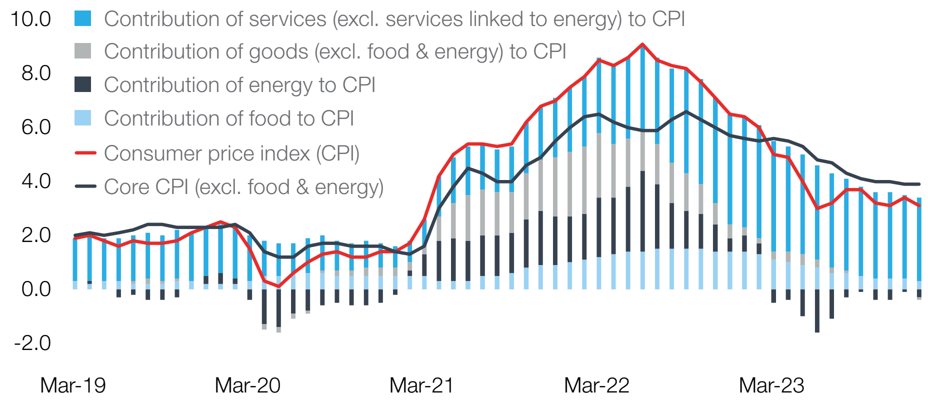
PERSISTENT INFLATION

March 2024

In this edition of the Economic Brief, we continue tackling inflation. A stubborn chunk is proving difficult to bring under control, and we will explore the factors contributing to it. We will also investigate the effect of this persistent inflation on the bond markets and the conclusions that can be drawn for upcoming monetary policy. Finally, we will touch on another issue affecting the US economy: the federal deficit and forecast rise in federal debt.

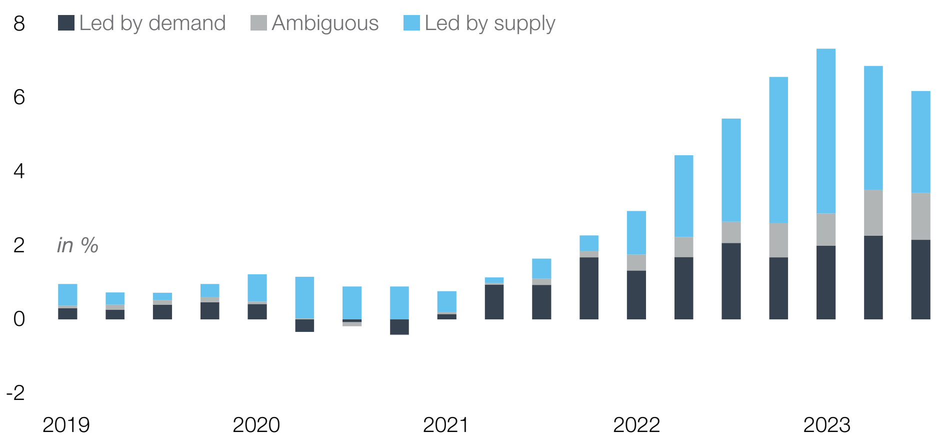
United States: the question of inflation in services remains unresolved



Sources: Accuracy & Bloomberg

Although inflation has significantly slowed since its heights in 2022, a significant portion remains. The graph opposite shows just what this persistent portion relates to in the US (something equally valid for Europe): services. Where the other factors contributing to inflation, such as energy and goods, have returned to their pre-Covid levels, services remain somewhere from 50% to 100% higher than their previous values, an issue linked in particular to the supply of housing.

Inflation in France (CPI): at least up to summer 2023, supply factors resist slowdown



Sources: Accuracy & OECD

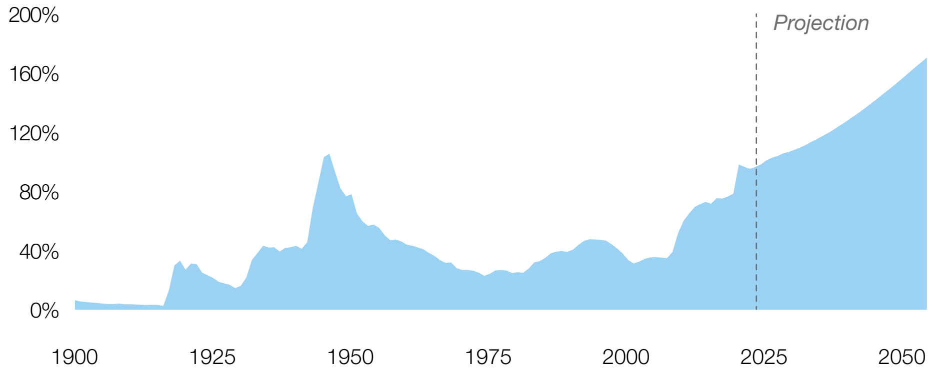
But housing is not the only supply issue behind this lingering inflationary effect. Europe is having greater difficulty shedding its inflation than the US, and the graph opposite demonstrates the connection with matters of supply (here what applies to France is valid for Europe as a whole). Let us consider two major contributors: energy and unit labour costs. The US's greater self-sufficiency in terms of energy – it largely produces and consumes its own supply – means that it has greater control over its energy prices than Europe, where much energy is imported (notably, gas). In addition, unit labour costs in the US have fallen in line with expectations much more quickly than in Europe, linked to improved productivity. In late February, Europeans had expected news from the European Central Bank that unit wage growth would slow in quarter 4 of 2023 thanks to an improvement in productivity; no such announcement came. On the contrary, wages continued to grow in Europe by 4.5% year-on-year for that period, indicating a probable unfavourable trend in unit salary costs.

World: the decrease in bond prices reflects uncertainty over upcoming inflation

Sources: Accuracy & Bloomberg

As part of their efforts to combat inflation, central banks have been hiking interest rates higher and higher for the past two years. We can see the impacts of these policies in the prices of bonds: generally speaking, when the base rate rises, bond prices fall, and vice versa. However, as we can see in the graph opposite, the price of bonds has been falling since the end of 2023. This trend betrays a certain nervousness in the bond market, particularly in Europe. Where the most probable outcome appeared to be a rapid return to normal interest rates once inflation had been tamed, uncertainty is once again creeping in.

United States: federal debt continuing on an upward trend



Sources: Accuracy & CBO

The US Congressional Budget Office established the federal deficit for the year 2023 at 6.3% of GDP or some $1.7 trillion, with a long-term estimation lying around 5% of GDP. Three assumptions drive this: increased spending on public pensions and health insurance (for an ageing population), a real long-term interest rate of 2% p.a. and a cruising growth rate of 1.5% p.a. This leads to a sharply rising federal debt level, as illustrated in the graph opposite. Will such a situation lead to a decline in confidence in USA Inc. and prove dissuasive to foreign investors? Maybe. But despite the situation, the USA continues to enjoy safe-haven status in a chaotic world.

So, there is still some work to be done before we land at the long-term forecast inflation level of 2%. Will continued interest rate hikes suffice to bring the final portion of inflation under control? If the issue lies in productivity, might other policies need to be put in place? And how will fiscal concerns, exemplified by rising deficits and debt levels, further complicate the economic landscape? The answers to these questions are not so clear.