Theme:

The inflation dynamic

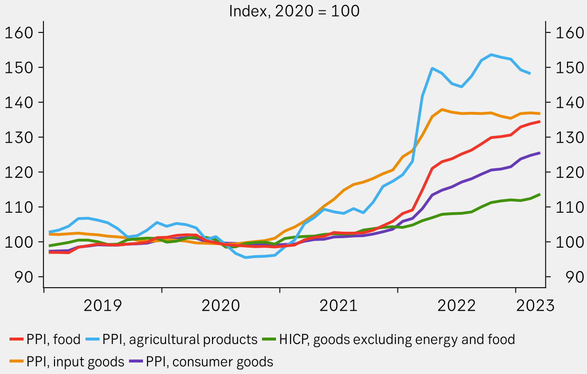
Long lead times and shifting drivers in the inflation factory

Rising inflation in the United States and Europe was initially driven by sharply rising commodity prices. For example, food prices in Sweden increased faster than at any time since the 1950s. Although energy and some commodity prices have fallen, producer and consumer prices are continuing to climb rapidly. But in recent months, we have seen signs that price hikes at producer level are slowing. This increases the likelihood that goods inflation at the consumer level is also about to fall, although we believe this is still some way off.

In recent years, the conditions for broad-based price increases have resembled what can be described as a perfect price storm. During and after the pandemic, prices were driven up by a combination of supply and demand factors. Supply shrank as production shut down, coinciding with disruptions in global freight flows. Expansionary fiscal and monetary policies contributed to a boom in demand for goods. By mid-2021, the energy situation also became increasingly strained, especially natural gas and electricity in Europe. Businesses found themselves in a situation where virtually all input costs had risen. As early as the beginning of 2021, companies started to pass on rising costs to consumers – breaking with the pattern of the 2000s, when for years they found it hard to do so. This was one important reason why forecasters were cautious in their assumptions about pass-through to consumers when input prices began to rise. Broad-based input price increases started taking hold, lifting overall consumer goods inflation above 10 per cent in a relatively short time.

Prices at different stages of production in Germany

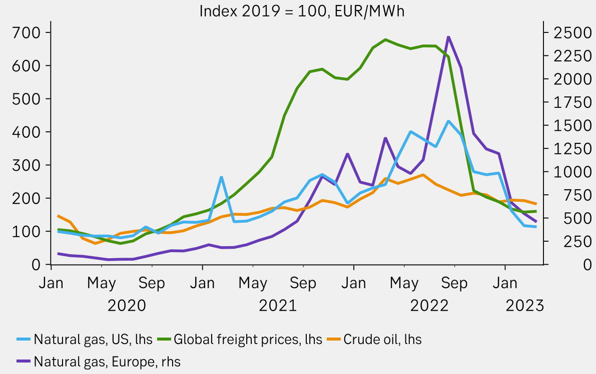
Index, 2020 = 100



Source: German Federal Statistical Office (Statistisches Bundesamt), Eurostat, Macrobond, SEB

Falling energy and freight prices

Index 2019 = 100, EUR/MWh

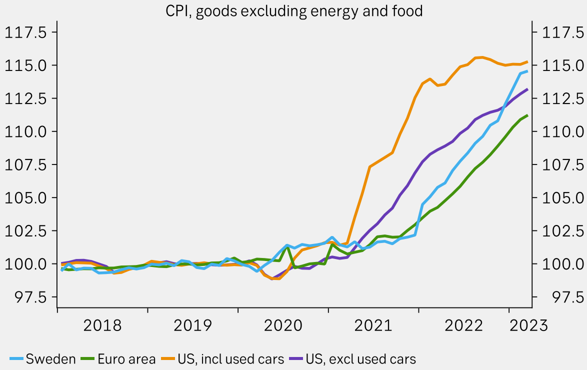


Source: Intercontinental Exchange, Harper Peterson, Energy Information Administration, Macrobond, SEB

US ahead, but not by as much as one might think. US inflation was the first to take off, but the difference is somewhat exaggerated by used car prices, which rose due to auto production problems, semiconductor shortages and rapid shifts in demand. Overall price increases have been roughly equal in the US, the euro area and Sweden. There were large differences in timing when it came to lifting pandemic restrictions and in the shape of fiscal and monetary relief measures, but most goods are traded in shared international markets – which helps ensure that the final impact of price hikes is fairly similar.

