June 16, 2021

# Inflation Focus Q2

## Key Points

- Headline inflation has surged, largely reflecting higher energy prices and transitory COVID and reopening effects
- Core inflation remains benign in most regions, with the US an exception, and is not expected to become a problem
- US core inflation is accelerating as supply-demand imbalances intensify, but should ease back as reopening proceeds
- Central banks remain vigilant and will respond to a broadening out of inflation pressure, should it materialise
- Inflation uncertainty is high due to untested policy measures and elevated savings along with supply constraints

Source: iStock by Getty Images

**Will the surge in headline inflation become permanent?**

No. At a global level, headline inflation has risen sharply, but core inflation is contained in most regions, with US the key exception. Oil prices have risen at the fastest pace on record over the past year, and this is a key factor driving headline inflation higher. As long as oil prices do not move materially higher from here, their impact will peak in Q2 and then fade. In addition, reopening effects have been large, particularly in the US. Prices on services that were hit hard by the Covid crisis have rebounded, leading to strong inflation on items such as transportation, hotel accommodation and food away from home. Unless prices on these services continue to rise at a similar pace going forward, which we have no reason to expect, this effect should also diminish over time. Higher inflation should therefore not be extrapolated.

**Global supply chains are very tight, will this spill over to domestic inflation?**

It is a risk, but as the recovery shifts towards services and goods demand eases back, bottlenecks and supply pressures should diminish. This will be important as the hugely imbalanced recovery has led to large price increases on some durable goods, particularly those that are exposed to complex supply chains and critical inputs such as semiconductors. Most notably, prices of both used and new cars in the US have surged because of strong demand and a lack of supply, with the former up by over 50% compared to the pre-crisis trend. While this helps to explain why US core inflation has risen much more than in other regions, there is little evidence that this is spilling over to broader – and domestically generated – price pressures. This suggests that as the recovery rebalances, supply-chain related effects should start to wane.

**Will labour shortages trigger a dangerous wage-price spiral?**

No, this is not expected. Many businesses are currently finding it hard to fill open positions, and the fear is that this will trigger much stronger wage inflation than in the past. Special factors, in particular health concerns and generous unemployment support, are, however, limiting participation in the labour market. In the US, for example, over 4mn persons have left the labour market over the past year, meaning that they are currently not actively looking for a job, and this comes on top of the close to 9mn workers that are registered as unemployed. As vaccinations continue to be rolled out, support measures are scaled back and schools fully reopen, we expect hiring difficulties to ease. While bottlenecks could delay and weigh on growth, we do not expect it to lead to a surge in wage inflation.

**What then, will it take for inflation to become a problem?**

While we anticipate US core measures of inflation to fall back to more sustainable levels towards the end of the year, core inflation in many other regions will gradually rise as conditions normalise and economies grow briskly. This is a benign outlook, which critically hinges on current price pressures not becoming entrenched. There are, however, risks to this outlook. If demand does not rebalance towards services, supply chain pressures in the goods producing sector are likely to intensify, leading to further increases in input and output prices, and potentially also driving up wages for scarce labour. Additionally, we need to see hiring difficulties ease, in part reflecting a pickup in participation rates as health concerns diminish and support measures are cut back. If this does not happen, wage inflation could rise more materially, particularly in services. Another risk is elevated savings rates. If savings are deployed at a faster pace than anticipated, the resulting surge in demand would give pricing power to businesses, potentially leading to a further upswing in inflation. Finally, the outlook hinges on the Covid situation improving, such that mobility restrictions and health concerns diminish. Should this fail to materialise, it would delay the services recovery, amplify pressures on the goods sector, and hold back labour supply.

**Given upside risk to inflation, should central banks not tighten policy?**

Patience is still required as economic conditions remain vulnerable amid the ongoing pandemic. Central banks are vigilant, though, and focused on inflation, and we expect them to adjust their policy stance if broader inflation pressures build up. Since debt-heavy economies are very sensitive to changes in borrowing conditions, this should help to dampen growth and choke off excess inflation.

**Has uncertainty around inflation risen?**

Yes. Untested policy measures and elevated savings have already increased uncertainty, and supply chain and labour market pressures are now adding to that.

