March 11, 2021

Inflation Focus Q1

Key Points

- Headline inflation will rise sharply over the next few months, largely reflecting higher oil prices and temporary COVID effects
- Core inflation should gradually move higher as the economic recovery continues, but is not expected to become a problem
- Wage inflation is likely to remain contained as job security has taken a hit amid challenging labour markets conditions
- Longer-term trends in inflation are also expected to be modest due to still vigilant central banks
- Inflation uncertainty has risen as a result of untested policy measures and elevated savings along with supply constraints

Source: iStock by Getty Images

Will inflation spike higher?

Yes. This partly reflects a rebound in oil prices. They are over three times as high as they were in April last year, and this will lift annual inflation rates over the next few months. Unless oil prices rise further, their impact will peak in Q2 and then fade away. In addition, prices collapsed on some of the most severely hit services in spring last year (e.g. travel, hotels, leisure activities). As this collapse falls out of the annual price comparison, it adds upward pressure on inflation. Additionally, the VAT rate was cut in some regions, lowering consumer prices last year, and this is now being reversed. These effects are well known and will lead to a sharp rise in annual inflation rates in 2021.

Will central banks tighten monetary policy as inflation spikes?

No, they will look through the rise in inflation as it is expected to be temporary and fade away quite quickly. Central banks will focus on underlying inflation pressures, removing temporary effects from oil prices, VAT changes and other COVID specific effects. Underlying inflation is expected to stay benign in 2021.

Will strong growth in 2021 not come with a rise in underlying inflation pressure?

Yes, underlying inflation should also rise as economic activity and labour markets continue to heal and normalise. However, inflation is increasing from a low level, and we do not expect it to become a problem. While growth will be high, we are still in a recovery phase where economic activity and output are catching up with their pre-crisis levels. In some regions, such as Europe, the level of GDP is not expected to return to where it was before the pandemic until 2022/2023. In others, including China, the catch-up has been quicker but, even so, there are deep scars on some sectors. At a global level there is space to grow, both this year and next, without creating excessive price pressures.

Will wages rise quickly as labour markets heal?

No, labour market conditions are still precarious, and we expect this will contain wage inflation in 2021. US unemployment has fallen sharply but 10 million Americans are still officially out of work. Actual unemployment is also likely to be higher than that as some people have simply stopped looking for a job while the pandemic lasts. In some other regions unemployment has risen by much less due to support measures that keep job losses artificially low. This helped during the crisis but will also hold back employment growth during the recovery phase. While labour markets should improve in 2021, we suspect the focus will be on maintaining jobs, rather than raising wages. This should prevent a spike higher in wages despite a strong recovery.

Will a surge in money growth result in uncontrolled inflation?

No, not necessarily. Broad money measures have surged, in many cases up by over 20% on a year ago, representing massive but temporary support measures. A large share of the extra money in circulation has not been spent but saved, and near-term inflation prospects depend on how these savings are deployed going forward. Some savings will be run down in 2021, helping to boost demand as economies open up further. However, future conditions are still highly uncertain given virus mutations and vaccine supply constraints, and the pandemic will have longer lasting legacies on sectors and businesses that are still to play out. Business and consumer sentiment remain depressed in many regions despite a rebound in spending, likely reflecting this uncertainty. We therefore suspect households and businesses will adopt a cautious approach in running down their excess savings and cash balances, which will help to contain upward price pressure.

Will central bank actions not lead to inflation spiralling out of control?

No. Central banks continue to inject liquidity into the global economy while keeping policy rates unchanged. They do this because conditions are still fragile, with large parts of the world economy under some form of lockdown. Looking forward, what matters is that central banks maintain their focus on inflation, with well-defined inflation targets. This is a key reason for why we except them to stay vigilant and tighten policy if inflation starts to build up more strongly. Since debt-heavy economies are very sensitive to changes in borrowing conditions, this should dampen growth and choke off any excess inflation.

Has uncertainty around inflation risen?

Yes. Untested policy measures, along with a surge in money growth and the potential for pent-up demand to be stronger than expected, have increased uncertainty around inflation – both over the short and longer term. Pockets of higher inflation should not be ruled out.

