

Global Economy Watch

Is high inflation back for good?

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Get in touch



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Dear Readers,
High levels of inflation in most advanced economies (AEs) is starting to make some policymakers, households and some of our clients nervous (see Figure 1). The real question is whether this is temporary or something that will last longer? To answer this question, we disentangle the inflation dynamics we see in AEs and analyse the arithmetic, demand and supply side drivers.

The arithmetic driver tells us that some of the increase in the inflation rate in the first half of the year is due to 'base effects'. Shutting down and reopening segments of the economy has led to erratic price changes. These have led to statistical oddities which will gradually fade.

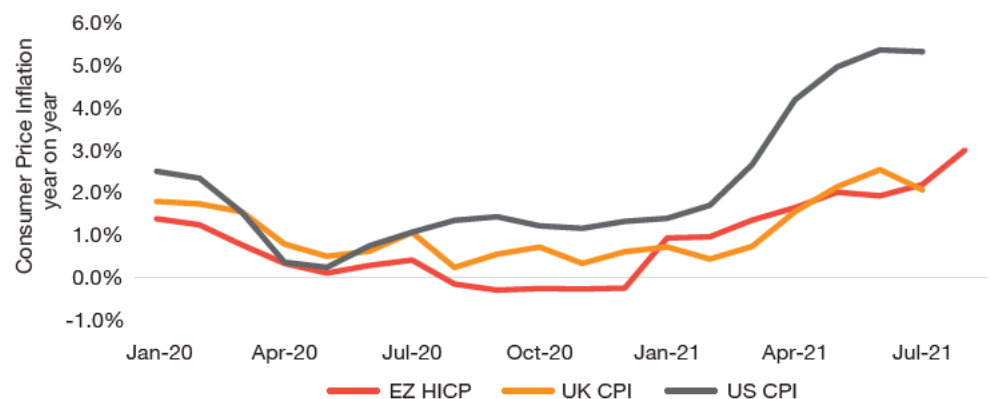
On the demand side, even though the rebound has been strong in the G7 (the Group of Seven is an inter-governmental political forum consisting of Canada, France, Germany, Italy, Japan, the United Kingdom and the United States), most are still operating with a significant degree of slack or an output gap. The International Monetary Fund (IMF) estimates that this will persist for a few years for all of the G7 except the United States (US). However, the employment data suggests that even the US labour market is operating with significant slack. On balance, we think that the risk of demand-pull inflation is low.

On the supply side, large and unpredictable swings in demand have stretched supply chains and logistic networks. Nevertheless, we are seeing evidence that, consistent with economic theory, prices are acting as signals to both producers and consumers to change behaviours. For example, US timber prices were at an all-time high in April this year, but have since then subsided, in part due to changing behaviours in the housebuilding industry and also supply side improvements.

We also revisit reshoring, a theme that was on the mind of CEOs during the trade tensions between the US and China a few years back, which later resurfaced at the height of the COVID-19 pandemic when there was a global shortage of personal protective equipment (PPE). Our static scenario based analysis shows that up to 1.2 million jobs could be created by reshoring in the G7. However, this requires more careful consideration as policymakers should factor in the potential negative economic effects of re-allocating labour to potentially less productive sectors against the security benefits of producing critical goods domestically.

Finally, we continue to monitor leading indicators for Eurozone growth for the third quarter of the year. Figure 2 shows that some of the Baltic economies have already exceeded their pre-pandemic levels of output. We expect this positive momentum to continue into the third quarter, particularly for the southern European economies.

Fig 1: Consumer Price Inflation in the Eurozone, US and UK



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Economic update: The Baltics bounce back

The Eurozone's latest Q2 Gross Domestic Product (GDP) figures shows that its economy grew 2.2% quarter-on-quarter. In year-on-year terms this comes to 14.3% growth relative to 12 months ago which marked the height of the pandemic in the continent. This relatively strong set of growth statistics was underpinned by a rapid expansion of the region's vaccination campaign, which paved the way to reopening some of the service sectors where activity was restricted. Consumer spending therefore recovered strongly as households began to spend some of the 'excess' savings accrued in the past few quarters.

However, as seen in Figure 2, the monetary union's economic recovery remains uneven. Since the end of 2019, the Baltics (Estonia, Latvia and Lithuania) have outgrown their pre-pandemic GDP unlike the mostly richer, central and southern neighbours. Greece is also in this exclusive club of countries with GDP higher than pre-pandemic levels.

