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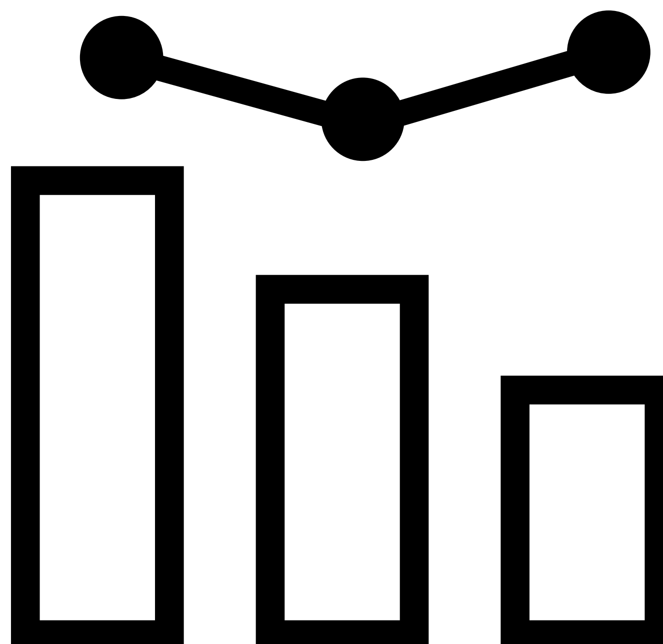


Market: trends & themes

July 2023

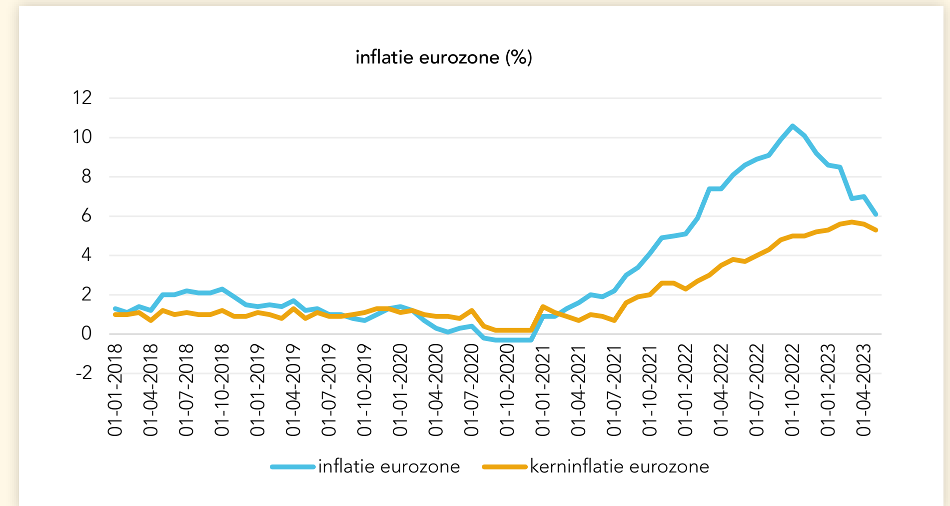
2023: the year of 'stagflation-light'