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## US

### Inflation soars as base effects kick in

Inflation rates spiked higher in April and May as pent-up consumer demand meets supply chain bottlenecks and base effects are kicking in. Headline CPI inflation reached 5% YoY in May, the highest level since 2008 while core CPI rose to 3.8% YoY. Meanwhile, PCE core soared to 3.1% YoY in April, the highest in almost three decades. Not surprisingly, prices were driven by the reopening of the economy with a substantial amount of the increase in prices representing transitory pressures caused by rising prices for used cars, lodging, airfares and food away from home. Inflation rates are expected to level off in the coming months and fall back to more sustainable levels towards the end of the year as base effects are fading and consumption patterns start to normalise. Rising house prices provide some upside risk as shelter costs represent a significant part of core inflation measures. House prices rose by more than 13% YoY in March. Rents usually follow house prices. As renting is most common among lower income households the expected pickup in hiring due to the reopening of the economy is likely to drive rents higher. So far, the Fed is keeping its dovish stance, but we expect the FOMC to soon shed more light on its tapering plans.

## UK

### Price pressures likely to increase as the economy fully reopens

So far, inflation pressures at this stage of the recovery seem limited. Headline CPI inflation accelerated to 1.5% YoY in April, the highest since the introduction of the first national lockdown in March 2020. A key driver of the pickup were energy costs. Base effects play a crucial role when comparing price levels to the same period a year ago, but stronger demand helped to lift prices in a number of areas like clothing and footwear, which made strong contributions as retailers raised prices to reverse the weakness seen in February. Core CPI rose more modestly to reach 1.3% YoY. Core services inflation ticked up by 0.1% to an annual rate of 1.6%. This is likely to accelerate further as the economy fully reopens. In addition, Brexit-related frictions may temporarily add to the overall price pressure. Producer prices accelerated significantly to an annual rate of 9.9% in April, reflecting the price pressure that is building in the production pipeline, part of which will spill over into consumer prices. Accordingly, inflation rates are expected to rise above the Bank of England's target in the coming months but should peak later this year as base effects fade and supply chain bottlenecks are worked down.

## Eurozone

### Headline inflation set to rise further, but underlying inflation still modest

Headline inflation in the Eurozone hit 2% for the first time since 2018 in May, mainly due to much higher oil prices this year compared to the same time last year. Headline inflation is likely to rise above 2% some time in H2 2021 as various other base effects kick in, including the full impact of a temporary cut to the German VAT in the second half of last year. Higher commodity prices are an ongoing risk to the headline inflation numbers, and we are also seeing significant pricing pressures in the manufacturing sector translating to higher manufacturing output costs. However, for a long-term inflationary problem to emerge in the Eurozone, we would need to see much stronger wage growth, that would then translate through to higher service sector inflation. Instead wage growth remains modest in the Eurozone, as does inflation in the service sector. What's more, somewhat higher inflation would probably not be a bad thing for the Eurozone, where the threat in recent years has been deflation rather than inflation. Given this overall backdrop, we expect that the ECB will continue with its very accommodative monetary stance, including large-scale asset purchases.

## Switzerland

### Prices rising again, but underlying trends are weak

Headline and core CPI inflation have turned positive, at 0.6% and 0.2% YoY in May. Price developments have been a bit firmer than expected, but this predominantly reflects one off factors. Domestic inflation is weak, with services and domestic goods prices 0.2% YoY. Imported consumer goods and some COVID-affected services, including transportation and restaurants & hotels, have seen higher inflation, but this is largely a transitory effect and should wane. Housing rent has, however, accelerated, likely reflecting the very strong housing market. With a large weight in the CPI (21%), this could lead to slightly firmer inflation going forward. Broader developments will remain muted though. The retail sector is under pressure from online and cross-border shopping and faces a difficult pricing environment. Conditions in the services sector will stay challenging as a return to normality is not on the table for 2021, with international travel particularly weak. Manufacturing is booming, but a strong franc will contain price pressures. Prospects for higher wage growth are also limited, with wages up by only 0.5% YoY in Q1. After accounting for gains in productivity, this is not sufficient to drive underlying inflation higher. This is why we maintain a low inflation forecast and expect the SNB to leave policy unchanged for the foreseeable future.