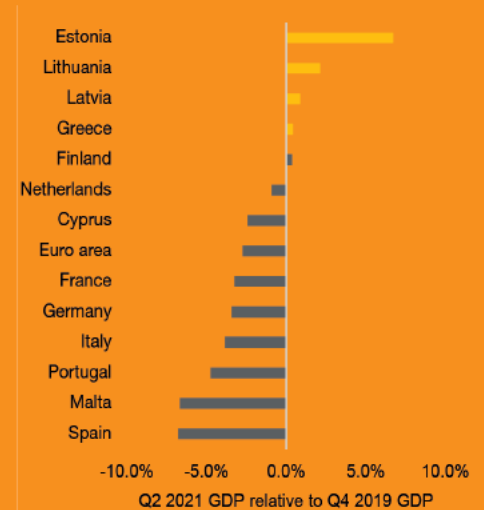
At the bottom of the pack are Spain, Portugal and Malta, all of which are highly dependent on services, in particular tourism. Before the sector ground to a halt in 2020, it accounted for around 15% of economic output in each country.¹

Similarly, the tourism sector accounted for at least 10% of GDP in 2019 for the other economies that are currently smaller than their pre-pandemic size, with the exception of the Netherlands and Germany.

The Netherlands has recaptured the majority of its lost output, but growth in Germany continues to be held back by supply chain disruption, particularly in the automotive sector which is facing a severe shortage of semiconductors.

Leading indicators suggest that the southern European economies will have a better tourism season than last year (see chart on pg. 4). So we would expect some of the Q3 GDP growth numbers to be on the positive side when released in a few weeks.

Fig 2: Q2 2021 GDP relative to Q4 2019 levels



Source: Refinitiv, PwC analysis

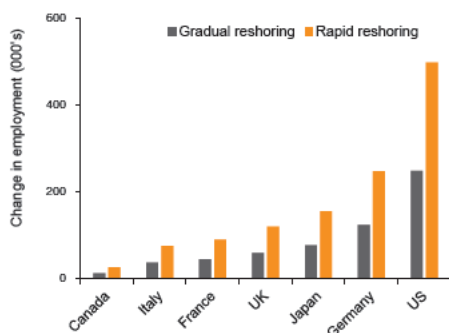
What is the economic impact of reshoring certain 'strategic' sectors to the G7?

Pre-pandemic some businesses were considering reshoring some of their overseas operations

The 2007-08 Global Financial Crisis (GFC) marked a turning point in international trade. World exports fell by 10% in one year as global demand dried up². And while subsequently exports recovered to pre-crisis levels, the growth rate slowed considerably towards the end of the last decade. Our analysis suggests that there were three key driving factors. First, wage growth in emerging economies reduced the monetary benefits of offshoring away from advanced economies. Second, new technologies (3D printing and artificial intelligence) reduced the benefit of labour cost arbitrage. And third, trade tensions between the US and China disrupted global trade flows.

But in 2020 another global economic shock changed the trajectory of global trade. As the COVID-19 virus swept across the world,

Fig 3: Estimated impact of reshoring on employment in the next 10 years



Sources: PwC analysis, WIO, OECD

governments tried to deal with shortages of certain goods and equipment by restricting their exports. This mainly related to 'critical' medical goods such as pharmaceuticals and PPE. This move also emphasised some of the downsides associated with having highly integrated supply chains which span more than one country.

What is the economic impact of reshoring?

In this article, we estimate the economic and employment impact of this reshoring trend. We limit our analysis to 'critical' sectors of the economy, which we identify through a combination of:

- Desktop research including public statements from policymakers in AEs;
- Import intensities, which determine how more likely the sector could succumb to disruptions in international trade; and

Three critical sectors where reshoring could be most prevalent³

Sector	Import Intensity	Labour Intensity	Security risk
Pharmaceutical products	Medium	Low	Multiple countries restricted exports of pharmaceutical products during the pandemic
Computers and electronics	Medium	Medium	Semiconductors, which power everything from mobile phones to weapons systems
Electrical equipment	Medium	Medium	Lithium-ion batteries are used to power EVs, which are essential to net-zero transition

- Labour intensities, which given an indication of the likely labour cost arbitrage element is in the sector.

We consider two scenarios. A period of 'Rapid' reshoring, which sees the G7 economies reshoring 20% of their imports over the next decade, and a period of 'Gradual' reshoring, where the G7 reshore 10% of imports.

Our analysis finds that reshoring has the potential to increase the annual output of the G7 by around \$136bn to \$272bn (in constant 2019 prices) over the next decade. Using GVA-employment ratios, we find that this is equivalent to around 0.6 to 1.2m jobs returning to the G7, with the largest increases seen in Germany and the US.

While this analysis is static and only considers three sectors, it highlights that reshoring could lead to a reasonable amount of job creation in the G7 over a period of ten years all things remaining equal.

