How high will inflation rise and how long will it last?

*After a longer period of low inflation – way below most central banks' targets – prices have started to rise again. Based on his research with colleagues **Anna-Lena Herforth** and **Jonas Zdrzalek, Markus Demary** looks at the drivers of the higher inflationary environment and draws conclusions about how persistent it will be.*

What looked like a combination of many one-off effects in the last year and the year before is now gaining persistency. In our report, we argue that the period of low inflation has come to an end based on six structural factors, which define the new inflationary environment:

Deglobalisation gained momentum with the lockdowns in Asia and the Russian war against Ukraine

Lockdowns in Asian harbours have caused disruptions in international shipments and thereby contributed to higher prices for food, raw materials, and intermediate products. De-globalisation has further accelerated with the Russian invasion in Ukraine as countries have reduced business with Russia. Energy price increases are not only caused by rising crude oil prices and gas prices, but also by price increases in uranium and coal. Given that the state of energy creation by sun and wind is not sufficiently developed in Europe, if it wants to achieve an acceptable degree of energy independence from Russia, a European energy crisis cannot be excluded with the further exacerbation of the Russian aggression,

Due to rising energy prices and rising freight rates, global prices of food have already increased. Wheat is expected to become even more expensive as the Russian war against Ukraine endures. Since wheat is also used for hog and cattle production, it is expected that the prices for meat will rise further. The rising global costs of food have already translated to higher consumer prices for food, since food is an essential good that cannot be substituted.

Decarbonisation is fostered through the introduction of CO_2 prices

One building block of the green transformation is the introduction of CO_2 prices. Higher prices create incentives to move away from fossil-fuels, while enhancing the benefit of carbon-neutral alternatives, which will become economic in their usage. Although the introduction of CO_2 prices was announced and thereby expected by households, the transformation of mobility and heating behaviours has been very slow. During the adjustment period, the introduction of CO_2 prices has increased the costs of living for many households.

Demographics affect the labour markets by enhancing the scarcity of workers

In the US, the unemployment rate increased by 11 percentage points compared to its pre-pandemic value, requiring two years to return to the pre-pandemic value. The response of the EU unemployment rate was minimal compared to the severeness of the output loss. Since firms could apply to short-term work schemes, they were not forced to terminate contracts during the recession and renegotiate them at higher wages after the recession. In addition to that, the European employment ratio is currently higher than its pre-pandemic value, while the one in the US never returned to its pre-pandemic level because a lot of older workers preferred to retire during the pandemic. Thus, US labour markets have become tight, which translated into upward pressure on wages. Statistics on demographics show that tighter labour markets will become a global phenomenon in the future as predicted by Goodhart and Pradhan.

Digitalisation has contributed to lower inflation for a long time

Some goods and services tend to contribute negatively to inflation. The quality of mobile phones, for example has improved significantly, while the price of an average mobile phone has not increased much. Due to quality adjustments in price statistics, the prices of mobile phones have a negative inflation contribution in the calculation of the inflation rate. But due to temporary supply-side frictions, the scarcity of semi-conductors has led to increases in the prices of electronics. Given a higher demand for electronics during the digital transformation, prices are expected to rise, thereby possibly ending the price-decreasing effect of digital innovations on inflation.

Fiscal policy in the US has led to an overheated economy with demand-driven inflation.

In contrast to the US, fiscal policy in Europe was more focused on shielding companies from the negative consequences of the pandemic than on increasing demand. The fiscal policy stance in Europe could, however, become more expansionary as a response to the Russian invasion in Ukraine, since Europe has to increase its defence spending. Moreover, Europe has to accelerate its green transformation in order to lessen its energy dependency on Russia. It can be expected that this rises the demand for steel and electronics, thereby accelerating the increase in raw material and intermediate product prices.

Monetary policy has created a low interest rate and high liquidity environment

Monetary policy was not inflationary after the Global Financial Crisis, as governments and companies were in a process of debt consolidation, especially in Europe. But this process has come to an end, since the needs to invest in carbon neutrality and increase military spending have emerged. Based on the change in investment behaviour, low interest rates can contribute to higher inflation now.

How high will inflation rise? How long will the new inflationary environment last?

The energy-crisis made the transformation of our energy systems necessary, which is, however, progressing slowly, contributing to a longer lasting energy-triggered inflation. The most likely result is that central banks have to slow down economic activity or even start a recession to prevent a loss of confidence in their inflation targeting strategies and to prevent a de-anchoring of inflation expectations. From this, one can conclude that European central bankers will be in a difficult position, similar to the one Paul Volcker had in 1979.

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Notes:

- *This blog post is based on The new inflationary environment: How persistent are the current inflationary dynamics and how is monetary policy expected to respond?, IW-Report 16/2022.*
- *The post expresses the views of its author(s), not the position of LSE Business Review or the London School of Economics.*
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