Rising inflation: Temporary deviation or here to stay? 6 chief economists discuss

Rising inflation: What's the prognosis?

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Gayle Markovitz
Partnerships Editor, World Economic Forum

- Inflation in on the rise: the reasons are complex and there is little consensus on the short and long-term trajectory.
- Six Chief Economists give their view on what's next for inflation - is it transitory? Will it endure? How should governments, central banks and policy-makers respond?
- The World Economic Forum's November 2021 Chief Economists Outlook is published today, offering insights into how the dynamics of inflation are playing

Price surges have emerged in many corners of the economy, and the multiplicity of causes has led to diverging views on the most likely trajectory for inflation.

The November 2021 Chief Economists' Outlook survey asked experts for their views on the short and long-term outlook and met with diverging opinion.

Responses vary on whether the greater risk in advanced economies is too much demand, leading to overheating, or rapidly rising costs on the supply side, leading to stagflation – increasing prices with simultaneously slower growth. Another point of contention is whether we are seeing a general rise in the overall price level or whether price pressures are contained within specific product markets.

There is the argument that inflation is self-fulfilling. If we think money will lose value as a result of rising prices, we tend to behave in ways that make it so.

The Economist refers to a "shortage economy" as the product of decarbonization, which has left some countries vulnerable to energy-supply panic, while protectionism has resulted in trade policies that are no longer governed by economic efficiency. And the Financial Times suggests "supply bottlenecks, surging energy prices and rising inflation" are threatening the global rebound.

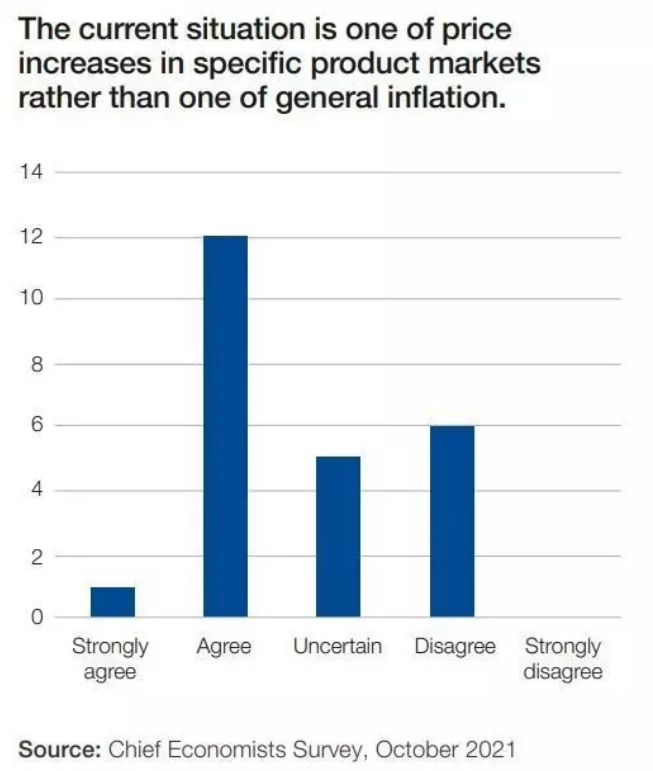
Although there is also some optimism that technology and innovation may eventually offset inflationary pressure.

What's clear is that as the world sits at an inflection point for the post-pandemic economy, the way in which governments and central banks deal with inflation will be pivotal. According to economists in a global Reuters poll, central banks reducing emergency stimulus too quickly and further supply chain disruption are "among the top risks to the world economy next year as the COVID-19 pandemic lingers".

We asked six members of the Forum's Chief Economists Community for their insights into the impacts of these developments, looking at how businesses, governments and central banks should be navigating the challenges.

'Policy-makers may have to entertain both possibilities: transitory and more persistent inflation'

Current inflation developments are driven by many overlapping factors. For now, pandemic-related causes still dominate, but these should be largely transitory. Some of the supply bottlenecks have been more severe and longer-lasting than expected, but ultimately most supply chain disruptions should resolve over time.



Price increases in specific product markets *Image: World Economic Forum*

The main risk for more persistent inflation comes from a potential de-anchoring of longer-term inflation expectations and/or a more structural change in the way labour markets respond. While inflation expectations have thus far remained well within their historic ranges, labour-market developments, especially in the US, have surprised by sharp wage increases amid a lack of labour supply (i.e. low participation). It will require more time to tell whether these are still temporary deviations due to COVID or may reflect lasting behavioural changes that imply a change in the slope of the Phillips curve.

How should policy-makers react to these uncertainties? American writer F. Scott Fitzgerald once opined: "*The test of a first-rate intelligence is the ability to hold two opposing ideas in the mind at the same time, and still retain the ability to function.”* Policy-makers’ minds may thus have to entertain both possibilities—transitory and more persistent inflation — as they take decisions in the coming months. This suggests acting with caution for now, as to avoid what ex-post could turn out to be policy mistakes, but with decisiveness when the true nature of the current inflation bout becomes clearer over time.

‘The energy trilemma of affordability, decarbonization and security of supply’

Eirik Waerness, Senior Vice-President and Chief Economist, Equinor, Norway

Inflationary pressure has increased this year, driven by a growing economy, supply chain bottlenecks and higher energy prices due to tightening balance in a market characterized by low price elasticities on both the demand and supply side.