US

Base effects will boost inflation

Headline inflation was relatively stable in the final quarter of last year and at the beginning of 2021 before accelerating to 1.7% YoY in February. The trend in core CPI was more muted with subdued price pressure for major goods and services components, keeping the annual change at 1.3%. Meanwhile, PCE Core, which the Federal Reserve tends to focus on, has accelerated to 1.5% YoY, but remains far away from reaching the Fed's average inflation target of 2%. Base effects will push up both core and headline inflation this year, particularly in the second quarter, and although the Fed keeps signalling that it is willing to look through any transitory spikes in inflation, financial markets could react nervously to any significant overshooting in the coming months. Overall price pressure will increase over the course of the year once the economy fully reopens and substantial pent-up demand fuelled by high savings and massive fiscal stimulus boost growth. Nevertheless, price trends for some crucial components of core inflation are expected to remain moderate for the time being. Rents, for example, are unlikely to pick up substantially in the near term as households that have been hit the hardest by the pandemic-induced economic drawdown will remain financially constraint for at least a couple of months.

UK

Transitory factors to drive inflation above target

Headline inflation has been very modest over the past few months, weighed down by the lockdown measures and the related slowdown in activity. Annual CPI inflation recovered to 0.7% YoY in January from only 0.3% in November. Though more volatile in recent months, core inflation remained higher than headline inflation, accelerating to 1.4% YoY in January from a low of 0.9% back in August. Base effects and the expected strong pickup in consumer spending and business activity once the economy reopens will push inflation rates higher over the course of the year. Later in 2021, the unwinding of VAT cuts implemented to support the economy during the pandemic will lift prices but given that the cuts have just been extended this will only have an impact in the second half of the year. The Office for National Statistics has adjusted the weights of the consumption basket to reflect changed consumption patterns observed during the pandemic. These adjustments are likely to have a small mitigating effect on the overall measured price rises. We nevertheless expect headline inflation to overshoot the BoE's target this year but given that the most significant price rises are transitory the Bank is likely to look through these developments.

Eurozone

Volatile factors affecting inflation

Inflation in the Eurozone jumped sharply at the beginning of the year on a mix of mainly temporary and one-off factors. Headline inflation moved back into positive territory and will likely move even higher over the next few months because of higher oil prices this year compared to last year. Core inflation has also increased due to a variety of factors such as changes to the weights of the consumer spending basket by Eurostat, the statistical agency, and the different timing of sales due to the COVID lockdowns. The increase in German VAT back to its normal rate, after it had been temporarily cut last year to stimulate the economy, has also boosted Eurozone inflation. It will take some time for the true picture to emerge from the official data given these many moving parts. Business surveys suggest some inflationary pressures are emerging, especially in the manufacturing sector. However, wage growth is subdued and likely to remain so given the slack in the economy, reducing the chances of a wage-price spiral emerging. The upshot is that the ECB is likely to look through any temporary spike in inflation and continue to provide substantial monetary support for the economy this year.

Switzerland

Deflation lessening

The pricing environment is improving but remains deflationary. Consumer prices are falling at an annual pace of -0.5%, up from the trough of -1.3% in mid-2020. Inflation should rise further, likely taking the average annual CPI rate from -0.8% in 2020 to a still deflationary -0.2% in 2021. Looking forward, headwinds from energy prices will unwind quickly and a weaker franc will lead to higher import prices, lifting import price inflation into positive territory. The drag from COVID impacted services will also diminish. While this should lead to a snap higher in annual inflation rates, broader pricing power is limited. The retail sector is struggling with pressure from online and cross-border shopping and the pricing environment is difficult. While higher energy and commodity prices should lead to a rebound in producer prices, intense downward pressure on profit margins and costs means that supply-chain inflation should be controlled. Conditions in the services sector will also remain difficult, as a full return to normality is not on the table for 2021. With reliance on part-time work support and weakened job security, prospects for stronger wage growth are limited. This is why we maintain a below consensus forecast for inflation and expect the SNB to leave policy unchanged in 2021.

