UNITED STATES: NAIL-BITING ABOUT THE NEAR-TERM INFLATION OUTLOOK

In recent months, purchasing managers in the euro area and the US have reported a significant increase in input prices as well as longer delivery lags. They reflect the next stage of the disruptive impact of the pandemic with supply struggling to meet the pick-up in demand. According to an Atlanta Fed survey, firms experiencing the most intense disruption tend to be those with the highest expectation of future inflation. It remains to be seen whether this will convince them to raise prices. The Federal Reserve is relaxed about this but, nevertheless, there will be lot of nail-biting in the second half of the year as US inflation data are released in an economy that should be able to close its output gap quickly.

A recent New York Times article called it floating traffic jams: huge container ships queuing to enter port[1]. They are a manifestation of the supply/demand imbalances caused by the Covid-19 pandemic. To make matters worse, there is now concern that the grounded container ship might block the Suez Canal as long as a week, which would imply more supply disruption and temporarily higher prices, due to shortages and the longer, more expensive alternative route around Africa.

Analysing and forecasting inflation is a complex matter. It starts with the need to see the forest for the trees. One-off factors –e.g. extending sales periods– and base effects –such as a temporary reduction in the VAT rate in Germany last year– complicate the interpretation. Short-run dynamics may be quite different from longer-term trends. In recent months, purchasing managers in the euro area and the United States have reported a significant increase in input prices as well as longer delivery lags.

Almost inevitably, the disruptive impact of the pandemic on demand and supply is causing an imbalance when demand recovers and supply is struggling to follow. The shortage of semiconductors is a case in point. The supply side reaction to the pandemic is clearly an issue in the United States. The Federal Reserve Bank of Atlanta recently analysed the swift, significant increase in its District's business inflation expectations survey. More than 50 percent of surveyed companies report delayed deliveries whereas uncertain pandemic-related employee availability is weighing on production capacity. "*Firms experiencing the most intense disruption tend to be those with the highest expectation of future inflation*."[2] It remains to be seen whether this will convince companies to raise their prices and if retailers can pass them on to customers.

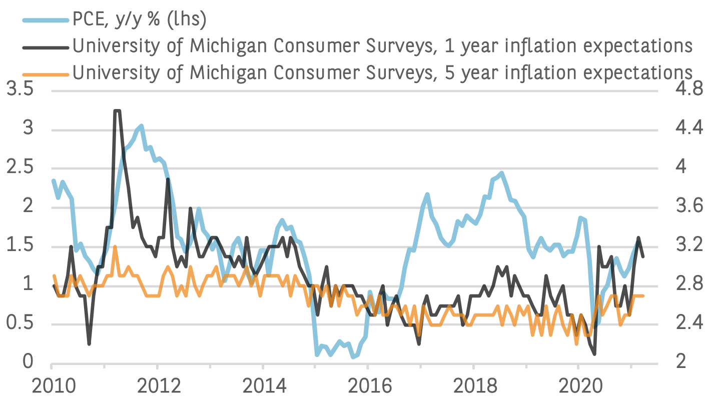
This depends on factors such as competitive pressures, the price elasticity of demand as well as demand growth. In the United States, the latter will get a boost from the USD 1.9 trillion American Rescue Plan. In this respect, the Atlanta Fed researchers finely note that their explanation of rising inflation expectations "*tamps down the speculation that the potential inflationary impact of recent fiscal stimulus on demand is behind heightened year-ahead inflation expectations*."

1. "*I've never seen anything like this*": chaos strikes global shipping, New York Times, 6 March 2021.
2. Inflation Expectations Reflect Concerns over Supply Disruptions, Crimped Capacity, Federal Reserve Bank of Atlanta, 22 March 2021.

To put it differently: should the fiscal stimulus cause heightened inflation expectations, it still has to show up in the data.

Fed chairman Powell has acknowledged there could be bottlenecks, adding however that the increase in inflation should be relatively modest and transient because the supply side is very dynamic. "P*eople start businesses, they reopen restaurants, (...) the airlines will be flying again, all of those things will happen. And so it'll turn out to be a one-time sort of bulge in prices, but it won't change inflation going forward. Because inflation expectations are strongly anchored around 2 percent*."[3] Until the pandemic, the longer-term expected change in unit costs per year –a factor which influences price-setting behaviour of companies– has fluctuated in a narrow band of about 40 basis points. Likewise, consumer 5-year inflation expectations –which could influence wage demands– and 10-year inflation expectations of professional forecasters –a measure of central bank credibility– exhibit very limited cyclical amplitude.

1-YEAR & 5-YEAR US INFLATION EXPECTATIONS



SOURCE: BEA, UNIVERSITY OF MICHIGAN, BNP PARIBAS

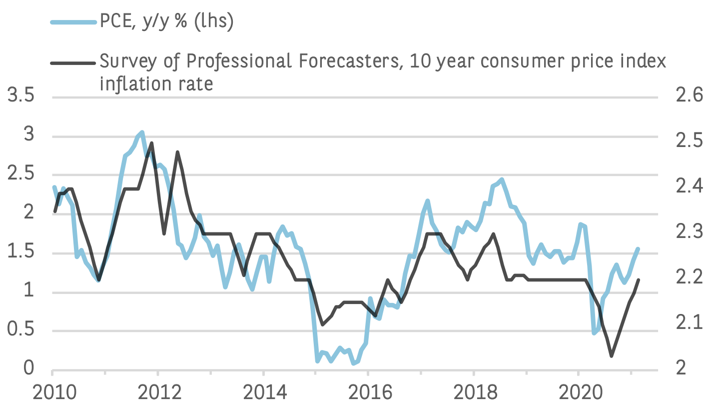
3. Source: Federal Reserve, press conference of Jerome Powell, 17 March 2021.

There will be lot of nail-biting in the second half of the year as US inflation data are released in an economy that should be able to close its output gap quickly.

There is some correlation between recently observed inflation and inflation expectations –which is suggestive of extrapolative behaviour– but the transmission from the former to the latter is small. Notwithstanding these observations, the second half of the year will see a lot of nail-biting as US inflation data are released in an economy that, on the back of a very successful vaccination campaign, accommodative monetary policy and massive fiscal stimulus should be able to close its output gap quickly.

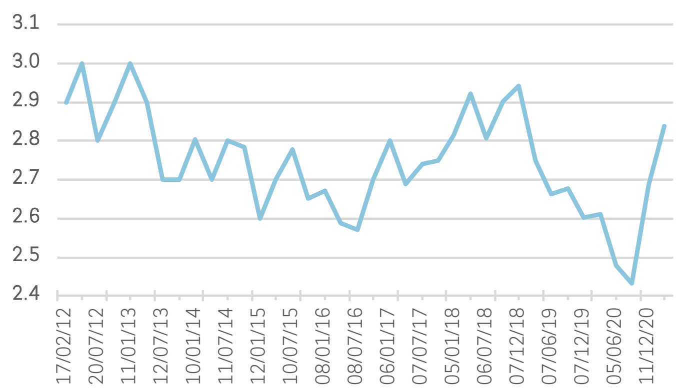
William De Vijlder

10-YEAR US EXPECTATIONS



SOURCE: BEA, UNIVERSITY OF MICHIGAN, BNP PARIBAS

MEAN EXPECTED CHANGE IN UNIT COSTS PER YEAR OVER THE NEXT FIVE TO TEN YEARS



SOURCE: ATLANTA FED BUSINESS EXPECTATIONS SURVEY, BNP PARIBAS