## Japan

### Disinflation is haunting Japan, but only temporarily

While global concerns about inflation have erupted, deflationary tendencies are hitting Japan. Both the nationwide CPI for April and the Tokyo CPI for May came in at -0.4%, while the various measures of core CPI are hovering in the -0.1% to -0.2% range. The biggest disinflationary contribution is coming from the 26.5% cut in mobile phone charges in April, which is pulling down core CPI by 0.6 percentage points and is a result of pressure from the PM Suga led government. This negative contribution will last for twelve months and may become even more pronounced after the rebasing of the CPI base year from 2015 to 2020 in July. Excluding the impact of special factors like mobile phone charges and the public 'GoTo' subsidy campaign, core CPI would have moved in the 0% to 1% range. Durable goods prices keep hovering around zero, while they have picked up significantly in the US. On the other side of the coin, rising energy and raw material prices are exerting upward pressure on inflation, which will likely lift core inflation out of disinflationary territory and towards the 1% mark going forward. Meanwhile, the Bank of Japan forecasts CPI ex fresh food at only 1% in FY 2023, which suggests that the 2% target will not be reached during the term of Governor Kuroda.

## China

Rising PPI inflation is unlikely to pull consumer prices higher

China's core CPI inflation is starting to pick up again, following zero core inflation in Q1, mainly driven by the traffic, communication, and recreational components. The 'Golden Week' Labour Day holidays in early May contributed to the increase. Turning to general CPI inflation, pork prices, the major driver of CPI inflation over the last two years, continue to fall, as the swine flu seems to be under control. The latest reading for May came in at 1.3% YoY. Meanwhile, rising PPI inflation has raised concerns of a spillover to CPI inflation. Producer prices surged 9% YoY in May, a 13-year high, and just a tad away from marking a 26-year high. Rising raw material prices are the driving force, putting China's authorities on high alert. During the recent Politburo meeting, Premier Li highlighted the importance of controlling overheated commodity prices, while major commodity producers have been warned that manipulating prices will urge severe punishment. We note that tight environmental controls and supply controls in line with carbon emission targets also exert price pressures. At least for this year, we do not expect rising PPI inflation to have a significant impact on CPI inflation, with perhaps the exception of gasoline and utilities prices, as long as no surge in consumption becomes evident.

## Australia

Supply constraints lift inflation, but bottleneck issues should eventually fade

The input price component of the May Manufacturing PMI surged to the highest level since 2008, while the supplier's delivery time notably extended. It clearly shows that supply bottlenecks have caused issues from the production side. The RBA commodity index climbed to a 20-year high as surging fuel prices fed into higher input costs. The Melbourne Institute Inflation Index showed a 3.3% YoY growth rate in May, but the rise came largely from a low base effect.

We expect supply constraints should dissipate as the economic environment further normalises. Besides, consumers are expected to shift more towards services consumption, removing certain demand pressures on goods consumption. Thanks to the strength of AUD, the passthrough effect of overseas inflation on import prices should remain modest. Wage growth, the core driver of underlying inflation, was only 1.5% YoY in March, despite a swift rebound in the labour market. According to the RBA, wage growth needs to hit at least 3% YoY sustainably to keep core inflation in a comfortable range between 2-3%. It is still some way to go. Therefore, our view remains that higher inflation will be transitory.

## ASEAN

Inflation edges higher mainly due to base effects

Low base effects inflated the annual CPI data for ASEAN, especially in Malaysia, which saw headline CPI hit 4.7% YoY in April. However, Malaysia's underlying inflation remained modest. In other developing economies in the regions, inflation, while edging higher, remained low by emerging market standards. The Philippines was the only exception, as its CPI has exceeded the central bank's target since January. This was mostly driven by supply disruptions due to prolonged lockdowns. However, May data showed that headline CPI has already begun to stabilise.

Global supply bottlenecks seem to be having a noticeable impact on input prices for ASEAN producers. The input price component of the Manufacturing PMI soared in May, but the gap between input and output prices widened markedly. This suggests manufacturers have limited pricing power to pass higher input costs to consumers. The number of new virus cases continued to rise rapidly, triggering more stringent social restrictions, especially in Malaysia and Vietnam. Since domestic demand remains vulnerable, we expect underlying inflation to stay benign in the region for some time.