Japan

'Lowflation' is here to stay

Contrary to the US, where price pressures are reflected in higher bond yields, the situation in Japan is different. We do not foresee any major pickup in inflation. We expect Japan's CPI to keep hovering in the 0-0.5% range that we have seen over the last five years. However, both headline and core measures of inflation are likely to see some downward pressure over the summer due to special factors. The 'Go To' campaign is likely to be re-instated, which pushes down prices for accommodation and dining, as the government is subsidising domestic travel and eating out in order to stimulate the economy. We expect the 'Go To' campaign to remain in place until after the Paralympics. In addition, PM Suga will follow through on his policies to reduce mobile phone service charges, which will push down core consumer prices to slightly negative territory this year. Only once these base effects have waned later this year are core CPI measures expected to move back towards 0.5%. Meanwhile, higher oil prices are likely to feed through to headline CPI. Significant wage increases seem unlikely amid rather cautious labour union requests, while semi-annual bonus payments and travel allowances are likely to remain depressed this summer.

China

Shrinking gap between CPI and PPI inflation

Pork prices were the main driver of consumer price inflation last year following supply constraints due to the outbreak of African Swine Fever. Surging pork prices by far outpaced the impact of lower pork demand in raising the weight of pork in the CPI basket. This basket is revised every five years, and the latest revision early this year resulted in a lower weight of food and clothing, while the weight for housing and health care have been raised. We believe the impact of rising pork prices will significantly diminish over the course of this year due to higher supply. Base effects will need to be watched as they are having a negative impact on CPI inflation in Q1 but are expected to contribute positively from May onwards. The unleashing of pent-up demand should also drive consumer price inflation higher. Meanwhile, rising manufacturing material prices are likely to shift producer prices back to positive territory following negative prints since July 2019. With that, consumer and producer prices are likely to move more in sync. As monetary policy is likely to find a balance between supporting the economy and reducing risk, we believe that neither inflationary nor deflationary forces will become a threat for China this year.

Australia

Underlying inflation remains weak

Inflation is back in the spotlight as the economic recovery gains steam. The RBA is firmly maintaining its stance on the benign inflation outlook, citing plenty of spare capacity in the economy. We share the RBA's narrative but also see an increase in the possibility of inflation reaching the RBA's target sooner than 2024. Currently, some areas already saw a noticeable rebound in prices, including commodity and housing. Low base effects will probably push headline CPI higher this year.

Overall, inflation data are still weak, despite an upside growth surprise in Q4 last year. Q4 CPI eased from 1.6% to 0.9% QoQ, with past policy support distorting headline CPI. The Home Builder grant trimmed a fraction of housing construction costs in Q4 2020, while the expiry of one-off childcare and preschool subsidies in Q2 2020 put upward pressure on education fees. Excluding volatile items, trimmed-mean CPI remained weak, and the wage growth index was at a record low level in Q4. While the labour market is healing much faster than consensus expectations, the withdrawal of the Job Keeper program at the end of March 2021 will potentially slow the pace of the recovery and put downward pressure on wage growth.

ASEAN

Inflation to rise but should remain well below trend

Following additional restriction measures imposed in Q1 2021, Malaysia, Indonesia, Thailand and Vietnam have started to see new infection cases trending down. The vaccine rollout has begun, but only Singapore has achieved noticeable progress. With pent-up demand supporting a rebound in consumption next quarter, we should see prices edging higher. However, most countries still have significant slack in the economy, and we do not foresee inflation becoming a threat anytime soon.

Not all ASEAN countries are showing the same trend. The Philippines, for example, experienced a lift in inflation to 4.7% YoY in February, which is above the central bank's target of 2-4% due to a low base effect and pressures from the supply side regarding food and fuels. On the contrary, Malaysia and Thailand continued to register negative CPI figures in February due to demand weakness. We expect Malaysia's CPI to edge higher once pent-up demand is unleashed post lockdown in Q2 2021. However, Thailand's inflation outlook remains benign, owing to the bleak outlook of the tourism sector.

Brazil

Inflation risk is biased to the upside

After remaining at around 2% in H1 2020, inflation has accelerated, reaching 4.5% in January, above the 3.25% mid-point of the central bank's inflation target range. Core inflation is still below the target, but it has also accelerated. Food prices have been the main drivers for inflation. They have increased not only due to demand factors explained by the significant fiscal stimulus but also due to currency depreciation and the jump in commodity prices. Furthermore, the increase in energy prices driven by the recovery of the oil price and its derivatives also caused political uncertainty after Bolsonaro decided to replace Petrobras's CEO, reflecting his disapproval of the current level o fuel prices.