Continued strong trend for consumer prices

CPI, goods excluding energy and food



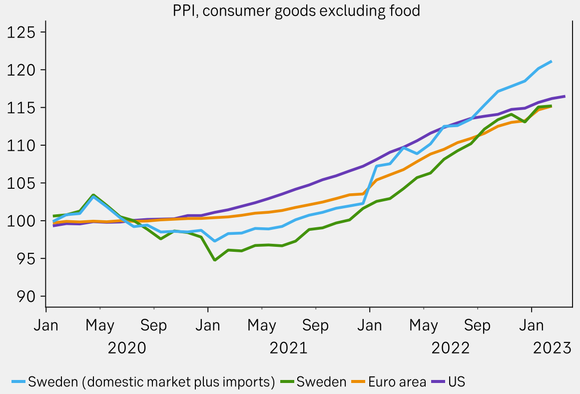
Source: U.S. Bureau of Labor Statistics (BLS), Eurostat, Macrobond, SEB

Falling prices, but continued setbacks... Several factors indicate that inflation will continue falling, but setbacks instead dominated early 2023, largely due to sluggishness in the process. For European companies, increased costs due to high energy prices are also a factor. Interest rate hikes are now tightening demand, which should produce a reversal of the pandemic effect (when expansionary relief measures fuelled demand) – eroding real household purchasing power. Prices of some commodity groups have fallen fast, although levels are well above pre-pandemic ones. One clear example is energy; gas and electricity prices have fallen, especially in Europe. Lower freight rates and better-functioning global trade are also easing the situation.

.... but many prices remain high. Although some upstream prices have fallen, many downstream prices continue to rise, albeit somewhat less. High price increases in 2022, known as base effects, are now helping to dampen consumer inflation, but high levels of many input prices continue to push up consumer prices and contribute to a sluggish decline in inflation. In Sweden, domestic supply indices are climbing more, since we import a large share of our consumer goods.

PPI on consumer goods is still climbing fast

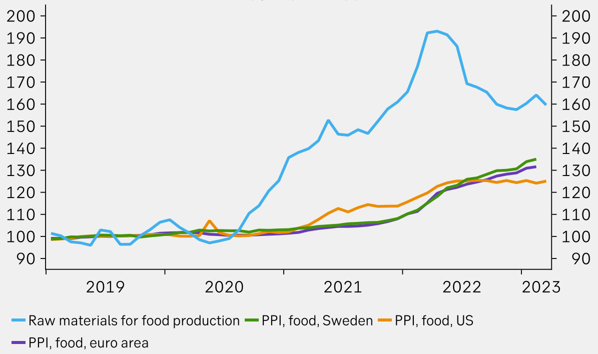
PPI, consumer goods excluding food



Food prices are important to CPI trends. The food price dynamic has generally followed patterns similar to those for other goods, but since food consumption can only be cut back to a limited extent, food prices have a greater impact on household living conditions. Global food prices started rising in late 2020, and the Ukraine war reinforced what was already an upward trend. Rising input costs in food production have been an important general driver of high food prices. Rising wholesale and distribution costs have also had significant effects on the food prices paid by consumers. For example, high energy costs make the operation of refrigeration facilities and transport more expensive. Although energy costs and raw material prices for food have fallen, they remain high and earlier increases have not yet been fully reflected in consumer prices, especially in Europe.

