, it is customary to speak of a chain-linked index.

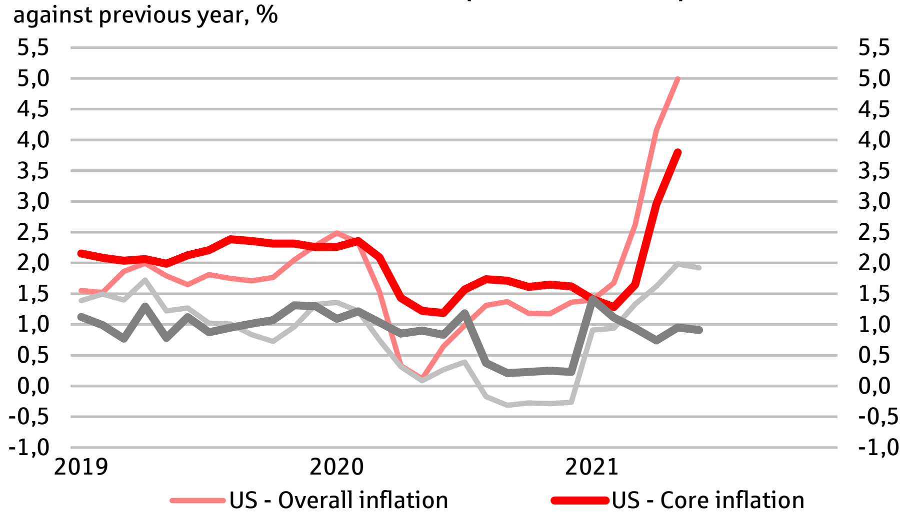
[3] Compared to the Destatis rate, which is still calculated on the basis of the 2015 reference period, inflation in Germany according to the HICP concept was 0.56 percentage points higher in January 2021, whereas previously it was 0.28 points lower.

A comparison with US inflation trends is informative

Inflation volatility turns out to be more moderate in the euro area than in the USA

The fact that methodological issues exert an influence on statistically reported inflation coud already be intuited last year if a comparison was drawn with price data from the United States. Stateside, a more marked downward price reaction was observed in response to the outbreak of the pandemic, while the practice of filling in missing price data partly concealed this in the euro area.[4] In the USA, however, the compensatory countermovement followed swiftly during the summer recovery phase. The core inflation rate, excluding volatile food and energy prices, halved to 1.2 percent in American cities between February and May 2020, before rising again to 1.7 percent by August. Half of the very striking 2.5-point rise in core inflation over the last three months to 3.8 percent (the headline inflation rate even climbed to 5 percent in May 2021) can therefore be attributed to the low baseline from the previous year. For this reason alone, fluctuations in inflation in the euro area are likely to prove more moderate than on the other side of the Atlantic.

Euro Area, USA: Inflation developments in comparison
against previous year, %



Source: Eurostat, BLS

Albeit in a mild form, prices in the euro area…

Nevertheless, the other half of the recent surge in inflation has to be attributed to price developments occurring at the present juncture. Since the US economy is cyclically ahead of its European counterpart, partly on account of the rapid rise in vaccination rates stateside, similar price trends could also take hold in the euro area after a time lag.

...are following in the footsteps of developments in the USA

However, two factors argue against US consumer-price trends being simply replicated on a 1:1 basis in the Old World. In the euro area, demand spikes comparable to those observed recently in the USA are scarcely likely to occur because such spikes were triggered primarily by

[4] We reported on this phenomenon in an issue of “Statement” published in September 2020: https://www.dsgv.de/content/dam/dsgv-de/englische-inhalte/standpunkte/200929-Standpunkt-Inflation-in-Zeiten-der-Pandemie_ENG-Final.pdf

the large fiscal package signed into law by the Biden administration. In addition, price jumps for just a few goods and services have recently exercised a major influence on the aggregate CPI index in the USA. More expensive used cars and air travel, for example, which account for less than 5 percent of the core index, have been responsible for as much as half of the spectacular rise in US CPI over the past two months.[5] The extent to which there will be more dynamic price adjustments across the board in the USA is therefore not yet clear. However, alternative measures of underlying price trends[6] confirm, at least to an attenuated degree, a rising trend in US inflation that cannot be explained by base effects alone.