## Brazil

Inflation to remain elevated during 2021

The increase in inflation has prompted the Central Bank (BCB) to begin the normalisation of monetary policy, raising the Selic rate by 150bps in the last two meetings and signalling another 75bps increase for the next one. The BCB maintains its diagnosis that the current shocks are transitory and that inflation should converge back to target.

Inflation expectations and headline inflation have however continued to rise and are above the upper range of the BCB target. Inflationary pressures are expected to remain high in the short term due to the significant dislocations produced by Covid. Likewise, the high price of commodities, despite the appreciation of the BRL, continues to impact input prices, and the recovery and the reopening of the economy will keep inflation high. Regulated prices are accelerating, mainly due to the increase in electricity and fuel prices. Core inflation has also risen, reaching above the midpoint of the target.

As a result, we expect the BCB to continue with the tightening cycle during the remainder of 2021. This should help to keep inflation in check, and we continue to view increased price pressures as transitory, with inflation likely to converge back to the upper part of the target range by year-end.

## LatAm

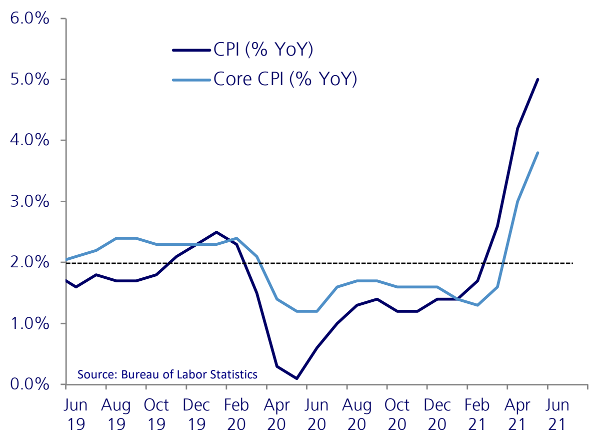
High and sticky core inflation in Mexico, still around target in Chile, but with an upward trend

The pandemic's transitory effects, particularly the increase in energy prices, are pushing up inflation in the region. In Chile and Mexico, headline inflation is accelerating due to stronger demand, supply bottlenecks, and the increase in energy and food prices. In Chile, core inflation is still around 3%. In Mexico, it remains high and sticky, and is currently above 4%. We expect that as dislocations in the economies begin to subside, inflation should converge back towards target.

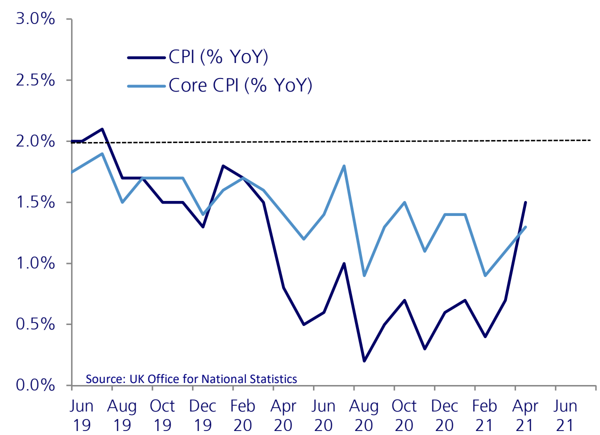
However, the more remarkable persistence shown by core inflation in Mexico may slow down this convergence. In Chile, we are also seeing a faster closing of the output gap due to a significant increase in private consumption associated with the high liquidity provided by the withdrawals from pension funds and the massive increase in fiscal spending during this year to support households. As a result, the central bank signalled in the last meeting that it is necessary to recalibrate the monetary stimulus. We now expect the tightening cycle to begin during 3Q 2021, but with the monetary policy rate remaining below the neutral rate over the policy horizon.

