23 August 2024

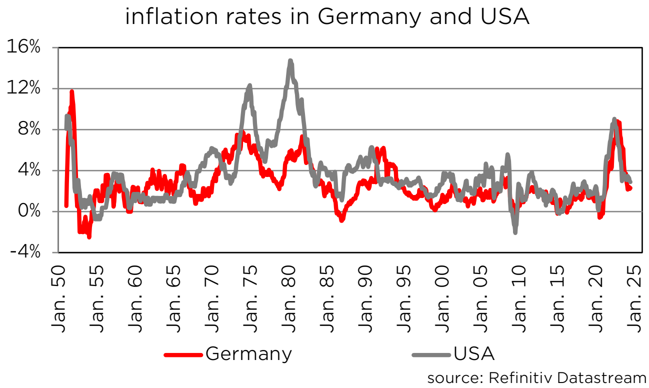
Inflation goes, the price shock remains

Rarely have economists and citizens assessed price trends as differently as they do now. While some celebrate the fall in inflation rates and the fact that the inflation rate is approaching the two percent mark as a return to price stability, others lament the fact that prices have risen sharply in recent years and remain at a high level. But which view is the “right” one?

The good news: inflation is falling sharply

Price stability is the cornerstone of central banks' monetary policy. Stable prices guarantee stable purchasing power and are therefore an important prerequisite for economic growth. Most central banks in industrialized countries define price stability as an inflation rate of around two percent and not zero percent. The central banks see the charm of the two percent mark in its effect on economic growth. According to the assumption, moderate inflation leads to households and companies having an incentive to spend their money in order to avoid the expected loss of purchasing power. In this respect, an inflation rate of two percent theoretically leads to higher economic growth than an inflation rate of zero percent. In addition, an inflation rate of zero percent would make the real price trend very rigid (keyword: ratchet effect), while a high inflation rate is also accompanied by high inflation rate volatility, which would shorten the optimal amortization period for investments - also with negative consequences for growth.

After inflation rates in many countries had been very low for a long time ¬ even too low in the opinion of some central banks ¬ the coronavirus pandemic with its supply chain problems and the resulting impact on the supply of goods as well as the subsequent monetary and fiscal policy measures with their effects on overall economic demand have led to an abrupt and sharp rise in inflation since mid-2021. It was initially assumed that this would only be a temporary (“transitory”) effect and that inflation rates would quickly return to normal. However, the Russia-Ukraine war and its impact on the prices of energy and other commodities meant that inflation only peaked at the end of 2022 and then initially only slowed down hesitantly. In many countries, annual price increases of ten percent and more were observed at the end of 2022. In the USA and Germany, inflation has only been this high three times in recent history: in the post-war period after the Second World War and the outbreak of the coal war in 1951, and during the first and second oil crises in 1974 and 1980/81.



The good news is that inflation rates around the world have fallen significantly again. Although the two percent target has not yet been fully achieved in many countries, it is often only a few tenths of a percentage point short. Some economists fear that a wage-price spiral could lead to a failure to meet the target and permanently higher inflation rates. However, we believe this is unlikely. In many countries, the labor market has cooled and wages are therefore rising more slowly. In the USA, average hourly wages are still 3.6 percent higher than in the previous year; in spring 2022, the increase was just under 6 percent. In Germany, too, the rise in nominal wages has recently slowed considerably. For full-time employees, the increase in June was 2.9 percent compared to the previous year, part-time employees earned 1.9 percent more and marginally employed persons recorded no change compared to the previous year.

However, central banks generally do not wait until their target values are exactly reached before cutting interest rates. In view of the significant progress made in the decline in prices, real key interest rates are now so high in many cases that a further easing of monetary policy is nevertheless appropriate. In the emerging markets, many central banks have already lowered their key interest rates, some of which are in double digits, and there are also more and more central banks in the industrialized countries that are easing their monetary policy again. In September, the US Federal Reserve will also cut interest rates, whether by 25 or 50 basis points remains to be seen.

