INFLATION – WHAT DOES THE FUTURE HOLD?

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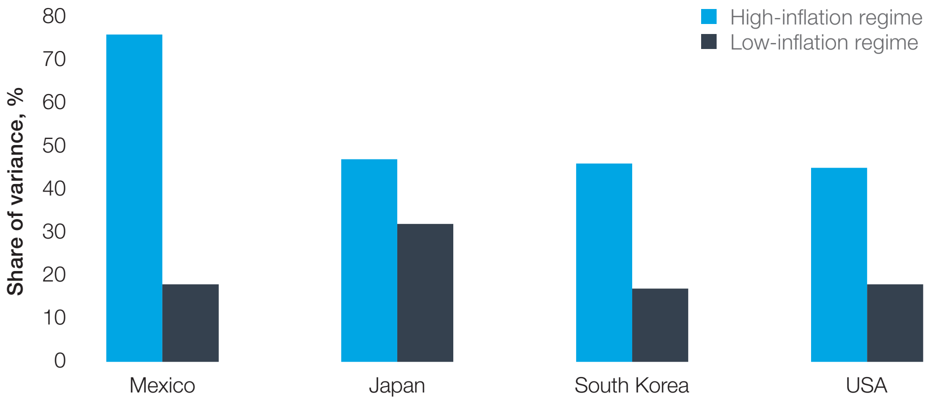
In this final edition of the Economic Brief before the summer break, we will zoom in on inflation and consider how the current situation might unfold. As we have seen in past editions, inflation is now at levels unseen since the 1970s, with numerous contributing factors, from the geopolitical to the macroeconomic. But just where is inflation heading?

This Economic Brief will take inspiration from Claudio Borio, a renowned economist at the Bank for International Settlements (BIS). In his analysis, he differentiates between two types of regime: low inflation and high inflation. A low-inflation regime is thought to have self-regulating properties, as relative price increases have only minor and temporary impacts on general price dynamics; in a high-inflation regime, however, the opposite is true and it does not self-regulate.

Price contamination between sectors based on inflation regime



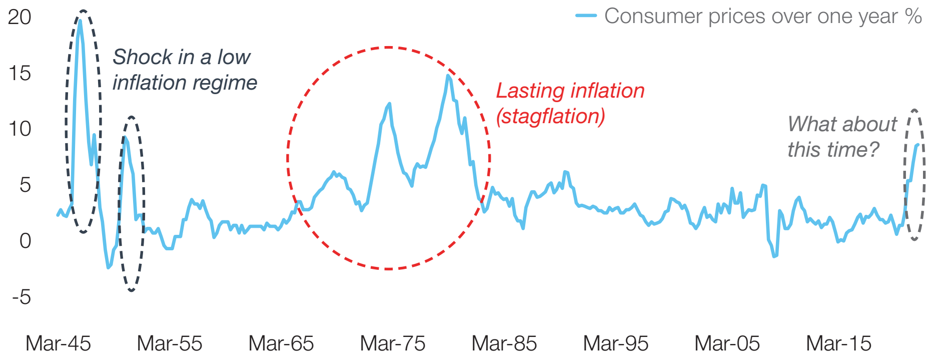
Source: BIS

The graph opposite demonstrates this price contamination effect across four countries and, in particular, the striking difference in contamination in one regime compared with the other. It is worth noting that the beginning of a wage-price spiral leads to a self-maintaining inflation phenomenon. However, in a low-inflation regime, wages and prices contaminate each other more slowly than in the high-inflation equivalent.

But how does one regime change to another? Three major factors must be taken into account: structural elements, economic cyclical logic and price dynamics. Structural elements include those influencing the pricing power of economic agents, such as globalisation, demographics, technology and public policies; economic cyclical logic corresponds to the balance between supply and demand, as well as the responses brought by economic policy; finally, price dynamics may be affected by the triggering of endogenous self-reinforcing mechanisms.

Let us attempt to apply the Borio method to the current situation. Structural elements appear to be favourable to a level of inflation maintained under control: globalisation is changing slightly but not enough to have a significant impact, and technology and demographics are seeing little change at all. However, this trend may weaken over time with the energy transition and a more inclusive society to be financed. Though there is a veritable mismatch between supply and demand at present, economic cyclical logic is trending towards a better balance between them; however, the timing necessary to achieve that balance is unclear. Finally, reviewing the endogenous nature of price dynamics entails scrutinising the wage-price spiral. Anecdotal evidence would suggest a genie has already been let out of the bottle… Does this need to be extrapolated this further? The jury is still out.

United States: from one inflation regime to another



Sources: Accuracy & Bloomberg

The graph opposite shows the evolution of consumer prices in the United States over the past 77 years. We can see examples of price shocks in both low-inflation and high-inflation regimes. In the 1940s and 1950s, for example, the low-inflation regime meant that the price shocks experienced were quickly resolved and inflation returned to a more typical level. The 1970s and 1980s, however, show how price shocks in a high-inflation regime can lead to more lasting and widespread effects.

So what does that mean for our inflation forecasts today? Unfortunately, looking back at the past does not lead us to the conclusion that there is a cast-iron law linking the scale and the duration of inflation…

In conclusion, it is difficult to determine just how high this period of inflation will go and how long it will last. What happens tomorrow will be a matter of behaviour: that of companies and households who will prefer an increase in variable costs to an increase in fixed costs; and that of policymakers who will need to balance an anti-inflationary 'whatever it takes' approach with the best possible management of a complex economic environment with contradictory aspects.