# Current and historic inflation

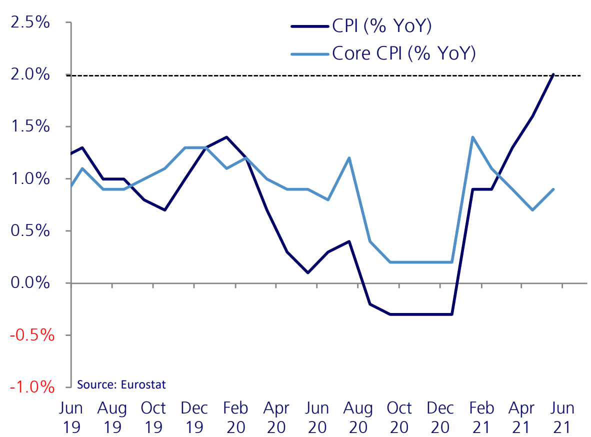
US: inflation sours on base effects



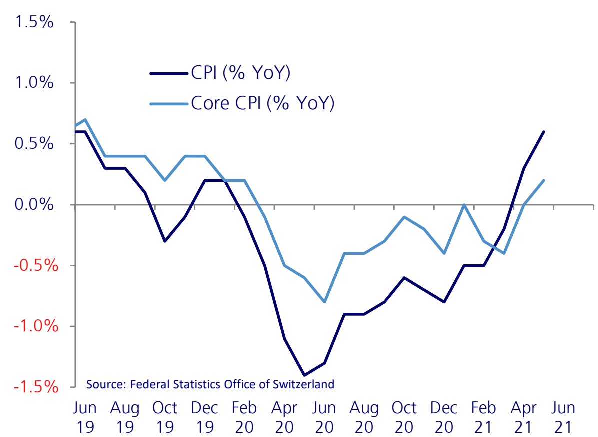

UK: inflation should rise as economy reopens



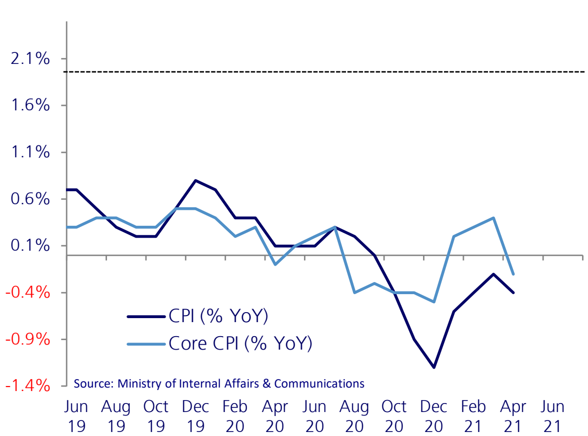

Eurozone: core inflation likely to remain modest



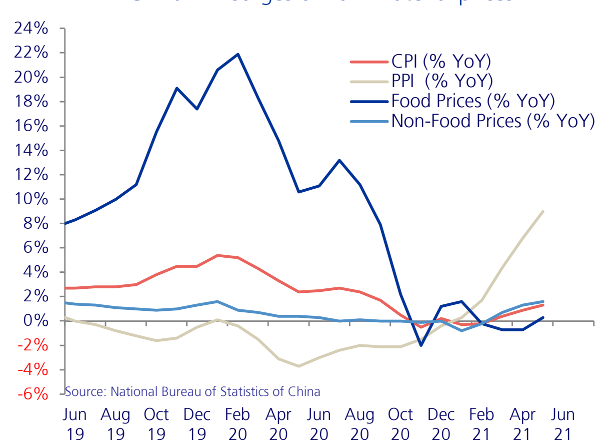

CH: prices rising, but underlying trends are weak




Japan: disinflation likely to be temporary