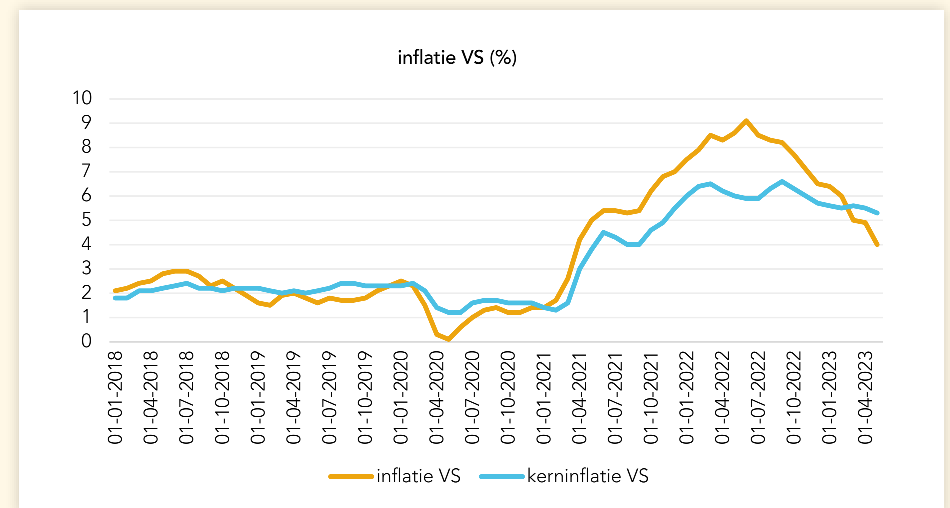
On these pages last year we focused on the sharp rise in inflation and the inflation outlook for the near and more distant future. Back then we noted that 2022 could be considered the year of 'turbo-stagflation' and asked the question: what will come after stagflation? One year on, it seems like a good time for an update: where are we now in terms of inflation and how has the outlook changed from one year ago?

From 'turbo-stagflation' to 'stagflation-light'

Let's start with the cold, hard figures: in June 2022, one year ago, US inflation had risen to 9% year-on-year. In the eurozone, inflation even ticked up to 10.6% year-on-year a few months later (in October 2022). Since then, inflationary pressures have eased significantly, falling back to 6.1% in the eurozone and 4.0% in the US. As our inflation dashboard also shows, the sharp decline in inflation can mainly be explained by the drop in energy prices witnessed over the past year. If we focus solely on core inflation, which excludes volatile food and energy prices, a markedly different picture emerges. In the US, core inflation hovered at around 6-6.5% for most of 2022 and has decreased only slightly since, now standing at 5.3% year-on-year. In the eurozone, core inflation still stood at around 3.5-4% in the summer of 2022, but then continued its rise, moving towards 6% in March 2023. Since then it has fallen back slightly and, at 5.3% year-on-year, is now at exactly the same level as in the US.

Although there has been a slight (core inflation) to marked (headline inflation) improvement in the inflation picture compared to one year ago, the same cannot be said of economic growth. In the first half of 2022, the global economy was still benefiting from the tailwind of the 'post-coronavirus' recovery, but in Europe and the US in particular (and, as now seems likely, China as well), this temporary upturn is now over. While the US economy still posted reasonable growth in the second half of 2022 and the first quarter of 2023, averaging just over 0.5% quarter-on-quarter, the eurozone economy more or less stalled during the same period. All in all, we can say that, while 2022 was the year of 'turbo-stagflation', with inflation levels we had not seen since the early 1980s, 2023 is set to be the year of 'stagflation-light', with lower inflation, but also lower economic growth than in 2022.



