INFLATION: SHIFTING FOCUS, SHIFTING CONCERNS

Historically, there is a close relationship in the US and the euro area between, on the one hand, a measure of price pressures based on survey data on manufacturing delivery times and input prices, and, on the other hand, core inflation. The recent flash purchasing managers' indices show that price pressures may be peaking, thereby providing hope that inflation will follow in the not-too-distant future. This will focus the attention to the speed of decline in inflation. A very slow process would be highly discomforting, raising fears that ever-higher interest rates would end up causing a recession. Everybody wants slower growth to bring inflation under control, but nobody wants the growth engine to stall.

Historically, there is a close relationship in the euro area between, on the one hand, a measure of price pressures based on survey data on manufacturing delivery times and input prices, and, on the other hand, core inflation, whereby the latter follows with a lag of about twelve months the former (chart 1). In the US, the correlation is also high although the lead time of price pressures is a lot shorter (chart 2 and 3).

Against this background, the recent flash purchasing managers' indices show that price pressures may be peaking, thereby providing hope that inflation will follow[1]. In the euro area, Germany and France, delivery times have shortened and the percentage of companies experiencing higher input prices has declined slightly in May (chart 4). US companies also report somewhat shorter delivery times, but more companies than before are facing higher input prices (chart 5).

With high and rising inflation having been the dominant concern so far this year, there is a risk of overreacting to any evidence pointing towards a possible change in direction. Such a change, if it were to be confirmed in the coming months, would clearly bring relief, but it would also shift the focus to how fast inflation will decline. The process will probably be slow considering that a large majority of companies are still complaining about higher input prices and long delivery times

The strength of demand, through its influence on companies' pricing power, also plays a role. In this respect, the flash PMIs for May show a small reduction in the number of companies in the US, the euro area and France planning to raise their output prices. In Germany, the decline was negligible, although a survey conducted in May by the Ifo Institute shows a bigger change[2]. It is the first drop in several months but given that the net balance of German companies planning to raise their prices in the next three months is still high, the decline in inflation should be slow. According to the ifo Institute, *"the trend suggests that monthly rates of inflation will fall from above 7 percent to below 6 percent in the second half of the year"*.

These developments have influenced financial markets. Bond markets have started to price that the inflation dynamics may be about to change, witness the recent decline in breakeven inflation in the US and Germany (chart 6). This reflects a combination of lower inflation expectations as well as a belief that the risk of upside surprises to inflation has declined.

Once inflation will have peaked, the question of its speed of decline will be particularly important because it will shape expectations about how much central banks will have to raise their policy rates. This in turn will influence the evolution of bond yields and, more generally, borrowing costs and hence economic activity. The slower the decline of inflation, the more discomfort it would generate, raising fears that ever-higher interest rates would end up causing a recession. This concern is particularly vivid in the US, considering the expected cumulative tightening by the Federal Reserve. Everybody wants slower growth to bring inflation under control, but nobody wants the growth engine to stall.

William De Vijlder

1. Data for the Eurozone were collected 12-20 May and for the US Data 12-23 May. Source: S&P Global.
2. Source: ifo Institute: Fewer Companies in Germany Plan to Raise Prices, 27 May 2022. The decline was noted in the different sectors (manufacturing, wholesale, services, construction).

EUROZONE: PRICE PRESSURES AND INFLATION

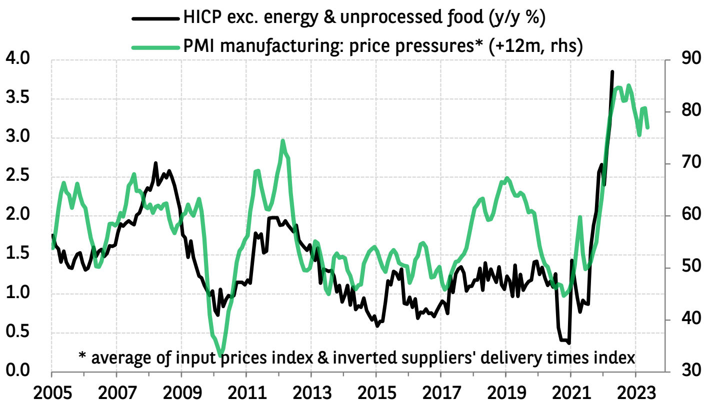


CHART 1 SOURCE: S&P GLOBAL, EUROSTAT, BNP PARIBAS

The slower the decline of inflation, the more discomfort it would generate, raising fears that ever-higher interest rates would end up causing a recession. Everybody wants slower growth to bring inflation under control, but nobody wants the growth engine to stall.

