

# A TRANSATLANTIC DIVIDE?

Transitory inflation in Europe but persistent in the US

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# A transatlantic divide?

## Transitory inflation in Europe but persistent in the US

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Inflation rates have spiked in many countries recently. Most attention is focused on the US, where some measures of inflation have now reached 5%, but even in the euro area one can find instances of countries – notably Germany – where inflation is now at 3-4%, clearly above the 2% target of the European Central Bank (ECB).

The key question is now whether this increase in inflation will be temporary or permanent. To answer this, one needs to take into account two temporary factors that distort the picture: i) the increase in energy prices, which has a strong impact on headline inflation; and ii) the base effect due to the temporary fall in prices at the trough of the Covid-19 recession in 2020. If one corrects for both these distortions by looking at core inflation rates over 24 months (to eliminate the base effect), one finds that inflation remains below 2% in the euro area but is now established clearly above 2% in the US. The data from labour costs confirms this picture of a transatlantic divide: wages are falling in the euro area but increasing in the US at the fastest rate since 2007.

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## Two reasons why inflation is spiking

### *The Covid-19 recession base effect*

The headlines about inflation in the euro area are stark. A typical one is '[Eurozone inflation rises to 10-year high](https://www.euronews.com/2021/08/31/eurozone-inflation-rises-to-a-10-year-high)'.<sup>1</sup> But these headlines should be expected. Experience suggests that a crisis leads first to a deflation and then an inflation scare. This pattern can be observed today: at the end of last year, inflation was negative, and headlines were about lingering deflationary effects of the Covid-19 crisis. It was similar during the Great Financial Crisis, when there was also an inflation scare at the bottom of the 2009 recession, which was then followed by an uptick in inflation.

Today the headlines are about inflation at unprecedented levels. A first point to understand is that inflation is usually reported as the increase in the consumer price index over the past 12 months. This distorts the figure when prices were unusually low the preceding year. Today, this base effect is not just one factor among many; it is key to understanding the numbers that dominate the headlines.

The easiest way to 'look through' the temporary spike created by the base effect is to compute inflation not as the increase over the past 12 months, but over the past 24 months. This should net out the Covid-19 crisis effect. On this basis, the latest numbers do not suggest strong inflation dynamics: the euro area Harmonised Index of Consumer Prices (HICP) has increased by 1.3% per annum over the past two years. Even in Germany, inflation, as measured by the HICP, has increased only by about 1.6%. The national German definition of the consumer price basket increased to 4.1 in September (in the same month of previous year), but over a two-year period, the increase is still only 1.9% per annum.<sup>2</sup>

### *Energy prices*

Another reason for the concerns about inflation is the rapid increase in many raw material prices. But this was to be expected. A global recovery is invariably accompanied by a recovery of raw material prices. Crude oil prices even went very briefly negative at the height of the financial market turbulences in early 2020. It is now trading at \$60-70 a barrel. A similar rollercoaster happened after the 2009 financial crisis. Gas future prices have soared in Europe recently. But this can only be a temporary peak – with prices in the European hubs five times the US level arbitrage, cheaper US shale gas will over time bring prices back down.

Other raw material prices such as metals also tend to jump when industry recovers. It is thus not surprising that copper metals have hit highs recently, although they are still below the post-peaks reached 10-12 years ago. The world experienced a similar commodity price boom in the early 2000s, but this was not followed by a sustained increase in inflation. In part this was simply

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<sup>1</sup> <https://www.euronews.com/2021/08/31/eurozone-inflation-rises-to-a-10-year-high>

<sup>2</sup> Destatis, see [https://www.destatis.de/EN/Press/2021/10/PE21\\_482\\_611.html;jsessionid=FCAE61CDA7C7440E1A8E61DE06E7B9.live742](https://www.destatis.de/EN/Press/2021/10/PE21_482_611.html;jsessionid=FCAE61CDA7C7440E1A8E61DE06E7B9.live742).