Massive inflation via the intermediate-input channel

Price spikes on commodity markets

It is an unmistakable fact that the economic recovery has spawned massive price increases for primary materials worldwide. This begins with high commodity prices, although differences across the commodity complex need to be pointed out here, as can be seen in the table below. For example, the price slump following the outbreak of the crisis was extreme in the case of energy sources (first column), but otherwise only moderate. In contrast (second column), today's prices for industrially used materials are significantly above pre-crisis levels, although (third column) price increases since the trough of the crisis have been high but not outstandingly so, and during the course of 2021 so far (last column) an almost unidirectional increase in commodity prices has been in evidence.

Commodity prices (euro-based)

Change in %	Apr 2020 vs. Jan 2020	May 2021 vs. Jan 2020	May 2021 vs. Jan 2020	May 2021 vs. Dec 2020
Aggregate index (HWWI, euro area)	-45	+19	+116	+36
without energy sources	-10	+51	+67	+31
Industrial commodities	-12	+62	+83	+36
Oil price (Brent)	-56	-2	+124	+36

Sources: HWWI (Hamburg Institute of International Economics), IMF, Macrobond, own calculations

The “supercycle” thesis does not carry conviction, at least not yet

The conclusion is that this data constelllation is again overlaid by base effects (focused on the energy sector), while showing an acceleration in

[5] In both these expenditure categories, price increases of a shade more than 17 percent have been reported: in this context, air travel is normalising in the wake of a phase of deeply discounted prices, whereas used cars are displaying genuine price spikes on account of a scarcity of semiconductors and, as a consequence, of faltering vehicle production.

[6] Reference should be made here, inter alia, to the *Sticky Price Index* compiled by the Atlanta Fed and to the *Underlying Inflation Gauge* modelled by the New York Fed.

the overall price level over the last six months - an accelelation which has not yet gone beyond a price normalisation in the case of the energy sector.

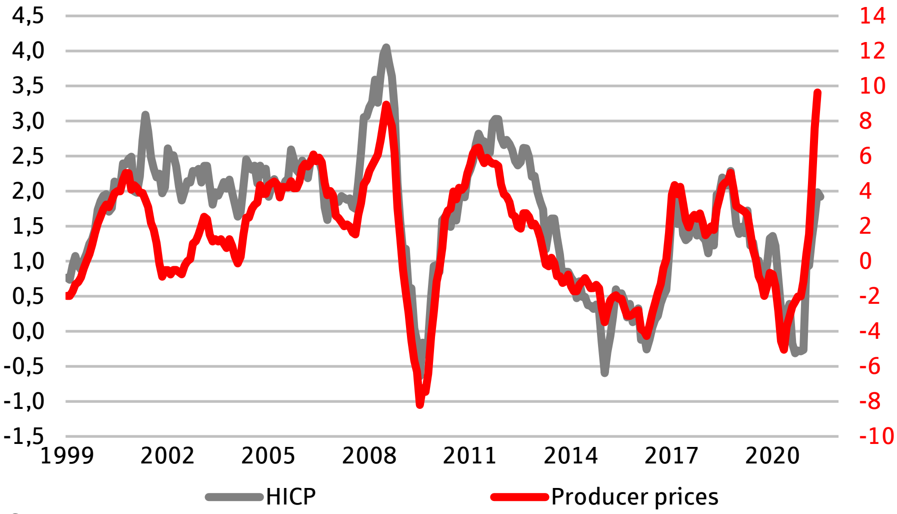
In the other segments, however, what we have seen certainly exceeds mere price normalisation, and significantly so in some cases. Marked price spikes have materialised, especially in the case of industrial raw materials. Sometimes there has already been talk of a new "supercycle" in commodity markets, which could result from a conjunction of general post-pandemic recovery tendencies with a structural increase in demand in connection with the fight to achieve greater climate neutrality. But such conclusions are still, as yet, merely speculative. This is because additional revenues naturally create incentives to ramp up production and smelting activity, which could be the starting-point for a correction of the steep price trend in the near future ("hog-cycle effect").

High goods-price inflation...