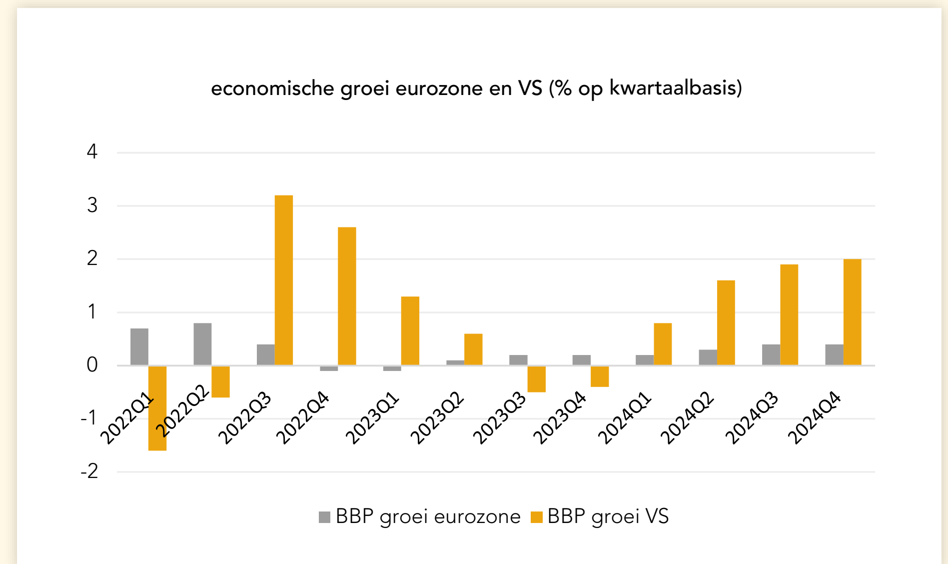


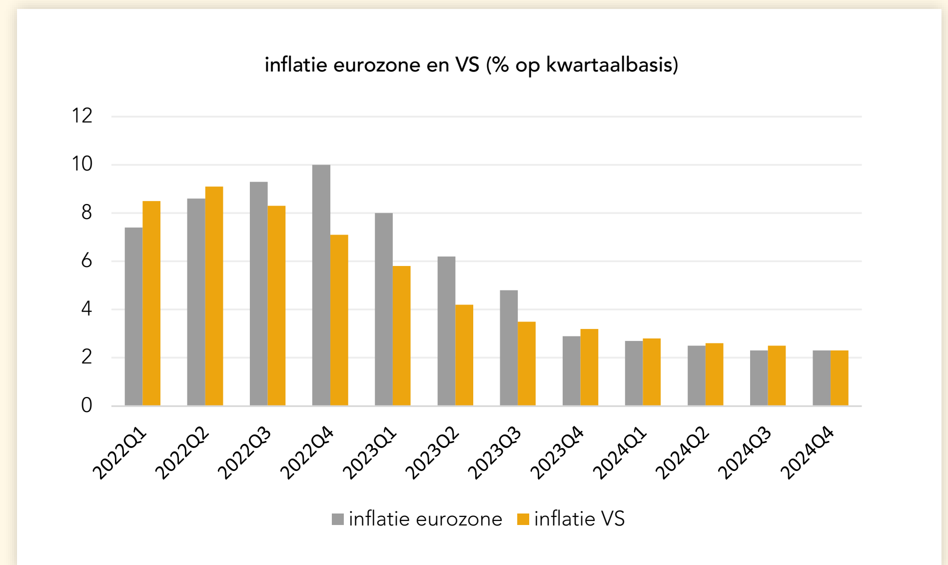
Source: Bloomberg

What next? Economy continues to falter, while inflationary pressures will ease further

How will the situation develop from here? As far as growth prospects are concerned, the picture for the near future seems clear, at least if you ask economic experts: it doesn't look great. For the eurozone, although the worst may appear to be behind us following the mild 'winter recession' of 2022-2023, nothing much more than marginal quarterly growth of 0.2%-0.4% is on the cards over the coming quarters. At least that is the consensus expectation of economists, according to Bloomberg. The picture is even bleaker for the US: after an expected recession (around -0.5% quarter-on-quarter growth over the next two quarters), a return to growth is not expected until the first quarter of 2024 at the earliest. The IMF is not enthusiastic either: for the global economy, the IMF is expecting growth of only 2.8% for the whole of 2023 (this was 3.2% in 2022) and only marginally higher growth of 3% for 2024.

As far as the inflation outlook is concerned, the direction is also clear, at least according to these same economists. In the eurozone, inflation will have slowed to 3-4% by the end of this year and will then fall further, towards 2.5% or lower, in 2024. The US has a fairly similar forecast: inflation of 3-3.5% by the end of this year and 2-2.5% by the end of 2024. Although this would mean inflation will still be above the 2% inflation targets of the US and European central banks at the end of 2024, we could then no longer really speak of a 'stagflation' scenario, especially if economies have also started to show signs of recovery by that point (as is expected).