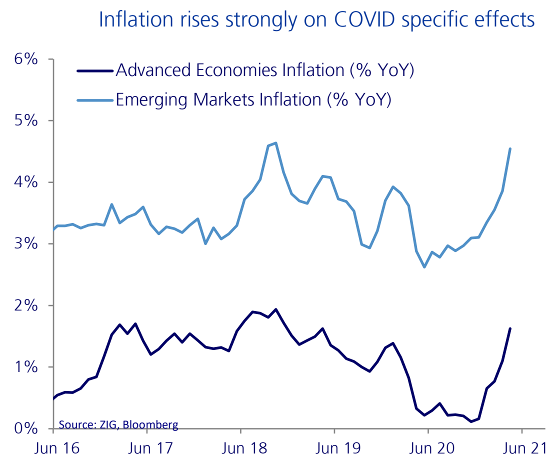


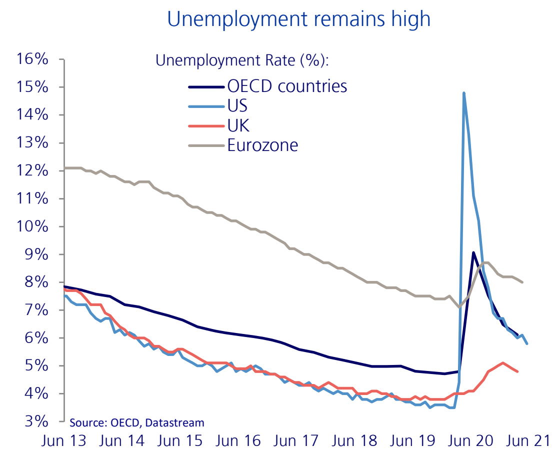

China: PPI surges on raw material prices

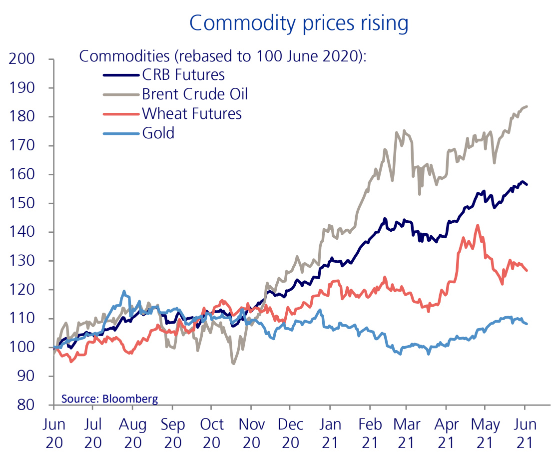


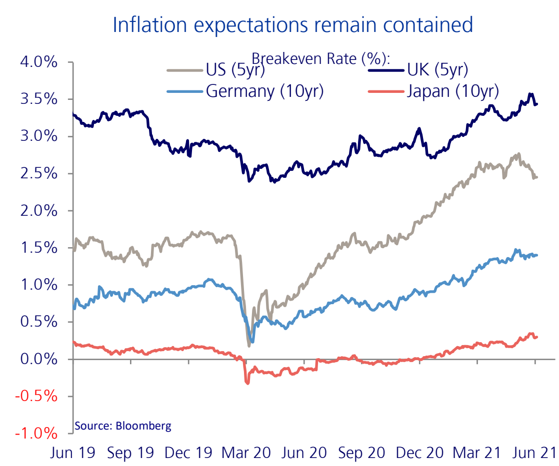

* Dashed lines show inflation targets or equivalent

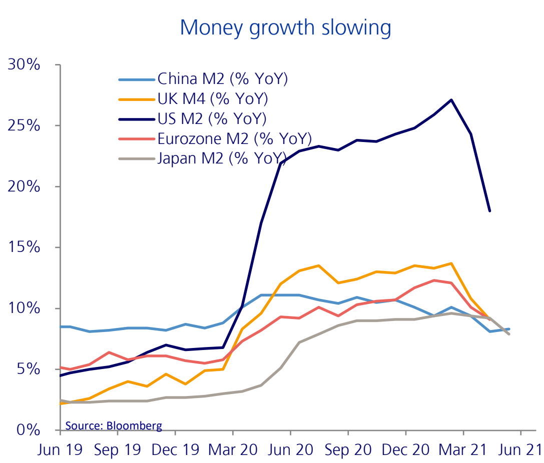
# Key indicators

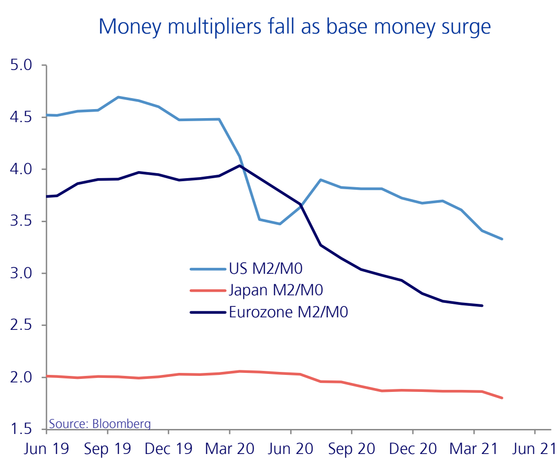


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