However, reshoring is not expected to be entirely costless. For example, countries that have already high employment rates or close to full employment could see some net output losses if reshoring results in transferring workers from potentially more productive sectors (e.g. financial services) to less productive sectors that are being reshored (e.g. manufacturing of pharmaceutical products). As a result, policymakers should carefully consider and balance these potential negative economic effects against the security benefits of producing critical goods domestically.

¹ Sources: OECD, European Commission.

² Source: IMF.

³ We calculate import intensities as the value of imports as a share of intermediate consumption and labour intensities as the employment share of gross value added.

Is high inflation in advanced economies a cause for concern?

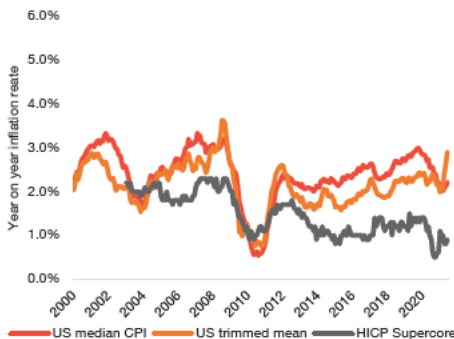
Inflation has been top of mind for CEOs and policymakers in AEs for the past few months. This is not surprising as inflation, measured with the Consumer Price Index (CPI), is currently at multi-year highs. Specifically, based on the latest data, inflation stands at more than 5% in the US and around 3% in the Eurozone which are both higher than the respective central bank inflation targets (see Figure 1). Does this herald a new normal era of high inflation? To answer this question we analyse inflation trends in AEs using three dimensions: arithmetic, demand and supply side analysis.

Arithmetic: 'Base effects' artificially push up inflation

Some inflation was expected this year as at the start of the pandemic, global demand collapsed and prices tumbled. Subsequently, as AEs unwound the lockdown restrictions impeding economic activity, prices shot up. The combined effect of these two factors—decreasing prices last year, rising prices this year—is to artificially increase year-on-year headline inflation rates. Adjusting for this effect, we estimate that inflation in the Eurozone would have been under-target in July (1.3% compared to an actual 2.2%) while the US would have still overshot its target but to a significantly lesser degree (3.1%, compared to 5.4%)⁴.

Nevertheless, base effects do not explain the full picture. Alternative measures of inflation which control for outliers (trimmed measures) or those that exclude prices which are largely determined by global macroeconomic factors outside the control of national central banks (core measures) show that inflation is running at lower rates than implied by headline figures. This suggests that extreme price changes are limited to a few specific components feeding into headline inflation and that price imbalances are not broad-based across the

Fig 4: Alternative measures of inflation in the US and Eurozone



Note: US trimmed CPI: Calculated the median price change (i.e. 50th percentile) of basked of goods and services included in CPI. US trimmed mean: Calculates the price changes between the 8th and 92nd percentile of US CPI. HICP Supercore: Measures Eurozone inflation focused on the basket of goods and services that are included in the HICP which are price sensitive to the economic cycle.

Source: Refinitiv

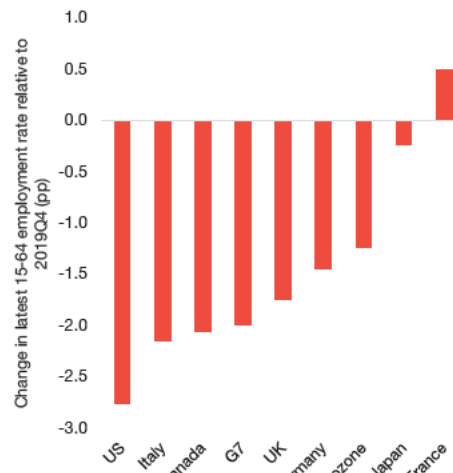
entire economy. For example, in the US, we see that new and used vehicles contributed around 1.6 percentage points (pp) to US CPI inflation in June this year compared to its historic average of around 0.1pp.

Demand side: Employment data shows slack still exists in G7

Economic theory states that inflation pressures are a function of the degree of slack in an economy. Using economy-wide measures of slack such as output gaps, the IMF main scenario projections show that most of the G7 economies, with the exception of the US, are currently operating with significant slack and are expected to continue to do so in the foreseeable future.

However, output gap estimates are based on theoretical constructions of potential output which are difficult to estimate and are heavily revised over time. Focusing on more frequently reported statistics for the labour market we find that in Figure 5, G7 labour markets have a significant degree of slack, with the US employment rate recording the largest decrease when compared to pre-pandemic levels. The US labour force participation rate, however, remains below pre-pandemic levels. We expect this will gradually normalise as the epidemiological outlook becomes gradually less uncertain. On this measure, everything else remaining constant, the risk of demand-pull inflation in AEs seems relatively low.