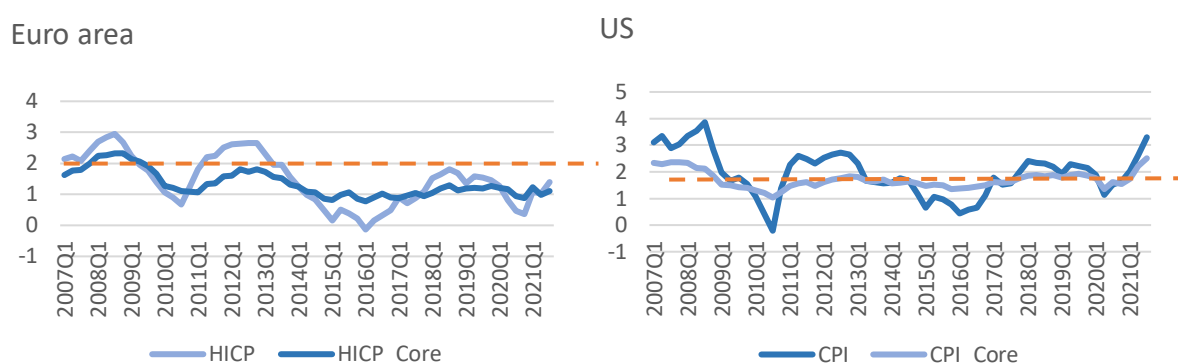
because the energy and raw material intensity of the advanced economies is much lower today, as argued by [Blanchard and Gali \(2007\)](#).

Forever-increasing energy prices could of course lead to persistent inflation. But recent forecasts of commodity prices do not point to a long-lived surge in the price of raw materials in the medium term.<sup>3</sup>

## Looking through the base effect and energy prices

Figure 1 shows that in the euro area the core inflation rate has been flat over the past years (if measured over 24 months), remaining in a narrow corridor around 1% per annum. Headline inflation has been more variable under the influence of the ups and down in energy prices, but again without a noticeable trend.

Figure 1. Inflation over preceding 24 months (at annual rate in %)



Source: own calculation based on Eurostat and Federal Reserve Economic Data.

The two-year indicator shows a clear difference between the euro area and the US. In the US, consumer prices have now increased by over 3.3% per annum on average for the past 24 months and even the core inflation is now running at close to 2.5% on a two-year basis, clearly above the range of the 1.5-2% that had characterised the past 10 years. The appendix shows that in general, the US is an outlier. Core inflation rates are not accelerating in other major economies.

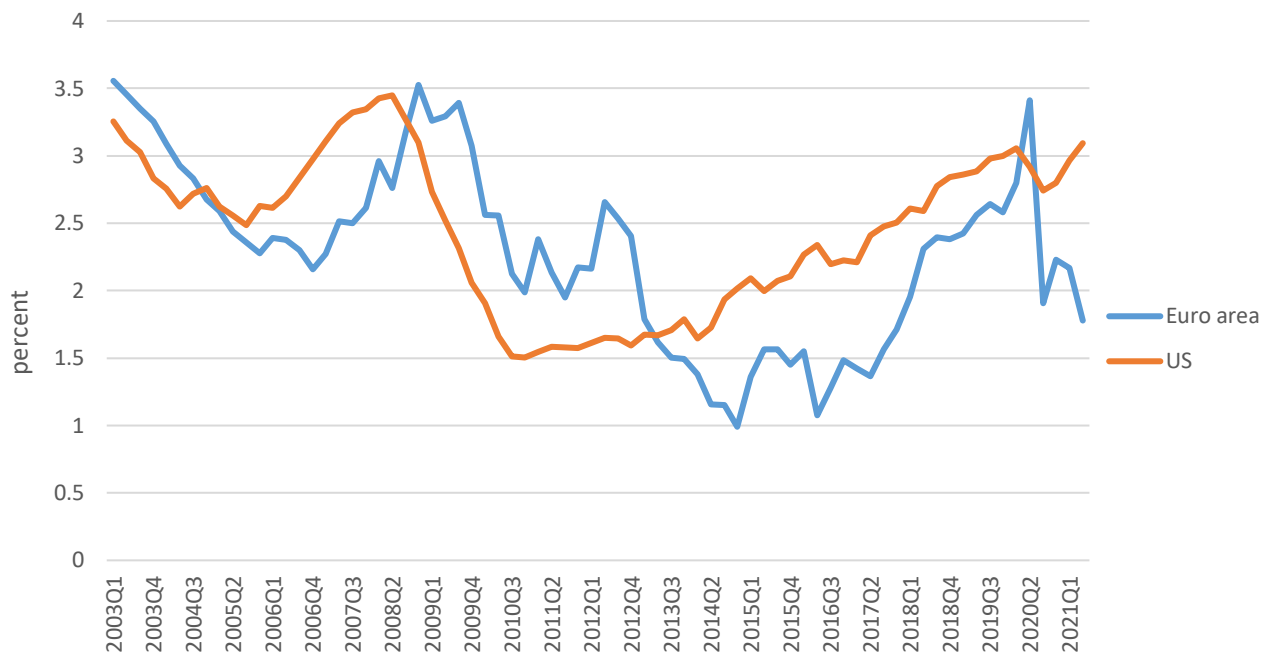
<sup>3</sup> World Bank Commodities Price Data, see <https://thedocs.worldbank.org/en/doc/5d903e848db1d1b83e0ec8f744e55570-0350012021/related/CMO-Pink-Sheet-October-2021.pdf>.