In the last policy meeting, the Central Bank removed the forward guidance that it would keep the policy rate low for a long time, while also mentioning that this does not necessarily imply immediate interest rate increases. Although we expect inflation to converge to the central bank's target by the end of this year, the risk is biased to the upside. The increase in inflation expectations, above target for 2021, and the fiscal uncertainty due to the renewal of the emergency aid program may lead the Central Bank to tighten sooner and faster. This is now being reflected in market pricing, and we also expect higher rates over the course of the year.

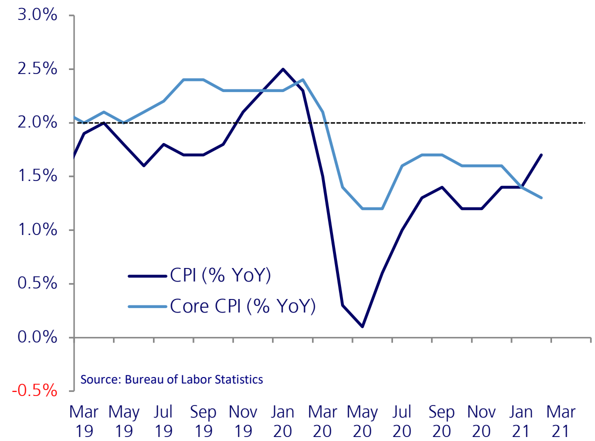
Latam

Price pressures should moderate, except Argentina

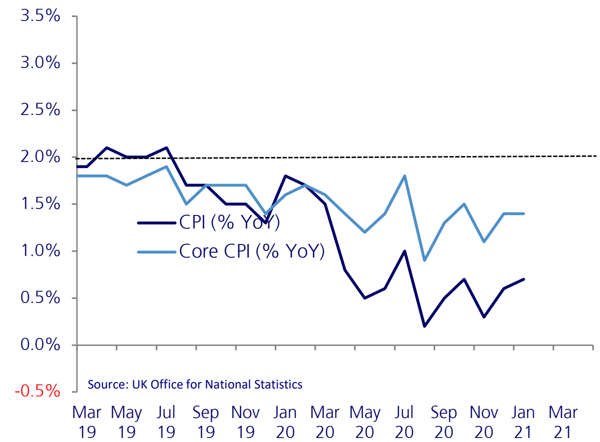
In **Chile**, inflation has mainly surprised to the upside over the past months, exceeding the Central Bank's 3% target in January. The increase in consumption due to the pension funds withdrawals and the fiscal stimulus, combined with supply restrictions that have impacted some goods prices explain the increase in inflation. However, inflation expectations are anchored around the inflation target. The output gap should lead inflation lower over the policy horizon, allowing the Central Bank to maintain the policy rate at the current level during this year. In **Mexico**, inflation has surprised to the upside during the pandemic and remains above the 3% mid-point target, with sticky core inflation despite the economic contraction. Nevertheless, the central bank resumed its easing cycle, with a 25bps cut to 4% in February, and left the door open for additional easing. The policy statement concludes that inflation should increase in Q2 2021 due to oil price effects, but then follow a downward trend during H2 2021, with core inflation converging to target in Q3 2021. While we agree that inflation is relatively benign in Mexico, we believe it will remain above target and expect only one further rate cut. Despite the measures to control prices in **Argentina**, inflation continues to accelerate, driven by increased food prices, large monetary expansion, and strong currency depreciation. We expect this trend to continue.