Fig 5: Change in latest employment ratios relative to Q4 2019



We use the Q2 2021 employment ratio for Japan, the US and Canada. For all other countries we use the Q1 2021 datapoint.

Source: Refinitiv

Supply side: Unpredictable and large changes in demand reverberate across global supply chains

Surveys, such as the US-based CNBC|Momentive Small Business Survey, show that businesses in most AEs are experiencing shortages of key inputs to

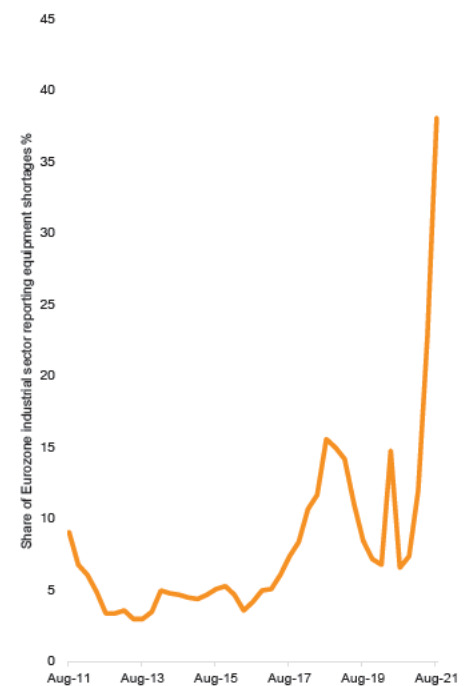
their businesses. In the Eurozone, shortages in the manufacturing sectors centre around the availability of equipment (see Figure 6). This is in part due to the effects of the pandemic. The unpredictable nature of opening and closing up sectors of the economy sent distorted signals to supply chains, which led to the inefficiencies and bottlenecks businesses are experiencing now. This is also known as the bullwhip effect.

However price changes should also be viewed as signals to consumers and producers to change behaviours. For example, in the US, timber prices more than doubled in less than 12 months reaching all time highs in April of this year, mainly driven by inadequate supply. But since then, prices have adjusted downwards by around 20% reflecting the use of alternative materials in construction and an increase in the capacity of suppliers⁵.

In most cases and aside from any country-specific reasons, the bullwhip effect, coupled with capacity constraints in the global logistics network, has resulted in difficulties in getting the right products, at the right place, at the right time.

In conclusion, our analysis suggests that inflation trends in AEs are being pushed higher by specific mathematical, supply and demand side reasons. Assuming a more certain epidemiological outlook, we would expect inflation rates to gradually fall back to normal levels as we slowly return to normality. Although policy changes (e.g. tax changes) or sector-specific pressures (e.g. semiconductor shortage affecting car manufacturing), are likely to mean that inflation rates will remain volatile over the near term.

Fig 6: Share of Eurozone manufacturers reporting citing equipment shortages as a limit to production



⁴ We estimate this by calculating the annualised change in CPI over two years.

⁵ Source: Refinitiv.

