ODDO BHF

MACROECONOMIC *view*

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Let's talk (for a change) about disinflation

Key highlights:

- Global inflation appears to have peaked at around 10% by the end of 2022
- Various factors are contributing to disinflation, including recession in several regions and restrictive monetary policies
- Many uncertainties remain, from the energy crisis in Europe to the long-awaited reopening of the Chinese economy

Rightfully, Time Magazine's Person of the Year for 2022 is Volodymyr Zelensky. **But if there were a Word of the Year title, it would no doubt be attributed to "inflation"**. Its use is on a par with the Ukrainian president's media omnipresence. According to Google Trends, this term has never been used more frequently in search engines and the media. Normally, inflation is a problem discussed only by experts such as central bankers, economists and investors. **But in 2022, for the first time in four decades, inflation has once again become a matter of great concern to ordinary people.**

In less than a year, inflation in Europe has more than doubled to over 10%. Food inflation has quadrupled to almost 15%. Energy inflation has exceeded 40%, and the shock would have been much greater had each country not put in place "energy price shields" to limit the rise in gas and electricity bills. In 2022, inflation has continued to surprise by its strength and persistence. One wonders whether it can be brought down to a level where it is no longer debated - except among experts.

There is reason for hope. Price pressures have eased a little in recent months, at least in some regions. According to our estimates, the global inflation rate has hit an apex at around 10% (graph). It is levelling off, a crucial step before a possible decline. Its historical average is around 3%. There is still a long way to go before the shock is over.

What are the forces pushing towards disinflation? To assess that, we need to look at the various factors that have caused a sudden surge in inflation almost everywhere in the world.

To some extent, the pandemic had provided fertile ground for inflation. On the demand side, fiscal constraints had been loosened to the maximum in order to trigger a rapid post-lockdown recovery. These stimulus programmes have now dried up. Without being restrictive, fiscal policies are much less stimulative. According to the European Commission, the government budget deficit in the eurozone halved between 2020 and 2022, from 7% to 3.5% of GDP. In the US, it fell from 15% to 6%. **The rise in interest rates is forcing governments to be more cautious.**

On the supply side, the pandemic had caused delivery delays, component shortages and supply chain fragmentation, all of which resulted in production being constrained precisely at a time when demand was being stimulated. The subsequent surge in raw material prices was first reflected in production costs, then in retail prices. This scenario is now playing out in reverse. **With global growth prospects falling below trend, commodity prices are cooling. Freight prices have dropped. Delivery times are normalising.** In several sectors, companies now have too much inventory, which will have to be cleared at a discount. **All this is disinflationary.**

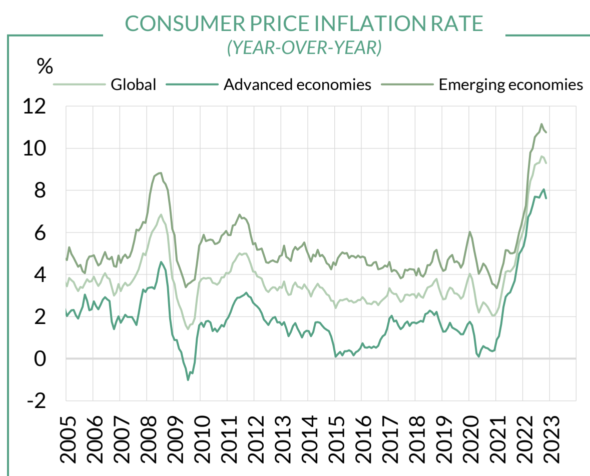
The inflation shock has also been fuelled by geopolitical tensions, especially the war in Ukraine, which highlighted Europe's excessive energy dependence on Russia. Such a supplier cannot be dispensed with overnight. The search for substitutes is long and costly, but major efforts have been made in terms of diversification and energy efficiency. **Even if the energy crisis is not yet over, its peak intensity seems to be behind us.** While energy prices will not return to the low levels we are used to, they will be more volatile but unlikely to soar as they did in 2022. The uncertainty shock has happened once, not twice. As time passes, the effect on inflation will diminish.

Finally, we should consider the monetary policy response to the inflation shock. All but a few central banks have tightened their policies at an unprecedented pace. On average across forty countries, **we estimate key rates to have risen by around 250 basis points in less than a year. This process is set to continue, at least into the first few months of 2023.** For the time being, the tightening is only weighing on interest rate sensitive sectors such as real estate, but the rest of the economy will inevitably be affected.

In sum, the conditions for an ease in price rises are gradually being put in place. Disinflation has begun timidly in the US since the summer. In Europe, where the demand is more depressed, disinflation is likely to follow with a 6-month lag. A rapid decline in inflation in 2023 cannot be ruled out because, despite the scale of the shock, medium-term inflation expectations have not slipped.

As a precaution however, we should consider two risks pushing in the opposite direction.

Firstly, tensions remain present in the **labour market** as some sectors face staff shortages. To date, there has been no price-wage spiral, but this should be monitored closely. Secondly, if China manages to successfully lift its zero-Covid policy (this remains hypothetical), **Chinese demand**, which has failed global markets for the past three years, will rebound, risking adding fuel to the inflationary fire.



Source : Thomson Reuters, ODDO BHF

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