Overheating a higher risk *Image: World Economic Forum*

There is potential for higher price pressure for longer. It is fair to say that the current situation in European and Asian electricity and gas markets is a vivid illustration of the energy trilemma of affordability, decarbonization and security of supply. Higher inflation may impact the energy transition in several ways: increased costs for commodities and labour, as well as higher interest rates, could slow the process, while higher fossil fuel and carbon prices increase the competitiveness of renewables and other low carbon solutions.

Business and governments should always plan to cater for different future developments, navigating the uncertainties through robust strategies based on scenario thinking. In the case of supply bottlenecks, governments should strive to reinstate efficient trading interfaces. In the case of volatile and high energy prices, a successful energy transition depends on governments securing predictable and stable operating conditions for energy producers and consumers, allowing for affordable, reliable and sustainable energy supply for years to come.

‘A trade-off between the cost of… decarbonization… and… rebalancing the economy’

Shusong Ba, Chief China Economist, Hong Kong Exchanges and Clearing (HKEX), Hong Kong SAR, China

China has established ambitious goals to achieve peak carbon emissions by 2030 and carbon neutrality by 2060. This is not an easy task, as China’s economic growth has largely been driven by energy intensive and highly polluting manufacturing over the past decades.

exacerbated a supply-demand imbalance that has already been aggravated by rebounding demand in developed markets and a delayed recovery in disrupted supply chains. That has pushed up the price of major commodities and PPI in China in the past year. However, in the medium term, there is a trade-off between the cost of moving towards decarbonization targets and the long-term benefit from rebalancing the economy.

In July 2021, China's national emissions trading scheme officially launched for carbon-credit trading, while the development of the relevant derivatives are still under planning. The development of ESG governance practice, high-quality carbon offset projects, and derivatives for carbon-emission allowances may create varied opportunities for the market to build up long-term sustainable green assets.

'New sources of upward pressure on the price level'

Giulio Martini, Partner; Director, Strategic Asset Allocation, Lord, Abbett & Co., USA

Over the next 12-18 months, higher inflation – above the standard 2% central bank target rate – is being driven by myriad forces: higher commodity prices, sectoral reallocation of demand, accelerating rent increases, and a widening mismatch in the labour market that is driving wage costs upwards.

As economies reopen, increasing pressure on service industries that have been experiencing weak demand – discretionary medical care and food away from home – is likely to increase, adding new sources of upward pressure on the price level. This pressure will be strong enough to force central banks to raise policy rates sooner than currently discounted in financial markets.

While inflation may turn out to be higher than expected in 2022 and 2023, the structural forces that have kept inflation low and stable worldwide since the mid-1990's – high debt burdens and increasingly skewed income and wealth distributions – remain in place and may have even been exacerbated by the COVID-19 crisis. As a result, the surge in inflation over the next couple of years is likely to give way to another period of low and stable inflation, energy transition notwithstanding.

Inflation expectations remain anchored around 2% *Image: World Economic Forum*

‘The toll of the shock will depend on how central banks respond’

Rafaela Guedes Monteiro, Chief Economist and Strategy Manager, Petroleo Brasileiro - PETROBRAS, Brazil

Rising energy costs may be read as an expression of the same equation driving supply-chain backlogs all over the world and leading to recent developments in inflation. COVID-19, and the necessary constraints on people movements to curb its spreading in the first half of 2020, created a never-seen disruption in oil demand. In response, companies slashed investments and OPEC+ members reached the highest oil supply cut agreement in history. Such a severe disruption in oil balances brought high uncertainty to the outlook of oil markets aggravated by extraordinary events such as hurricanes, tornados and droughts which brough shortfalls not only to the production of oil and gas but also to other sources of energy such as hydroelectric power. An additional layer of complexity was added as we experience an unexpectedly strong rebound in demand which runs headlong into stagnant supply.

The inflationary consequences of costly energy are likely to rise further in coming months, since fuel prices are bound to continue high until the beginning of 2022. However, contribution of energy to inflation is expected to fade once prices plateau during 2022. Fundamentally, the toll of the shock will depend on how central banks respond. We expect some to act as they worry that the energy shock worsens the risk that inflation expectations become detached from their targets. As for the long run, governments have an important part to play in stimulating more investment in renewable power capacity, so that energy constraints bind less.

‘Though there has been increasing talk of stagflation, this seems misguided’

Guy Miller, Managing Director and Chief Market Strategist, Zurich Insurance Company, Switzerland

Inflation is likely to remain elevated into the middle of next year before base effects and new supply capacity take effect. Demand is also expected to become more balanced, with consumption shifting towards services as mobility restrictions are eased further, taking pressure off manufactured goods. Worker participation in the labour force should also rise as

expected to remain robust for a number of years, helped in part by longer-duration fiscal spending on infrastructure.

The risk is that inflation becomes self-fulfilling. The longer it remains elevated, the greater the risk that companies will be encouraged to increase prices further, and workers seek higher wages. The profit motive will keep companies focused on cost control and productivity enhancements as capital for labour substitution and an accelerating pace of digitization ultimately curb the pace of wage growth. The shift to decarbonization may well create pockets of price pressures further out, but will also demand improved efficiency. What is clear is that central banks have not lost their inflation-fighting credentials, which is critical to both the short- and longer-term outlook.