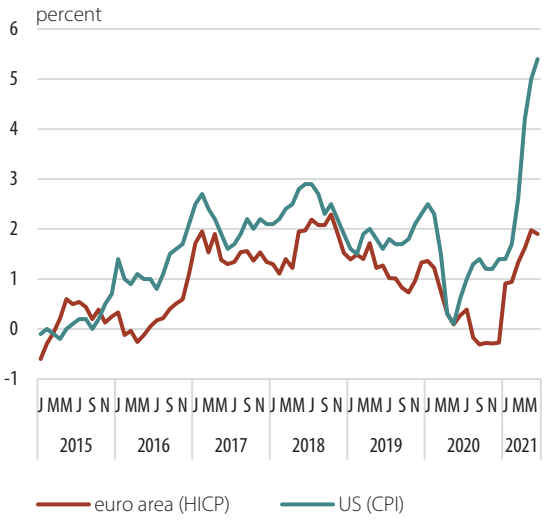
External inflation – recent developments and outlook

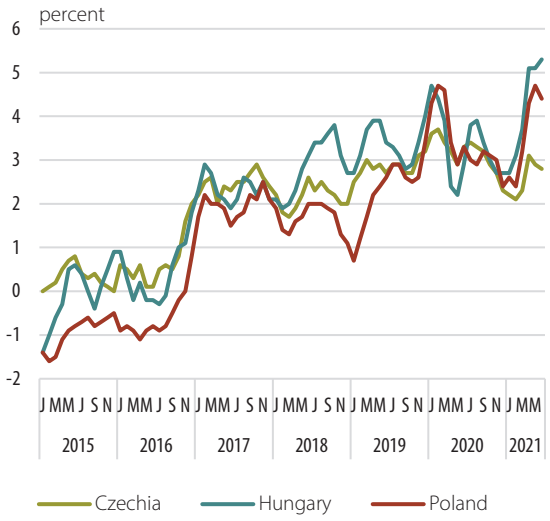
In 2021 H1, inflation saw a general uptrend at global level, accompanied, however, by significant heterogeneity among countries in terms of magnitude. In the euro area, the annual HICP inflation rate went from negative territory to slightly above the 2 percent benchmark, while in the US, the CPI inflation rate rose more sharply (5.4 percent in June – Chart A). The differences between the two geographical blocs may also be attributed to the US's swifter progress of post-pandemic economic recovery. Central and Eastern European countries saw a pick-up in CPI dynamics, as well (Chart B). These developments have fuelled a debate on the prevalent level of inflationary pressures in the medium and long term, related primarily to the temporary or persistent nature of the recent bout of price hikes and, consequently, to the mismatch between demand and supply[1]. Under the circumstances, this box aims to provide an overview of the main factors that led to the recent rise in inflation, as well as of the prospects for future price dynamics.

Chart A. Annual HICP/CPI inflation rate in the euro area/US



Source: Eurostat, OECD

Chart B. Annual CPI inflation rate in emerging economies in the region



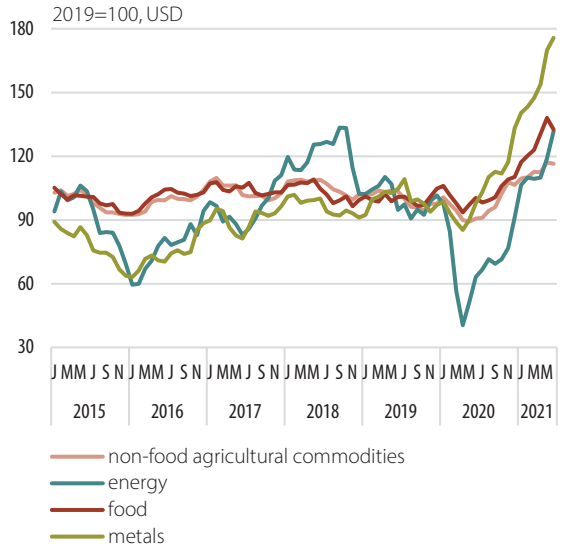
Source: OECD

The energy component contributed notably to the recent pick-up in inflation, on the back of the hike in oil prices and of some significant base effects, associated with the extremely low levels recorded in spring 2020, following the outbreak of the pandemic. In addition, commodity prices have witnessed broad-based increases of late, amid robust demand from manufacturing and construction, and for stock replenishment, especially in China (Chart C).

The advance of inflation was also ascribable to the surge in demand for certain intermediate goods, to which supply could not respond sufficiently fast in the short term. One such example is the shortage of microchips, used alternatively for manufacturing several categories of industrial goods, e.g. motor vehicles,

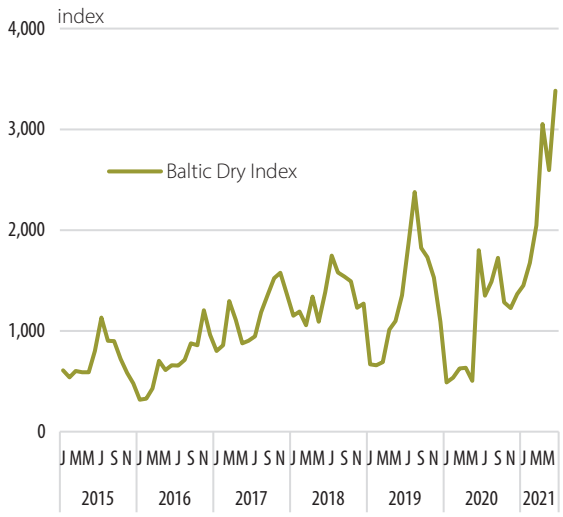
[1] This debate is also relevant for participants in international financial markets (inflation trade).