Source: Bloomberg (NB realised through to end of 2023Q1, consensus expectation from 2023Q2)

Inflation since coronavirus pandemic: initially largely determined by supply-side factors, now mainly demand-driven

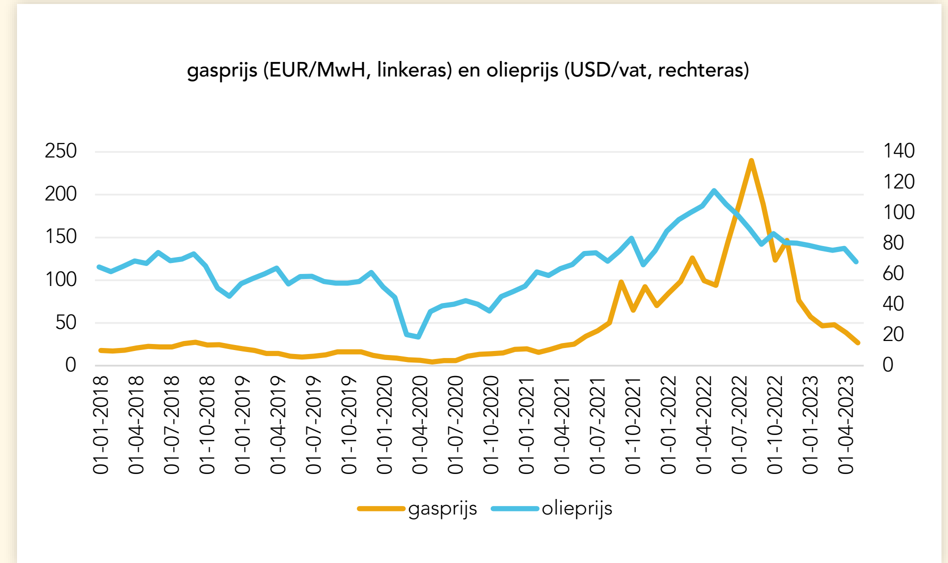
In the short term, i.e. over the next few months, we will remain in a 'stagflation-light' environment, but economists anticipate that we can then expect to see a gradual 'normalisation', with at worst slightly below-average economic growth and at most slightly above-average inflation. To determine how realistic these expectations are, it makes sense to delve a little deeper into the background to the inflation wave we have witnessed in recent years. This has now been researched by various economists and institutions.
The inflation wave that began in 2021 is mainly attributed to a combination of demand- and supply-side factors that largely resulted, directly or indirectly, from the coronavirus pandemic and intensified over the course of 2022 as a result of the war in Ukraine.