Current and historic inflation

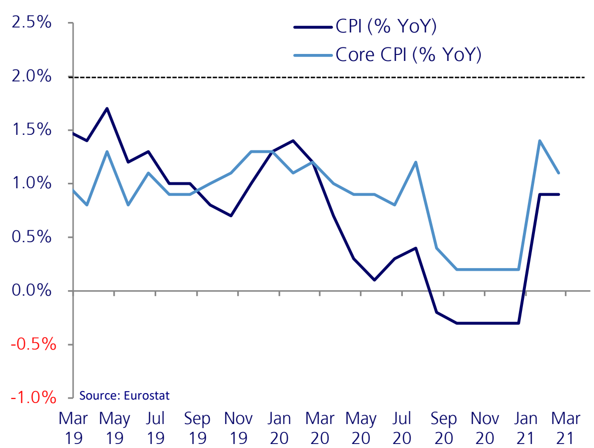
US: base effects will boost inflation



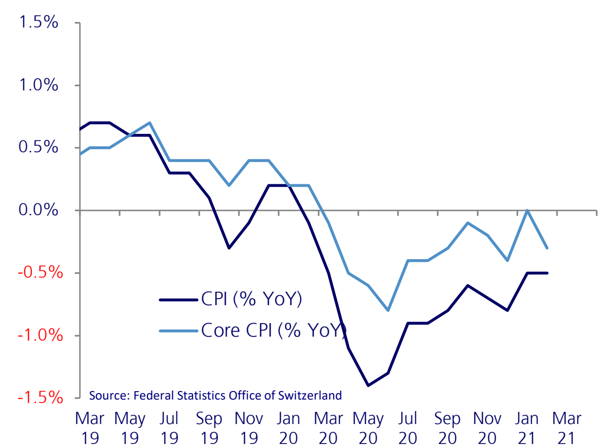
UK: transitory factors should drive inflation above target