International food prices have fallen

Index 2019= 100

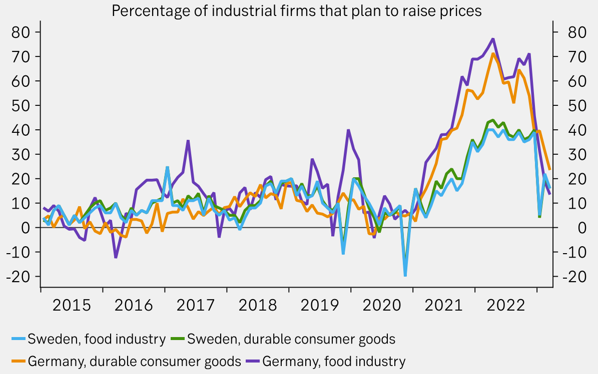


Source: Eurostat, BLS, Statistics Sweden, Hamburg Institute of International Economics, Macrobond, SEB

Time lag even when prices fall. One important question for future inflation forecasts is connected to how long the time lags in different stages will be during the downturn phase. Intermediate goods prices in the German producer price index (PPI) peaked in May 2022, but price levels for consumer goods in the producer stage are still rising, though slightly less than a year ago. This suggests continued sluggishness in the consumer stage. A large majority of retailers still expect rising prices for both food and other consumer goods.

Clearly falling price expectations in industry

Percentage of industrial firms that plan to raise prices



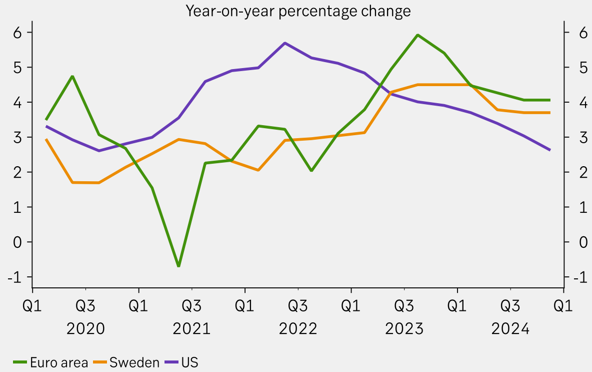
Source: Ifo Institute, Swedish National Institute of Economic Research (Konjunkturinstitutet, NIER), Macrobond, SEB

Some will go down, some will go up. But there are signs that the upturn in food and other goods prices is approaching a slowdown in the producer stage, where the percentage of firms intending to raise prices has moved closer to historically normal levels in recent months. With a lag of 3-4 months, it is likely that consumer price increases will also slow. The time lag is not as clear for services, which are not only affected by rising costs of goods but increasingly by rising labour costs. Similarly, rents are often affected by the general inflation level, so this component also moves with a historical lag. Rents in the US accelerated sharply in early 2022, and rents in the euro area and Sweden have started to rise faster in 2023, though not as clearly as in the US.

Shifting drivers in the inflation factory. Despite this easing trend, wage and salary growth will now take over as the driving force behind inflation. We saw early on that US and UK pay hikes, for example, speeded up as the labour market tightened during the reopening after the pandemic. In those parts of Europe where pay increases are more closely linked to collective bargaining, we are only now seeing a clearer acceleration. This is partly reflected in our wage forecasts. It is also clear from both inflation statistics and wage responses that the economy is reacting more quickly in the US than in Europe. A more sluggish upturn and downturn in wage response is thus one major reason why inflation now looks set to decline over a longer period in Europe.

Wage and salary forecasts

Year-on-year percentage change



Source: Macrobond, SEB

But inflation will fall in 2023. Inflation is now falling in most countries, but the decline is mainly in total inflation, with base effects from energy amplifying the downturn. Adjusted for energy, the downturn is much slower. In the US, wage and salary growth is slowing. Although a lot of collective bargaining negotiations are still ahead of us in Europe, most indications are that pay increases will soon accelerate. The upturn looks set to be slightly higher for a while than the level that is compatible in the long term with inflation targets. This indicates that in 2024, core inflation will be a bit above 2 per cent in Sweden and in the euro area. Because of uncertainty about exactly how many price-raising effects remain in the system, short-term risks (until summer) are on the upside. But due to a likely normalisation of international prices, long-term risks will instead be on the downside. Inflation risks are somewhat higher in the euro area than in Sweden due to greater uncertainty about wage forecasts. Even if the inflation rate declines and central banks are able to ease their tightening, high price levels will continue to rise.