Private households have a different yardstick for measuring inflation

In contrast to the positive assessment of economists and central banks, many people view the development of inflation from a different perspective. By definition, inflation is the annual rate of change in a (fictitious) basket of goods, so the price trend over the last 12 months plays a role here. Private households, on the other hand, tend to assess the development of inflation on the basis of the absolute price level and set a different "reference point" than the economists with their 12 months. In most cases, a longer period of time is used as a reference, for which prices are supposedly remembered with certainty. This was the case after the introduction of the euro, for example. According to our observations, many people tend to compare today's prices with the prices before the start of the pandemic. So instead of a 12-month rate of change, perhaps a 48-month rate of change plays a greater role here. And this way of looking at things shows that the price shock of 2021 and 2022 is still having an impact.

In order to assess the extent to which prices for various goods and services have changed over the last 48 months, we examined almost 400 different price statistics published monthly by the Federal Statistical Office. This reveals some interesting aspects that show where prices have risen particularly sharply and why many people there feel "ripped off".

A comparison of the German consumer price index from July 2024 with the index value from July 2020 shows a price increase of just over 20 percent for this period. The last time there was a similarly sharp price increase in such a short space of time was in 1994 after German reunification and before that in 1982/83 and between 1973 and 1976. Which goods and services have become particularly expensive?

Would you have known? Which goods have become how much more expensive since July 2020?

Our overview of over 100 selected different prices (no guarantee of completeness):

Price trends for selected goods and services between July 2020 and July 2024
source: Statistisches Bundesamt, Refinitiv Datastream

olive oil	115,4%	eggs	42,1%	pork	29,6%
coal	102,0%	poultry	41,7%	meat	29,4%
gas	88,5%	petrol	41,5%	restaurants, cafes, bars	28,8%
natural gas	87,9%	chocolate	40,4%	electricity	28,2%
sugar	83,7%	pizza	39,4%	domestic flights	27,5%
district heating	83,6%	butter	38,9%	jewelry, jewels, watches	27,3%
garage rent	75,1%	rice	38,8%	flowers, plants	27,2%
sunflower oil, rapeseed oil	62,9%	bread	37,1%	domestic packgage tours	26,7%
condensed milk	61,3%	mineral water, soda, juice	37,0%	tires	26,2%
oils and fats	59,1%	vegetables	36,5%	clothing cleaning	26,0%
margarine	58,2%	used cars	36,5%	beer	25,4%
flour, cereals	53,4%	yoghurt	34,7%	new cars	25,2%
pasta	52,4%	international flights	34,6%	newspapers	24,8%
diesel	52,3%	flights	34,1%	passenger transportation	24,4%
plumber	51,9%	painting work	33,9%	vehicles	24,1%
potatoes	50,0%	soft drinks	33,7%	hairdresser	23,9%
fruit juices	48,7%	jam, honey	32,2%	overnight stays	23,8%
potato chips	48,5%	mineral water, soda, juice	32,0%	pets	23,7%
car insurance	46,0%	ice cream	31,7%	cameras	23,5%
cheese and curd	46,0%	fish	29,8%	canteens	23,4%

Price trends for selected goods and services between July 2020 and July 2024
source: Statistisches Bundesamt, Refinitiv Datastream

coffee	23,4%	musical instruments	17,0%	toys	10,1%
body care	23,1%	motorcycles	16,9%	package tours	9,6%
dry cleaning	22,6%	jewelry and watches	16,8%	package tours abroad	8,6%
hotels, motels	22,6%	schnapps, liquer	16,7%	healthcare	7,9%
insurance companie	22,4%	museums, zoos	16,5%	net rent	7,7%
hairdresser	22,2%	travel insurance	16,1%	rent	7,4%
new cars	21,8%	bicycles	16,0%	letters and parcels	6,7%
cigars	21,3%	books	15,7%	rail travel	6,0%
tobacco products	21,2%	shoes	14,1%	train tickets	6,0%
wine	20,4%	kindergarten	13,6%	dentist	2,2%
cigarettes	20,0%	hospitals	13,5%	post and telecom	0,3%
salt and spices	19,8%	clothing	13,3%	internet	-0,2%
newspapers, books	19,6%	bank, post office	13,1%	telephone	-0,3%
furniture	19,5%	software	13,1%	PCs	-4,6%
motor oil	19,4%	household appliances	12,6%	cell phones	-8,2%
fuenrals	19,1%	watches	12,5%	TV	-9,2%
jewelers	19,0%	insurcance health	12,4%		
fruit	17,8%	education	12,3%		
fish	17,4%	cinema, theater	12,2%		
tea	17,3%	cooking utensils	12,1%		