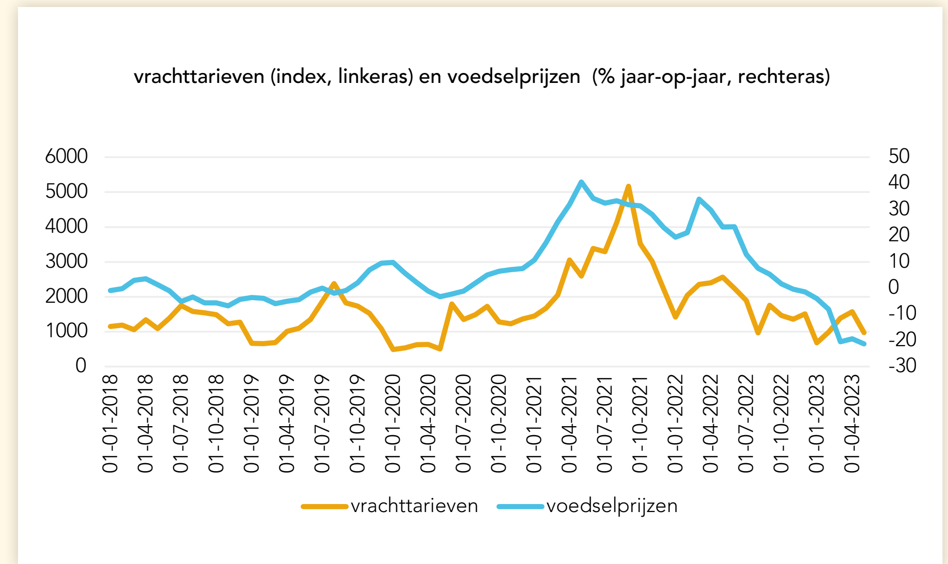
In the estimation of Adam Shapiro, economist at the San Francisco Fed, roughly half of the increased inflationary pressure in the US was initially due to supply-related factors, such as disruptions to supply chains and the labour market. Around a third of the rise was attributable to an upswing in demand (mainly thanks to all the coronavirus support measures introduced by the US government) and the rest to a combination of supply- and demand-side factors. Based partly on this US study, economists from the ECB carried out a similar study on European inflation. They concluded that the inflation wave, which started in the eurozone in the second half of 2021, was initially driven to a large degree by supply-related factors. Over time, the relative importance of demand-related factors began to increase and, by mid-2022, both demand- and supply-side factors were roughly equally responsible for the high level of inflation.

Inflation now mainly due to tight labour market, especially in services sector

Meanwhile, another year on, the importance of supply-side factors seems to have diminished further. Logistical constraints are no longer playing a major role and this has been especially true since China abandoned its 'zero Covid' policy in late 2022. This is demonstrated, for example, by the fact that freight rates, which had increased tenfold in the first year of the coronavirus pandemic, are now back below historical average levels. Disruptions to the supply of energy resources, especially oil and gas, have also been largely resolved. These had a very decisive impact on inflation during the first phase of the war in Ukraine one year ago, but in Europe the loss of supply from Russia has now been compensated for through the use of alternative supply routes.

The supply of food on the global market remains a concern, however. According to the FAO, the United Nations' food and agriculture organisation, food prices worldwide are now on average 20% lower than a year ago, although the food supply remains vulnerable to developments in the war in Ukraine (such as the recentblowing-up of the Kakhovka dam in the agriculturally important region of southern Ukraine), as well as weather- and climate-related developments (e.g. prolonged drought or floods).





Source: Bloomberg

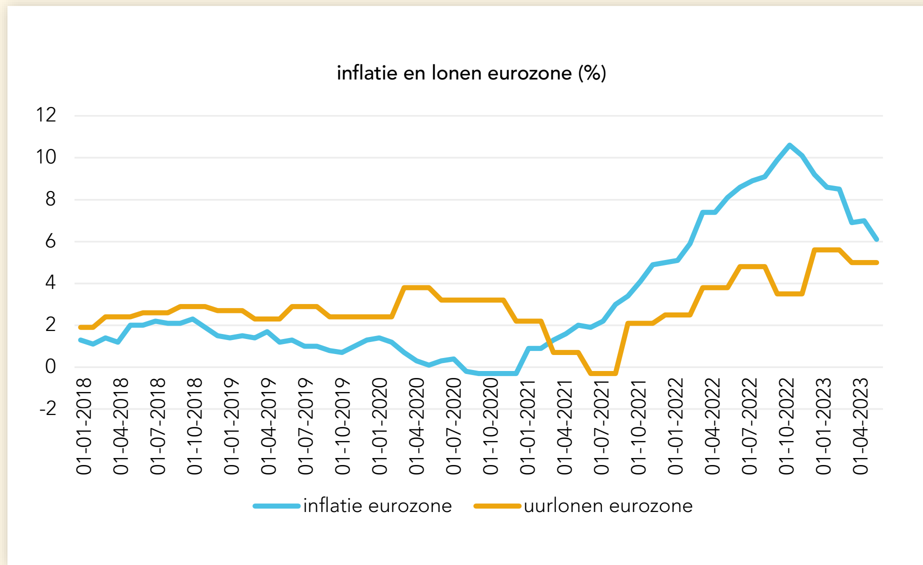
Recently, two well-known US economists, Olivier Blanchard and former Fed chair Ben Bernanke, presented a study in which they noted that supply-related inflation was mainly related to goods. This form of inflation has now declined significantly, also according to their calculations. At present, inflation is mainly being driven by labour market tightness, is related more to services and also has the potential to be more persistent. If labour market tightness persists, there is then a risk of the infamous 'wage-price spiral' coming into the equation. This was responsible for inflation remaining high for a sustained period in the 1970s in particular. In the end it could only be contained by means of extreme interest rate hikes (to over 10% in the Netherlands and 20% in the US) and structural reforms (e.g. the 'Wassenaar Agreement' of 1982).