For the time being, however, this does not change the increasing cost pressure on the intermediate-inputs side, which has now become clearly visible at the level of imported inflation and producer-price inflation: while producer prices are now exhibiting high single-digit annual rates, the rates of change for import prices are currently even in the double digits. Such trends will not leave the cost of living for private households unscathed. As the following chart illustrates, the transmission process is, however, only very subdued, with prices in the domain of consumer goods already rising a good deal more slowly than the respective overall indices.[7]

Euro Area: Consumer and producer prices

against previous year in %



Source: Eurostat

[7] Across the euro area, producer prices for consumer goods are currently running at an annual rate of around 2 percent; the rate of change for imported consumer goods is lower.

With a view to general inflation trends, an inflationary movement in goods prices can definitely be ascertained, on the one hand. On the other hand, this effect should not be passed through in full to the cost of living.

... is only feeding through to the cost of living in a muted manner

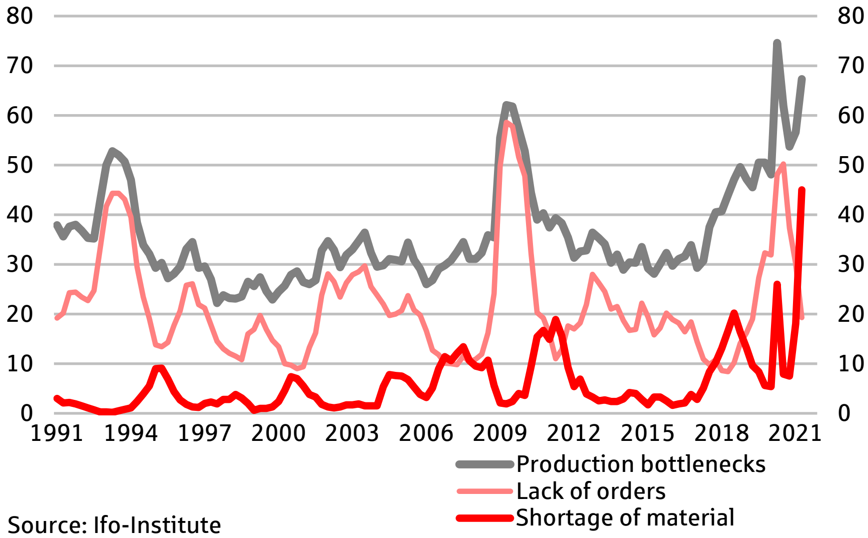
Prospects for industrial-goods prices

This equation must currently be enlarged to include factors arising from acute material shortages. For the lack of semiconductors, timber or special plastics is being cited by German industry as an unprecedented obstacle to production. Worldwide supply-side and logistics bottlenecks, most recently massive logjams in the merchant-shipping field, are causing tensions that could likewise become the starting-point for price increases.

Primary materials are in short supply

Germany: Obstruction of production / reasons

Business survey, manufacturing, yes-answers in %



Source: Ifo-Institute

However, the greater the extent of actual interruptions in production, the lower material consumption will be. This ought to alleviate demand-driven price pressure, at least in the case of those intermediate products for which there are no acute supply shortages. To some extent, then, the "double whammy" of demand-driven price spikes and material shortages should therefore be viewed not as complementary but as alternative phenomena. True, it must be taken into account here that value chains have generally become more vulnerable as a result of the pandemic, making inventory accumulation, even to the point of hoarding critical goods, a plausible corporate reaction. However, one can still assume that the current disruptions can be overcome and that the resulting upside price pressure will turn out to be only transitory in nature.

Production disruptions are putting a brake on the recovery and thus also on demand

Vulnerable value chains are stimulating demand

Another argument suggests that price pressure is going to ease further down the road in the industrial-goods sector. The mild price decline for non-energy raw materials at the beginning of the crisis can probably be explained by the fact that the sluggishness of consumption was concentrated on services provided via personal contact and that consumption habits shifted towards industrially produced goods. The recovery in demand that is now hoped for should then, logically, be accompanied by a gradual reorientation towards pre-crisis consumption patterns. If prices are currently still being driven by a mixture of "recovery" and "shift," this could, in turn, at least mitigate the inflationary pressure in the goods sector in the future.