The first table shows the components of the basket of goods used to calculate the consumer price index whose prices have risen particularly sharply. These are primarily goods from the energy and food sectors. For most consumers, these have the disadvantage that they are very difficult to substitute, i.e. they can be replaced by other goods whose prices have risen less sharply. If olive oil has become too expensive for you in view of the drastic 115 percent increase in price since July 2020, you might buy sunflower oil, which has become 63 percent more expensive in the same period. If butter has become too expensive for you (+39 percent) and you therefore have to switch to cheaper margarine, you will find that its price has risen even more sharply (+58 percent). The situation is similar for soft drinks, which have become 34 percent more expensive. Switching to cheaper mineral water or juices is somewhat easier on the household budget due to the lower absolute prices, but here too prices have risen sharply (+37 percent). Driving to work or shopping by car also costs significantly more than four years ago. Diesel has become 52 percent more expensive. Switching to a petrol car is of little benefit, as premium petrol has also become significantly more expensive (+42 percent). In addition, a new car costs a lot of money, whether new (+25 percent) or used (+36 percent). But that's not all: car insurance also has a big impact with an average premium increase of around 46 percent.

The massive price increases of the last four years are a particular burden on those in society who are on low incomes. This is because they have to spend an ever greater proportion of their income on food and energy. There is less and less money left over for other things in life, such as vacation trips or leisure activities. The fact that package holidays have "only" increased in price by just under nine percent in a four-year comparison is due to a favorable base effect; just a few months ago, the price increase was around 40 percent. So it is no wonder that there is so much dissatisfaction in large parts of German society. The same phenomenon can also be observed in the USA. Although the economy there has grown strongly and inflation has fallen significantly, many Americans are dissatisfied with the economic development. For Republican supporters in particular, inflation is the most important economic issue.

But why have food prices in particular risen so sharply in recent years? Are consumers being "ripped off" because companies have increased their profit margins? From an economic point of view, it is hardly possible to recognize price exorbitance and take countermeasures. As a period of four years may be arbitrarily chosen to assess the long-term price trend, we have also taken a look at the changes over a period of ten years.

In order to better understand the figures, we have calculated annualized ten-year inflation rates for the individual components of the basket of goods. This means that the 27 percent increase in consumer prices between July 2014 and July 2024 corresponds to an annual inflation rate of 2.4 percent over this period. Here, too, it can be seen that energy and certain foods have risen the most. Oils and fats such as olive and sunflower oil by 6.2 percent per year, gas by 6.0 percent, but also newspapers by 5.1 percent, package tours by 4.6 percent, vegetables by 4.6 percent, bread and cereals by 4.1 percent and milk, cheese and eggs by 4.1 percent. There may be good and understandable reasons for these sharp price increases in individual cases, but at first glance they are not always comprehensible. It could be that some companies have raised prices disproportionately to the benefit of their profit margins. If this were the case (and it cannot be ruled out), then these "excess returns" would attract additional competitors and the margin would quickly normalize again. From this perspective, functioning markets are the best protection against such a development in the long term.

In addition, there are no negative economic effects, as can be observed with government interventions such as price caps. These may be popular with some politicians and consumers, but the economic effects are almost always negative. The best example is the rent cap in Germany, which contributes to the fact that too few new apartments are being built. Statutory price caps only make sense where there are markets with monopolistic structures ¬ but this is not the case with food.