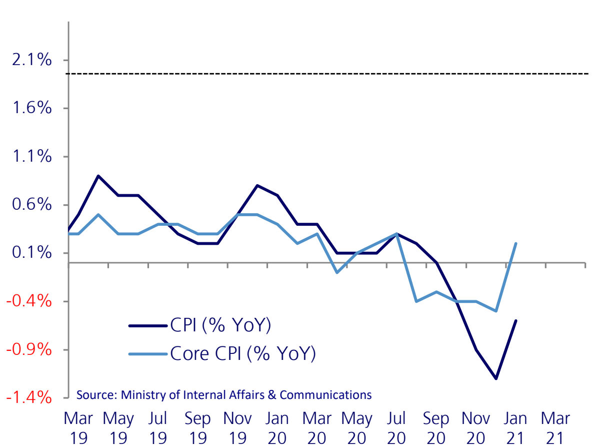
Eurozone: inflation should stabilise



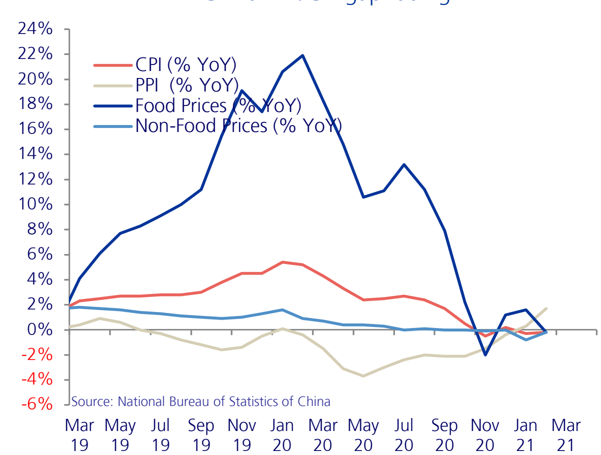
CH: deflation diminishing



Japan: 'lowflation is here to stay



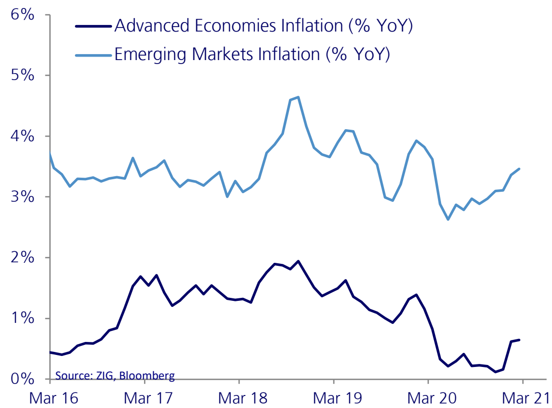
China: PPI/CPI gap fading



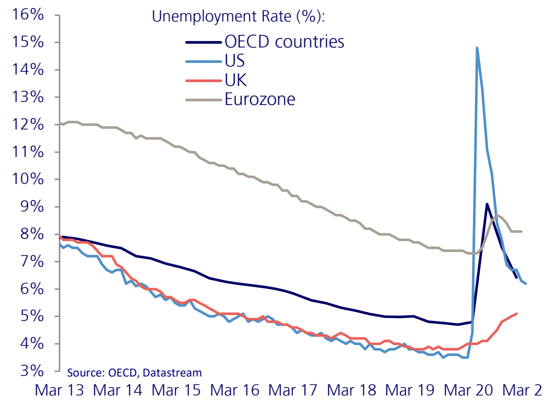
* Dashed lines show inflation targets or equivalent

Key indicators

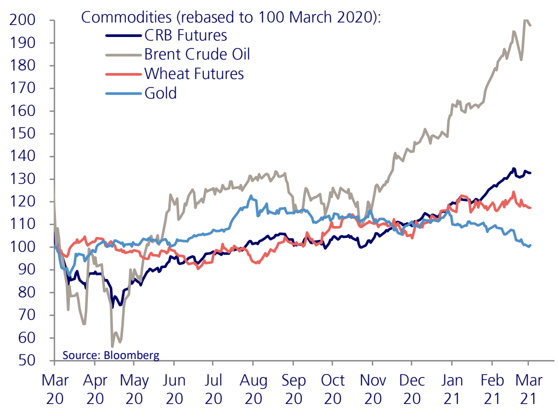
Inflation rebounding from historical lows



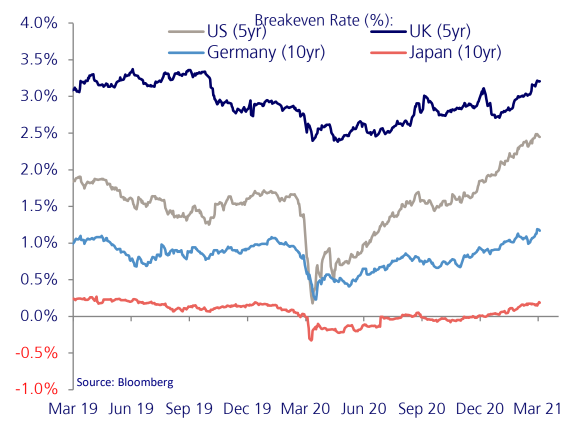
Unemployment puts a lid on wages



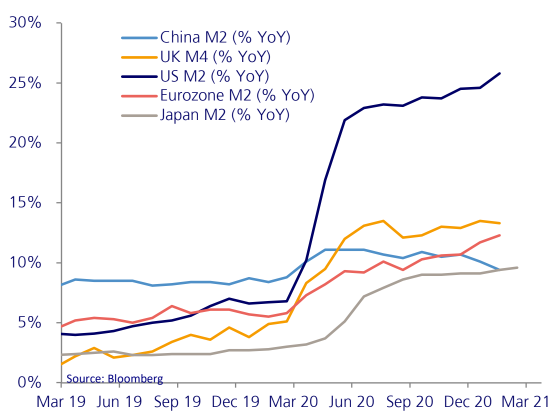
Oil price base effects will be large



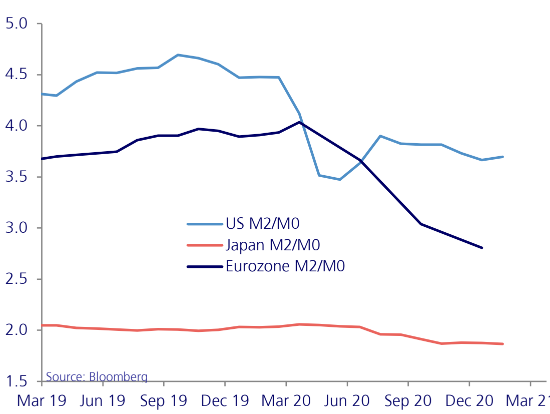
Inflation expectations rise on support measures



Huge liquidity injection, but should be temporary



Money multipliers fall as base money surge



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