The repercussions of changed consumption habits

Finally, imported inflation itself will presumably slow down the economic recovery this year by siphoning off purchasing power from euro area economic agents. As things stand at present, the average annual increase in import prices for goods in the European Monetary Union could work out at 10 percent, which would put the extent of this effect at no less than three percentage points of GDP. With inflation running at just under 3 percent, additional export earnings would only compensate for one-third of this effect. Last year, by contrast, the euro area still logged an increase in purchasing power of 1.5 percentage points of GDP due to relative shifts in foreign-trade prices on the merchandise-trade side.

The higher import bill is slowing down the recovery

As an interim conclusion, it can be inferred that inflationary impulses in the goods sector are *firstly* focussed on raw materials and intermediate inputs, *secondly* that the currently high annual rates are very largely, but by no means exclusively, due to base effects, *thirdly* that this price pressure - albeit in a significantly mitigated form - is bound to have a delayed effect on consumer prices, and *fourthly* that neutralising and, in some cases, countervailing influences can be anticipated going forward.

An interim conclusion

A restart beset with difficulties

Industrial goods, together with energy and food, account for almost three-fifths of the basket of goods underlying the HICP, while services account for the remainder (41.8 percent). After the adjustment to the HICP weights for the basket of goods and services, aimed at bringing it into line with the expenditure structure of the crisis year 2020, their share fell by 3.4 percentage points, with the four categories passenger transport, leisure and culture, package tours and restaurants and accommodation alone suffering a disproportionate "loss in importance" of 4.8 percentage points, taking their cumulative share down to a current level of 11.8 percent. This corresponds to a dramatic relative reduction

The weightings of service prices have declined

Gaps in inflation computation

in the weighting of these categories by almost 30 percent, but without any significant price reductions being recorded in the process.[8]

Demand recovers, but supply is still limited

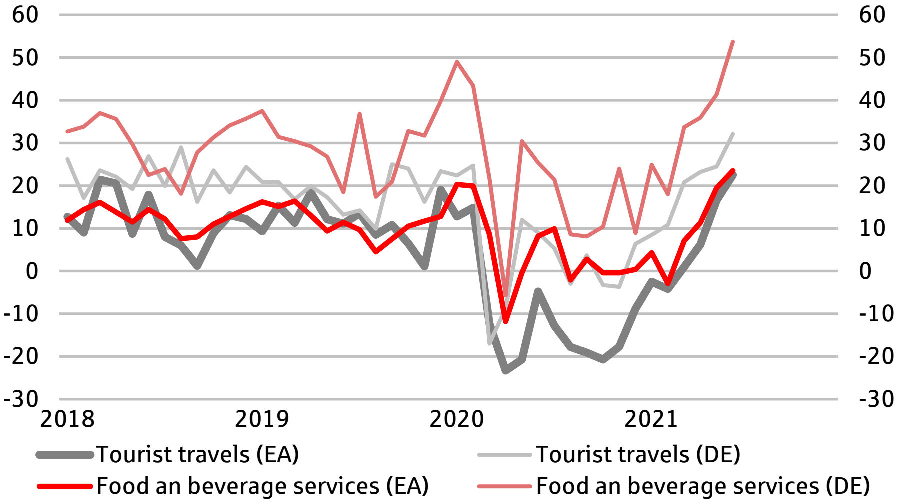
Against this background, no inflationary base effects are, at any rate, to be expected from these spheres in 2021. Nevertheless, there is certainly cause for concern that the combination of a recovery in demand with a still limited supply situation could lead to relatively noticeable price increases in these areas. Similar tendencies have already been in evidence recently in the USA, for example, regarding accommodation and car-rental prices. In Germany, the catering industry is similarly complaining about difficulties over bringing back staff, who cannot as yet be offered real employment security given the still uncertain outlook.

Imponderables remain

There are still many imponderables on the demand side as well. One case in point is travel, where people's desire to "up and off" will remain muted until freedom of movement has been comprehensively restored. It is true that travel within the EU is beginning to normalise; but many non-European destinations are still subject to considerable restrictions. Conversely, visitors from outside Europe are often going to remain absent along the continent's shores. In addition, business travel will be slow to ramp up, and activity in this sphere is likely to remain subdued for quite some time to come.

Price expectations in services

Balance, charged prices in three months



Source: DG EcFin

According to surveys, many households are still as cautious regarding their travel planning as they were last year.[9] However, inflation may be driven higher by the fact that the smaller group of travellers to be

[8] Often, however, these HICP components have simply been extrapolated due to a lack of available data, the corollary being that price data are less than entirely informative about the past year.