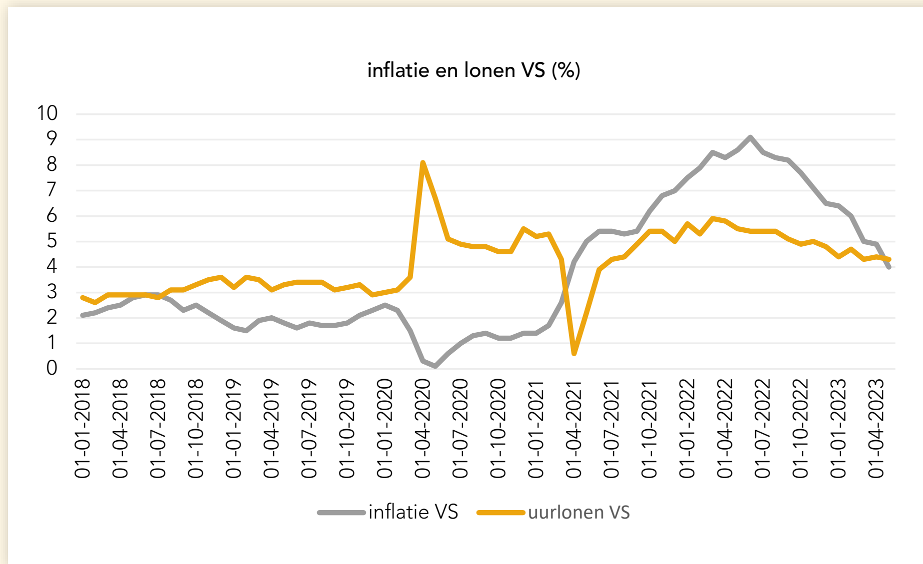
Labour market tightness: also driven more by demand than supply?

Whereas in the US many working people (especially those aged 55+) have dropped out of the workforce since the coronavirus pandemic and also do not seem to have any intention of returning, the situation is different in Europe, and certainly in the Netherlands. Unlike in Europe, a large proportion of the US government's coronavirus support directly targeted households, which seem to have used it, at least in part, to take early retirement. Europe's coronavirus support, on the other hand, focused mainly on companies, enabling them to retain their staff. This has contributed to the fact that, although the Netherlands and US have broadly similar levels of unemployment (around 3.5%), over 75% of the potential working population is participating in the labour market in the Netherlands, compared to just over 60% in the US.

Therefore, as Sandra Phlippen, chief economist at ABN AMRO, also noted recently, the problem in the Netherlands is not so much the supply of labour as the high demand for labour.

'Fortunately', demand for labour is easier to influence than the labour supply, which is relatively inflexible. Less fortunately, in order to curb labour demand, and thus reduce the risk of a wage-price spiral, economic growth has to be slowed down. This is currently already at a low level in Europe, and certainly in the Netherlands, which was one of the laggards within Europe in the first quarter of 2023, posting negative growth of 0.7%. Against that background, it is not surprising that there has been no sign of a wage-price spiral to date. On the contrary, wage growth in both Europe and the US has lagged behind price increases, at least until recently. Even though the tightness on the labour market has persisted for some time, it was only last month that real hourly wages in the US rose above 0% for the first time since the coronavirus pandemic; in other words, wages rose faster than prices. In Europe, too, this tipping point is only now coming into view.