## Cost-push pressures?

Inflation could of course become entrenched if workers asked for higher wages because the cost of living has increased. But a look at the data confirms the transatlantic difference already documented above.

Figure 2 shows an indicator of labour costs for both the US and the euro area. The broad pattern is that of slow-moving cyclical waves, with the US leading the euro area. However, this pattern has been broken over the past year; in the euro area wages slowed more strongly than in the US during the Covid-19 recession (although unemployment was much higher in the US) and actually declined (until Q2 2021). By contrast, in the US, after a mild slowdown in 2020, labour costs are accelerating and running now at a rate last seen close to the peak of the boom of 2006-07 (and just before the Great Financial Crisis).

Figure 2. Annual change in the labour cost over preceding 24 months, euro area and the US



Source: Federal Reserve Economic Data.

## Inflation expectations: losing the anchor?

The evidence so far has consisted only of past data on prices and wages. Central banks should be more concerned about inflation expectation and whether the public continues to believe the inflation target as credible. [Reis \(2010\) argues](#) that one should look at distribution of inflation expectations by consumers and finds preliminary evidence of a de-anchoring in the US. Here again the data for the euro area give a different signal. Figure 3 shows the results from surveys on price trends conducted in the euro area. This indicator does not yield a single

number for expected inflation, but the longer-term trend is still clear. Inflation expectations fell during the deep recession in 2020 and have since risen. But the level reached now suggests that consumers in the euro area do not see a stronger pressure on prices than before Covid-19, namely as happened during 2012-13.

Figure 3. Consumer survey on price trends, euro area



Source: Eurostat

Note: Balance is the differences between pessimistic and optimistic views (in percentage points of total responses), as index.

## House price inflation

The difference between the US and the euro area in inflation is also influenced by the way it is measured: in the euro area the cost of owner-occupied housing is not considered, but in the US this component forms an important part of the consumption price index and is one key driver of inflation (Gros and Shamsfakhr, 2021).

We find robust significant correlations between consumers' inflation expectations and house price index (HPI) in the euro area, based on a panel data analysis using data from 18 euro-area countries<sup>4</sup> since 2010. The results are shown in Table 1.

<sup>4</sup> The HPI is not available for Greece.

Table 1. House prices and inflation expectations, regression analysis

	Pooled	Fixed effect	Random effect
HPI (annual growth rate)	0.6*** (0.11)	0.8*** (0.11)	0.6*** (0.11)
HICP (annual growth rate)	7.6*** (0.40)	6.4*** (0.73)	7.6*** (0.40)
Constant	8.5*** (1.1)	9.5*** (1.2)	8.5*** (1.1)
Observations	756	756	756
R-squared	0.36	0.35	0.36

Notes: Dependent variable is consumer sentiment on price trends over the next 12 months. Robust standard errors in parentheses. Sample period 2010Q1-2021Q2. \*\*\* p<0.01, \*\* p<0.05, \* p<0.1

According to our finding, a 10-percentage point increase in the house price inflation is associated with 6 to 8 percentage points' increase in the share of households expecting consumer prices to rise over the coming 12 months. Given that house price inflation is increasing in the euro area (now running at 6.8%) this implies that the inflation perceived by households might increasingly diverge from official inflation numbers as the latter do not take into account the cost of housing.<sup>5</sup>

## Conclusions

Inflationary trends are diverging: in the US most indicators point to inflation being more permanent than a transitory phenomenon, whereas this is not yet the case for the euro area.