Carsten Klude

Market data

Stock marktes	As of 23.08.2024 07:58	Change versus 16.08.2024 -1 week	22.07.2024 -1 month	22.05.2024 -3 months	22.08.2023 -1 year	29.12.2023 YTD
Dow Jones	40713	0,1%	0,7%	2,6%	18,7%	8,0%
S&P 500	5613	1,0%	0,9%	5,8%	27,9%	17,7%
Nasdaq	17619	-0,1%	-2,2%	4,9%	30,5%	17,4%
DAX	18493	0,9%	0,5%	-1,0%	17,8%	10,4%
MDAX	24967	0,6%	-1,8%	-8,0%	-8,3%	-8,0%
TecDAX	3336	-0,2%	0,5%	-3,4%	7,7%	0,0%
EuroStoxx 50	4885	0,9%	-0,3%	-2,8%	14,7%	8,0%
Stoxx 50	4483	0,7%	0,5%	-0,4%	14,3%	9,5%
SMI (Swiss Market Index)	12305	1,0%	0,1%	2,9%	13,1%	10,5%
Nikkei 225	38211	0,4%	-3,5%	-1,1%	19,9%	14,2%
Brasilien BOVESPA	135173	0,9%	5,7%	7,6%	16,4%	0,7%
Indien BSE 30	81130	0,9%	0,8%	9,3%	24,4%	12,3%
China CSI 300	3324	-0,6%	-5,4%	-9,8%	-11,5%	-3,1%
MSCI Welt	3608	0,7%	0,6%	4,1%	24,0%	13,8%
MSCI Emerging Markets	1101	0,7%	1,4%	0,5%	13,9%	7,5%
Bond markets						
Bund-Future	134,25	-1	232	370	314	-297
Bobl-Future	117,77	4	133	122	256	-151
Schatz-Future	106,23	4	57	112	132	-32
3 Monats Euribor	3,54	-12	-12	-37	-27	-34
3M Euribor Future, Dec 2024	3,01	-2	-27	-33	-34	70
3 Monats $ Libor	5,36	-3	-18	-23	-28	-23
Fed Funds Future, Dec 2024	4,55	-3	-30	-47	8	71
10 year US Treasuries	3,84	-5	-41	-59	-49	-2
10 year Bunds	2,25	5	-18	-27	-38	25
10 year JGB	0,89	1	-13	-10	23	27
10 year Swiss Government	0,46	3	-12	-33	-58	-24
US Treas 10Y Performance	616,82	0,3%	3,5%	5,7%	8,0%	2,6%
Bund 10Y Performance	565,65	0,1%	2,1%	3,2%	6,1%	0,1%
REX Performance Index	451,34	0,1%	1,7%	2,5%	4,9%	0,8%
IBOXX AA, €	3,16	-3	-20	-30	-67	9
IBOXX BBB, €	3,67	-3	-22	-35	-99	-9
ML US High Yield	7,56	-9	-23	-48	-118	-23
Commodities						
MG Base Metal Index	415,69	3,1%	2,2%	-11,1%	8,7%	6,3%
Crude oil Brent	77,25	-3,3%	-5,9%	-6,0%	-8,1%	-0,6%
Gold	2492,49	0,1%	4,4%	4,2%	31,4%	20,7%
Silver	29,10	2,2%	0,4%	-7,2%	24,3%	20,0%
Aluminium	2462,92	6,2%	9,9%	-4,6%	15,7%	5,0%
Copper	9010,28	0,0%	-0,9%	-12,5%	8,2%	6,5%
Iron ore	98,19	0,4%	-9,2%	-16,5%	-8,0%	-28,0%
Freight rates Baltic Dry Index	1768	4,6%	-6,8%	-2,0%	48,1%	-15,6%
Currencies						
EUR/ USD	1,1125	1,2%	2,2%	2,7%	2,2%	0,7%
EUR/ GBP	0,8485	-0,5%	0,7%	-0,3%	-0,4%	-2,1%
EUR/ JPY	162,01	-0,4%	-5,1%	-4,4%	2,1%	3,6%
EUR/ CHF	0,9476	-0,7%	-2,0%	-4,3%	-0,9%	2,3%
USD/ CNY	7,1390	-0,4%	-1,9%	-1,4%	-2,2%	0,5%
USD/ JPY	146,28	-0,9%	-6,8%	-6,7%	0,3%	3,7%
USD/ GBP	0,76	-1,7%	-1,5%	-2,9%	-2,9%	-2,8%

Source: Refinitiv Datastream

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