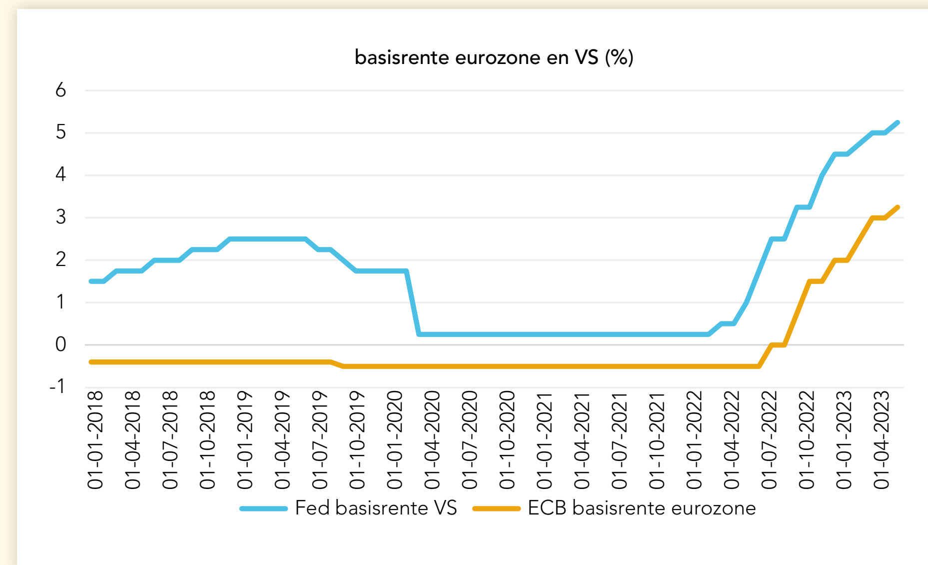


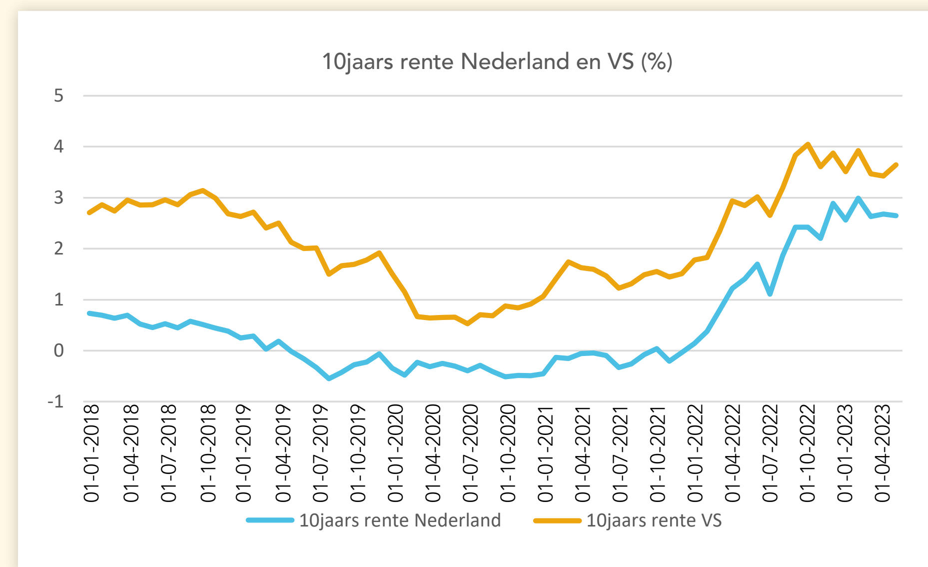
Source: Bloomberg

Effect of higher interest rates on growth and inflation is only now becoming apparent