Some argue that, given the sharp increase in energy prices, central banks should reconsider the experience of the 1970s when an oil price shock set off a deflation spiral. However, the experience with equally high oil prices in 2008 suggests that the influence of energy prices has sharply diminished. The new element of the 2020s might be housing inflation, which feeds through to consumer prices in the US, but not in the euro area. However, even here, house prices influence inflation expectations and could thus, over time, lead to a de-anchoring of inflation expectations.

We have not discussed supply chain bottlenecks as a further driver of inflation. These bottlenecks have arisen as demand has recovered and shifted from services to goods, which need to be transported physically, often from one continent to another and then delivered at the doorstep. These bottlenecks are of course driving costs and thus prices, but this is a level effect, which cannot generate continuing inflation unless the bottlenecks were to worsen continuously. On the contrary, it is likely that the transport sector and the production of some important inputs (such as chips) adjust over the next few months, which would then tend to have a dampening impact on inflation.

<sup>5</sup> On determinants of inflation expectations, see for example Belke et al. (2008), Ueda (2010), and Bellemare et al. (2020).



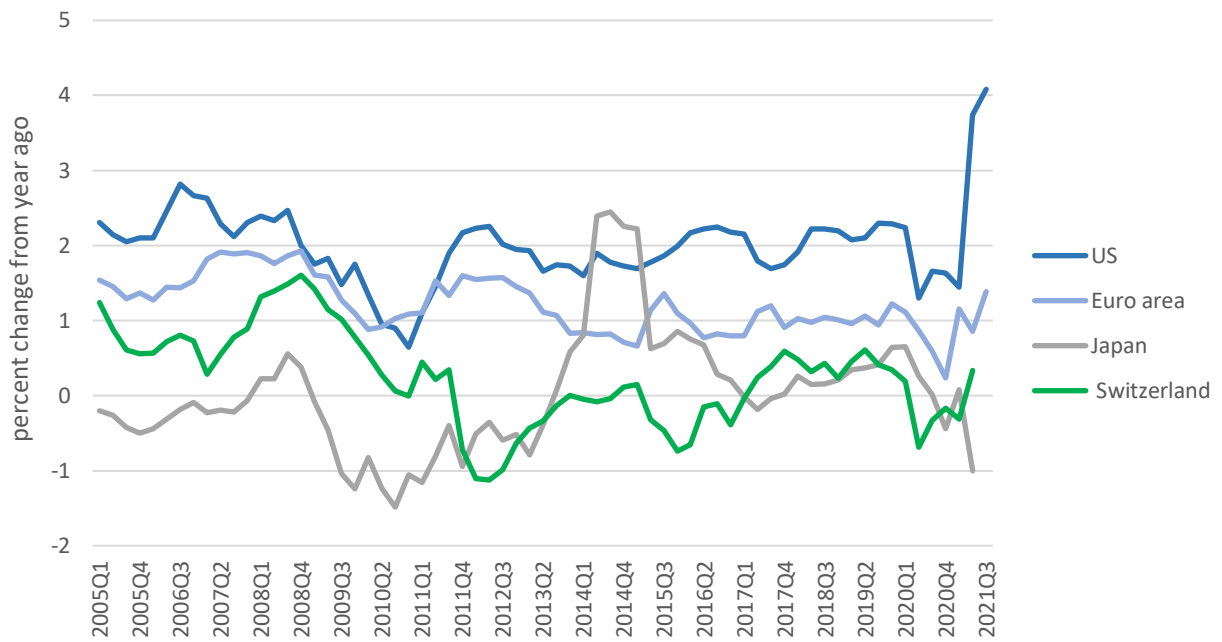
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## Appendix: Is inflation a global or a US phenomenon?

The chart in Figure 1 suggests clearly that inflation has gone up in the US, but remains moderate to low in other jurisdictions.

Figure 1. Core inflation



Source: Federal Reserve Economic Data.

Note: The series for the US is seasonally adjusted.