[9] This was, for instance, a finding generated by a representative survey conducted on an annual basis by Berliner Sparkasse.

anticipated in future is likely to include more households with higher travel budgets, which will furthermore have to be distributed over a still limited range of destinations.

Admittedly, the price expectations of tourism-related industries are showing a moderate upward bias compared to the crisis year of 2020. However, a marked majority of restaurants expect to be able to implement higher prices.[10]

The return of inflation?

The rationale for "reflation"

As inflation has risen in recent months, the debate about an imminent paradigm shift in price dynamics has gained greater resonance. Proponents of this thesis assume that the era of low inflation is coming to an end because, firstly, the size of the working population is now declining due to demographic trends and following the global economic integration of many emerging countries and, secondly, demand for more labour-intensive services increases in ageing societies, so that wage increases will arguably be easier to push through in the future. In addition, it is argued, the trend towards de-globalisation will become stronger, the alleged upshot being that cost-reduction potential from international trade ties would come into play to a lesser extent. Last but not least, the argument continues, fiscal policy will bring the economies closer to their capacity limits through large-scale crisis interventions, and the monetary policy of central banks will be trapped in a permanent supportive mode, allowing countermeasures to be taken hardly at all, or else only after a great delay, in the event of price dangers rearing their heads.

Confirmatory evidence is still missing

These considerations are plausible, in principle, and such warnings are therefore quite justified. Equally justified, however, are doubts about the reflation thesis. For example, the negative correlation between unemployment and inflation ("Phillips curve trade-off") no longer seems to have been particularly robust for some time now. In the second half of the last decade, core inflation in particular did not react to the decline in unemployment rates in the way that economic textbooks implied it should.

The role played by wages

The way wage growth shapes up will be a decisive factor in determining whether inflationary dynamics become entrenched or not over the next few years. So far, there are no indications of rising wages. In the course

[10] At this point, it is worth recalling a composition effect in inflation computation. The exposed sectors showed above-average rates of price increases over time, so that their reduction in weight will slightly dampen inflation in 2021, whereas a normalisation of the situation over the next few years would then have a slightly inflationary effect.

of the crisis, collective bargaining talks focused on securing employment and on setting a framework for mobile work, while wage settlements took a back seat and turned out to be moderate.[11, 12]

Reasons for keeping an open mind

In the longer term, other structural influences on price developments are also set to bring relief. These include technological change and its repercussions on the labour market. Even demographically-induced structural shifts in the labour market have been mobilised in the recent past as an explanation for more sluggish wage reactions, the argument here being that a higher proportion of older workers is associated with a lower degree of willingness to change jobs.[13] Moreover, labour market and pension reforms could also modify the framework conditions and, at the same time, influence the baby-boomer generation's propensity to save. If so, the assumption (held by proponents of the life-cycle hypothesis) of a strongly declining propensity to save in later life, which is important for the reflation hypothesis, would have to be reviewed critically.

In the light of such considerations, only sketched here in rudimentary form, a halfway reliable prediction of the longer-term inflation path hardly seems possible. However, a structurally steeper inflation trajectory cannot be ruled out either. Thus, vigilance with regard to changing longer-term price trends is definitely called for.

Inflation expectations

Firmly-anchored expectations are the key to inflation control

In recent years, firmly-anchored inflation expectations have played a major role in warding off second-round effects which could have potentially emanated from sporadically occurring exogenous price shocks. This is one reason why cyclical fluctuations on the labour market or in the utilisation of the production potential have receded into the background as explanatory variables for inflationary developments.

The upward bias in inflation metrics does need to be carefully monitored

Over the last few months, however, market-measured inflation expectations have also risen, although, here too, there is more reason for careful observation than for alarm. After all, the current inflation readings of around 1.5 percent derived from inflation swaps are still

[11] Relevant metrics of wage developments such as the labour-cost index or hourly compensation are distorted by reduced working hours and additional government benefits and are therefore hardly amenable to interpretation. Accordingly, the ECB's experimental indicator for collectively agreed earnings currently provides a particularly important point of reference. For the first quarter, this gauge shows a declining, and low, annual rate of change of 1.36 percent.