US: PRICE PRESSURES (PMI) AND INFLATION

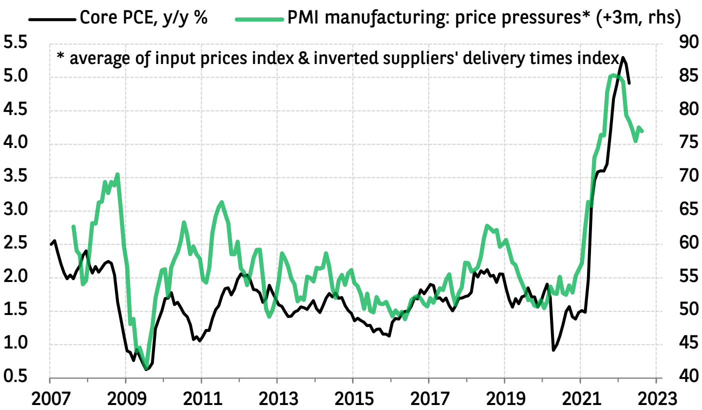


CHART 2 SOURCE: S&P GLOBAL, BEA, BNP PARIBAS

US: PRICE PRESSURES (ISM) AND INFLATION

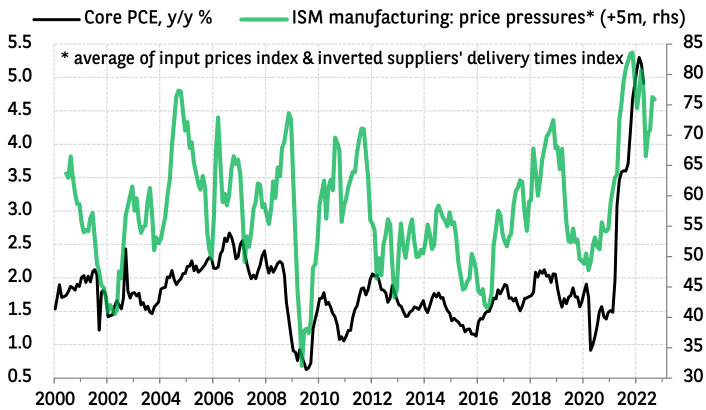
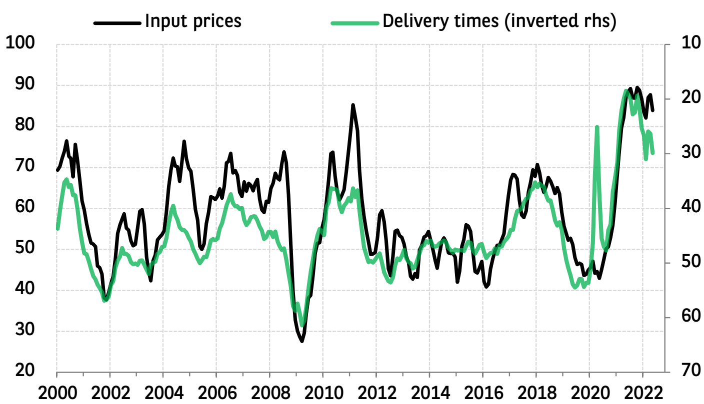


CHART 3 SOURCE: ISM, BEA, BNP PARIBAS

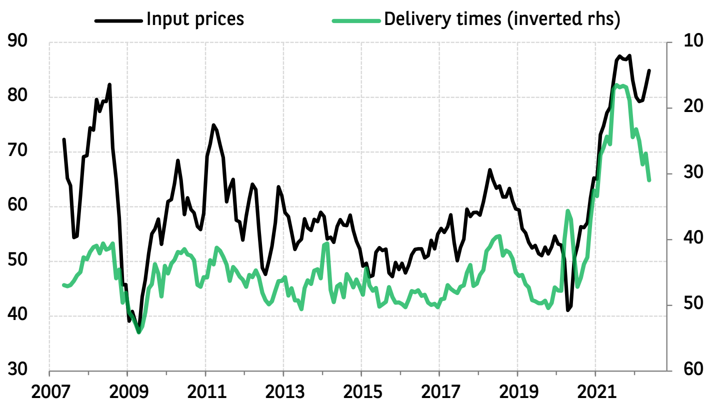
EURO AREA PMI



In the PMI survey, a higher number means shorter delivery times, hence the use of an inverted scale.

CHART 4 SOURCE: S&P GLOBAL, BNP PARIBAS

US PMI



In the PMI survey, a higher number means shorter delivery times, hence the use of an inverted scale.

CHART 5 SOURCE: S&P GLOBAL, BNP PARIBAS

BREAKEVEN INFLATION: GERMANY AND UNITED STATES

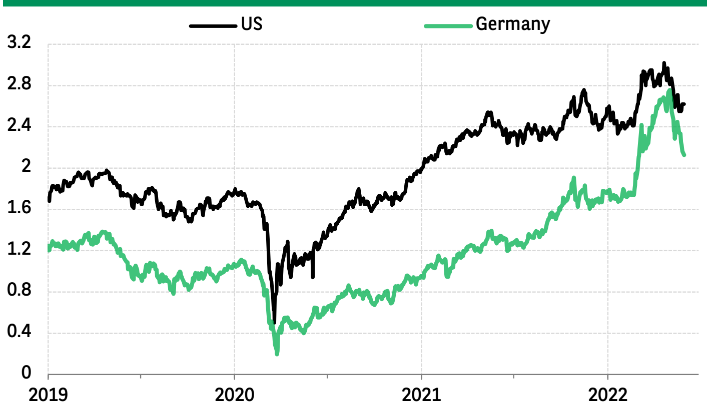


CHART 6 SOURCE: REFINITIV, BNP PARIBAS