Despite warnings from the likes of DNB and the ECB, the risk of a wage-price spiral does not seem particularly high. The economic growth outlook is moderate at best, inflationary pressures are easing and wages have so far risen less than might have been expected given the long-standing tightness on the labour market. Moreover, it is likely that the impact of central bank measures on the real economy and inflation is only now beginning to be felt. Over the past year, the Fed has raised the US base rate from 0% to 5.25%, while the ECB's European base rate has gone from -0.5% to 3.5% in less than a year. For the coming months, the interest rate market is anticipating further rate hikes that would bring the base rate to 5.5% in the US and 4% in the eurozone by the end of the summer.

At current interest rate levels, economists' expectations of continued low economic growth, or even recession, and of a further decline in inflation in the second half of 2023 seem perfectly realistic. The main question is what will happen next, and how determined central banks will prove to be in further driving inflation down towards their 2% targets in 2024. Central bankers, of course, say they will do whatever it takes to achieve this, but the question is how desirable, and therefore also how realistic, that is. Having pulled out all the stops for over a decade to avoid deflation, including devices such as 'negative interest rates' and 'quantitative easing', the question is how bad it would be if inflation were now to stay 'above but close to 2%' for a while, especially if the alternative would be to raise interest rates (much) further, thus contributing to a prolonged period of low (or negative) economic growth.





Source: Bloomberg

Risk of spiralling inflation appears limited

An additional complication for central banks is that various structural factors will continue to have an underlying upward impact on inflation, even after the current 'coronavirus-driven' inflation wave has subsided. As we also described last year, these may include, for example, the price-driving effects of climate change and the energy transition and of possible further 'deglobalisation'. In addition, the tightness on the labour market will not disappear any time soon, even if the economy were to slump over the coming period. These and other factors were also cited by ECB Executive Board member Isabel Schnabel in a recent speech on 'the risks of stubborn inflation'.

The main risk, which Schnabel also cites, is that consumers and financial markets will come to expect persistently higher inflation. This has a self-reinforcing effect and can lead to structurally higher inflation via a wage-price spiral, for example. In the United Kingdom, which is facing a serious stagflation problem partly as a result of Brexit, this is an all-too-real risk, although we see no signs of it in the eurozone. According to research by the ECB, although the level of future inflation expected by European consumers had risen towards 3% during 2022, it has since fallen back towards 2.5%. Even in Germany, where it seems that the hyperinflation of 1923 has still not been forgotten, consumers have few concerns about inflation getting out of hand. Financial markets are also not pricing in long-term high inflation. Long-term interest rates have remained stable in recent months, at around 2.5-3% in the case of the Dutch 10-year rate. Inflation-linked bonds have been pricing in inflation of around 2-2.5% on a 10-year horizon for almost a year now.

'Stagnation' or 'growthflation', that is the question...

Ultimately, this presents central banks with a dilemma. Should interest rates be raised further to banish the spectre of inflation, risking long-term economic stagnation? Or would it be better to loosen the monetary reins a little to limit the damage to economic growth, but with the risk of longer-lasting high inflation? In terms of the economic scenarios we discussed last year, this basically amounts to choosing between a 'secular stagnation' (or 'Japan') scenario and a 'growthflation' scenario, as in the 'reconstruction' years after World War II. From a culinary perspective that choice may not be so difficult (would you rather eat sushi or Brussels sprouts?), but from an investment perspective it is rather more tricky.
A 'Japan' scenario is more likely to mean lower interest rates and low investment returns (in other words, it is relatively favourable to bonds), while in a 'growthflation' scenario both interest rates and investment returns are expected to be higher (in other words, it is relatively favourable to more 'risky' investments, such as equities), especially in nominal terms. It is currently difficult to estimate which way things will go, but one thing is certain: in a year's time, we will know more...

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