[12] Especially with regard to Germany, there were repeated calls in earlier years for more generous wage agreements to counteract international imbalances. In the meantime, however, competitiveness across the euro area has already converged, so that this factor should no longer put upward pressure on wages in the Federal Republic.

[13] Cf. Benoit Mojon and Xavier Ragot in a working paper for the Bank of International Settlements published in 2019: “Can an ageing workforce explain low inflation?“

thoroughly compatible with common notions of price stability. It must be taken into account here that payment flows on such swap contracts embody not only a compensation for inflation and a liquidity premium but also a risk premium. Especially in view of the severe drawdown sustained during the pandemic and of the aforementioned discussion about a possible return of inflation, this risk premium is currently somewhat higher again. In the last quarterly report from the Bank for International Settlements, for example, it was determined on the basis of a yield disaggregation for the USA that, viewed in isolation, higher risk premiums were responsible for an increase in the break-even inflation rates derived from ten-year TIPS[14] by a quarter of a percentage point from the middle of 2020. This is certainly worth noting with respect to a possible undesirable de-anchoring of inflation expectations. However, it means that the average inflation rate expected by market participants has not increased as clearly as the numerical break-even inflation rate.

In addition, the inflation expectations derived from capital-market data follow shifts in current inflation rates. If the present acceleration in CPI indeed proves to be largely caused by temporary influences, what are currently still burdensome base effects will be reversed further down the line, meaning that lower inflation readings would be on the cards again for 2022 and that inflation expectations would also be set to backtrack to a certain extent.

Outlook

Burdens will be forthcoming in the second half of the year

In the second half of the year, the HICP baseline will be lower again due to the reduction in the German VAT rate carried through one year previously, which will cause inflation to drift upwards. Three further negative influences are foreseeable. Prices of industrially produced consumer goods are likely to move gradually higher from their current low levels. Although the price trends in the accommodation and catering sectors remain difficult to predict for this summer, they could cause unexpected upward spikes. This would then be followed by another phase in autumn in which the now smaller weight accounted for by seasonal price reductions in the travel category should temporarily push up overall inflation a little more.

A declining trend should emerge over the course of 2022

All things considered, however, the significance of the base effects which had a heavy burdening impact in the first half of the year stands to decline again in the second half of the year. From the beginning of 2022, this will also apply to the distortion wrought by the H2 2020 reduction in

[14] TIPS = “Treasury Inflation-Protected Securities“: break-even inflation rates capture the yield differential between an inflation-protected and a conventional maturity-congruent US Treasury security.

German VAT. The rise in import prices should also level off and help to bring inflation rates back to below the two-percent mark next year.

There are numerous open questions about the way forward

This notwithstanding, we will have to keep a close eye on the extent to which higher input prices can still be passed on into final retail prices, on whether supply restrictions caused by the pandemic will indeed be resoved, on what price effects will still result directly or indirectly from climate-policy requisites, on whether second-round effects on wage growth remain manageable, and on what inferences private households will draw from the pandemic with regard to their savings behaviour.

Low inflation is no longer an immutable guiding principle

For the time being, it is likewise difficult to assess the long-term consequences of the various types of fiscal-policy support put in place during the pandemic. The latter have increased the danger of monetary policy succumbing to fiscal dominance.[15]

In what are, in general, very unsettled economic times, implicit confidence in an immutable price environment characterised by low inflation has also been undermined. Timely and careful monitoring of price risks has therefore become even more important. So far, the rise in inflation expectations has remained within defensible and comprehensible bounds. But the upward bias in inflation expectations does demonstate that at least the risk of a higher inflation trajectory has increased.

[15] Member states must not, through excessive indebtedness, deprive the ECB of the instruments it may need to counteract erratic price developments. A few weeks before the present position paper, the supplementary issue "Monetary Policy in the Post-Corona Era" was published in the same series: https://www.dsgv.de/positionen/standpunkte-der-chefsvolkswirte/210615-Standpunkt-Geldpolitik-D.html

Disclaimer

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Imprint

Publisher
German Savings Banks and Giro Association e.V.
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Editorial deadline for this issue
5th July 2021

Design
Franz Metz, Berlin

Picture credits
Pixabay/Salina13

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ISSN
2509-3851