Projections: September 2021

	Share of 2019 world GDP		Real GDP growth				Inflation			
	PPP	MER	2020	2021p	2022p	2023-2027p	2020	2021p	2022p	2023-2027p
Global ('MER')		100.0%	-3.3	6.1	4.3	2.9	1.8	3.1	2.6	2.5
Global ('PPP' rate)	100.0%		-3.2	6.3	4.6	3.4	2.5	3.5	3.0	2.8
G7	31.7%	45.5%	-4.9	5.5	3.8	1.6	0.8	3.0	2.3	1.9
E7	36.2%	27.5%	-0.5	7.6	5.2	5.1	3.4	3.4	3.3	3.3
United States	15.9%	24.6%	-3.5	6.5	3.8	1.9	1.2	4.1	2.9	2.2
China	17.4%	16.5%	2.3	8.5	5.7	5.7	2.5	1.4	2.3	2.8
Japan	4.1%	5.8%	-4.7	2.8	2.5	0.8	0.0	0.1	0.5	1.0
United Kingdom	2.4%	3.2%	-9.9	6.5	5.3	1.8	0.8	2.2	2.7	2.0
Eurozone	10.7%	13.2%	-6.7	4.6	4.3	1.6	0.3	2.0	1.5	1.7
France	2.4%	3.1%	-8.1	5.9	4.1	1.7	0.5	1.5	1.3	1.6
Germany	3.5%	4.4%	-4.9	3.5	4.2	1.4	0.4	2.8	1.9	2.0
Greece	0.3%	0.2%	-8.2	4.2	5.2	1.8	-1.2	0.0	1.0	1.6
Ireland	0.3%	0.5%	3.6	5.6	4.8	2.9	-0.4	1.6	1.5	2.0
Italy	2.0%	2.3%	-8.9	4.7	4.1	1.0	-0.2	1.4	1.2	1.3
Netherlands	0.8%	1.0%	-3.7	3.1	3.4	1.6	1.2	2.0	1.7	1.8
Spain	1.5%	1.6%	-10.9	6.1	5.8	2.5	-0.3	2.1	1.4	1.7
Poland	1.0%	0.7%	-2.7	4.2	4.9	2.8	3.4	4.2	4.5	3.0
Russia	3.1%	2.0%	-2.9	3.7	3.1	1.9	3.9	5.7	4.0	4.1
Turkey	1.8%	0.9%	1.8	8.5	3.4	4.0	12.3	18.5	13.5	8.5
Australia	1.0%	1.6%	-2.4	4.2	3.2	2.5	0.9	2.4	2.0	2.3
India	7.1%	3.3%	-7.7	10.6	7.5	7.5	6.3	5.5	4.9	4.0
Indonesia	2.5%	1.3%	-2.1	4.2	5.4	5.2	2.0	1.8	2.9	3.0
South Korea	1.7%	1.9%	-4.7	2.8	2.5	2.7	0.5	1.9	1.6	1.7
Brazil	2.4%	2.1%	-4.1	4.1	2.4	2.2	3.6	6.8	4.1	3.4
Canada	1.4%	2.0%	-5.4	5.8	4.2	1.8	0.7	2.9	2.4	1.9
Mexico	2.0%	1.4%	-8.3	5.4	3.1	2.3	3.3	5.9	3.7	3.0
South Africa	0.6%	0.4%	-7.0	3.7	2.4	2.2	3.3	4.3	4.5	4.8
Nigeria	0.8%	0.5%	-1.8	2.4	2.6	2.5	13.3	16.6	12.4	11.1
Saudi Arabia	1.2%	0.9%	-4.1	2.6	4.2	3.0	3.4	3.0	1.9	2.5

Sources: PwC UK and global analysis, national statistical authorities, EIKON from Refinitiv, IMF, Consensus Economics, European Commission and the OECD. Our projections are the average of projections from the OECD, IMF, European Commission and Consensus Economics, where available for each country. They also incorporate inputs from select teams across the PwC global economic network. 'MER' refers to market exchange rates and 'PPP' is purchasing power parity. Note that the table above form our main scenario projections and are therefore subject to considerable uncertainties. PwC recommends that our clients look at a range of alternative scenarios.

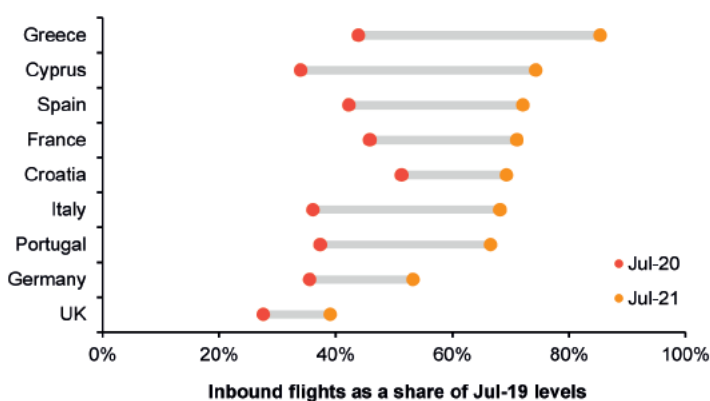
Interest rate outlook of major economies

	Current rate (Last change)	Expectation	Next meeting
Federal Reserve	0.00-0.25% (March 2020)	No rate rise for the foreseeable future	September 21-22
European Central Bank	0.00% (September 2019)	No rate rise for the foreseeable future	October 28
Bank of England	0.10% (March 2020)	No rate rise for the foreseeable future	September 23

Top of the charts

After the dramatic slump in tourism activity last year, and early this year, there are initial signs that tourists are starting to flock back to Europe. The graph to the right shows that inbound flights to European hotspots such as Greece and Cyprus are closer to pre-pandemic levels than they were at the same time last year. This should herald stronger growth in the third quarter of this year. By contrast, in the UK and Germany – where their economies are less reliant upon tourism – inbound flights are still way below pre-pandemic levels.

Flights to Europe start to rebound as tourism hotspots open up



Source: Eurocontrol

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