Chart C. Developments in commodity prices



Source: IMF Primary Commodity Price System

Chart D. Developments in water transport prices



Source: Bloomberg

computing or other electronic equipment. After the onset of the pandemic, demand for the latter was strongly boosted by a rise in digitalisation, i.e. growing recourse to telework[2], which involved an adjustment process for companies. Specifically, the microchip shortage led, for example, to a sharp hike in motor vehicle prices in the US[3], which spilled over – via the supply-demand imbalance – to the prices of used cars. This was also amplified by supply-side factors, such as bottlenecks in global supply chains, given the disruptions to water transport, which had direct consequences, namely higher freight rates[4] (Chart D).

Additionally, as restrictions are eased, some categories of services strongly affected by the pandemic witness significant base effects, associated with the decline in prices in the previous year.

It should be noted that these developments are attributable to a fragile climate of aggregate demand, according to output gap assessments. The latter, despite marked by heightened uncertainties, continue to indicate, in 2021, further negative values for the euro area and approximately neutral values for the US[5]. These aggregate assessments notwithstanding, the breakdown shows several economic sectors that faced a pronounced imbalance between demand and supply. These individual developments led, in fact, to the ample changes in some commodity prices.

According to the forecasts of the main international financial institutions[6], global inflation will decline in 2022, *inter alia* amid some base effects, when the significant price hikes throughout this year drop out of the calculation of the annual inflation rate, after 12 months. The sharp slowdown in annual inflation will occur as the supply-demand ratio rebalances, under the influence of the easing of the

2 See Box entitled "The Semiconductor Shortage and its Implication for Euro Area Trade, Production and Prices" in the ECB's *Economic Bulletin*, Issue 4/2021.

3 The US covers most of its microchip needs from imports, as the share of its own production decreased to 12 percent of total global production from 37 percent in 1990.

4 See Box entitled "What is Driving the Recent Surge in Shipping Costs?" in the ECB's Economic Bulletin, Issue 3/2021.

5 For example, from the European Commission's Spring Forecast or World Economic Outlook, IMF, April 2021.

6 European Commission (Summer Forecast – July 2021), IMF (World Economic Outlook – July 2021), ECB (Staff Macroeconomic Projections – June 2021), World Bank (Global *Economic Prospects* – June 2021), OECD (*Economic Outlook* – May 2021).

above-mentioned factors, which are assessed as having only a transitory impact. Looking at commodity prices, futures prices indicate their stabilisation or moderation. For developed economies, inflation expectations, albeit slightly accelerating in recent periods, continue to be anchored around the inflation targets in the medium and long term. Moreover, the improvement of labour market indicators is estimated to remain slow. However, the balance of risks to the inflation rate is assessed as being tilted upwards, yet primarily in the short term.

The risks to medium-term inflation are numerous and can act in both directions. Persistently high demand, in tandem with a supply deficit in the case of some intermediate goods and commodities, may generate additional pressures on corporate costs. Furthermore, their pass-through into final prices may be facilitated by the advance in aggregate demand, which is in turn influenced by the packages – extremely stimulative in some cases – adopted by the authorities to combat the effects of the pandemic. In addition, these may fuel a prolonged period of increase in commodity prices (a so-called "super-cycle"[7]). The second-round effects of corporate cost hikes also cannot be excluded. There are, however, risks in the opposite direction as well, connected, for example, to labour market developments. Before the pandemic, despite the increase in economic activity and the decline in unemployment, wage dynamics were relatively moderate in developed economies, contributing to a slowdown in inflation to low levels. If economic growth is not also reflected in higher wage earnings, the conditions for fast-paced and long-lasting inflation dynamics will not be met.

In the longer term, both inflationary and disinflationary pressures are expected from the evolution of such factors as global value chains, demographics, automation, digitalisation or climate change. In the case of production and distribution chains, the activities of certain strategic industries may be relocated due to disruptions observed during the pandemic, leading to increased production costs. The dynamics of global demographic factors will also contribute to higher inflation, as the share of working-age population continues to narrow. In its turn, climate change may have a direct impact on the level and volatility of food prices. Indirectly, via policies to reduce greenhouse gas emissions, it may affect energy prices and, hence, the prices of some considerably larger categories of intermediate and final goods. By contrast, automation will further generate productivity gains. Moreover, the advance of online trade (which received an additional boost during the pandemic) will lead to greater price transparency, increasing competition and, possibly, reducing inflation. This positive influence could be, however, mitigated/offset by market concentration to a limited number of players and by the possibility of them applying significantly high mark-ups.

7 However, analysing the previous relevant episodes, it was found that commodity prices tended to be volatile, often exceeding the historical trends in the early phases of economic recovery and subsequently stabilising close to the trend values.