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## BRUNETTI VIEW Q4 2022

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# HOW PERSISTENT IS THE INFLATION PROBLEM?

Since the „Brunetti View“ of October 2020, we have been dealing more and more with the topic of inflation. It started two years ago -- even before it was evident in the data -- with the „overheating scenario“, which we identified back then as a possible development given the very specific pandemic shock. It was already our assessment by then that the probability of such a scenario would be underestimated. With significant increases in consumer prices, our 2021 reports addressed the unusual accumulation of price-increasing shocks that hit the global economy simultaneously. Last spring, we discussed the additional price-increasing shock of the Ukraine war. For a very long time it was unclear whether this was a temporary phenomenon due to the particular post-pandemic situation or whether a persistent inflationary process had been triggered. Today this seems to be the case: inflation has become clearly consolidated in most countries and there is little reason to believe that it will reverse itself swiftly. I would like to explain this assessment here, highlighting Switzerland in particular, which seems to be proving more and more to be a (positive!) special case.

## **Real inflation problem only in case of a wage-price spiral**

Price changes are completely natural in a market economy and a sign that scarcity signals are working, which is crucial for the efficiency of resource allocation. The very popular claims for price caps on gas or electricity are therefore problematic, but that is a different story. If prices (which have a greater weight in the consumer price index) rise sharply, statistically this manifests itself in a considerable increase in the index, i.e.

inflation. However, this has nothing to do with a critical and self-perpetuating inflationary process. It only becomes a real inflation when price-increasing shocks in individual economic sectors lead to a process of longer-lasting price increases and, above all, when the price increases spill over to other economic sectors. The key element is rising inflation expectations, which trigger wage-price spirals. If we put it in a nutshell, this dynamic unfolds as follows: Because wages are usually fixed for a year, their purchasing power falls if goods prices rise during that year. The decisive factor is what happens in the subsequent wage negotiations. If there is an inflationary adjustment and wages rise by the same amount as prices rose earlier, in macroeconomic terms it is still a one-time price increase. However, if wage negotiations take place in an environment with rising inflation expectations, then employees will demand a wage increase that exceeds the inflation of the previous period, otherwise they risk another excessive loss of purchasing power if they fix their wages for an entire year in the negotiation. The companies, for their part, will try to compensate for the higher wage costs in the coming period by further price increases. This will increase the price level even further and the „game“ will start again. The crucial factor is inflation expectations: The higher they are, the more wage demands go beyond mere compensation for past inflation and the more pronounced wage-price spirals are unleashed.

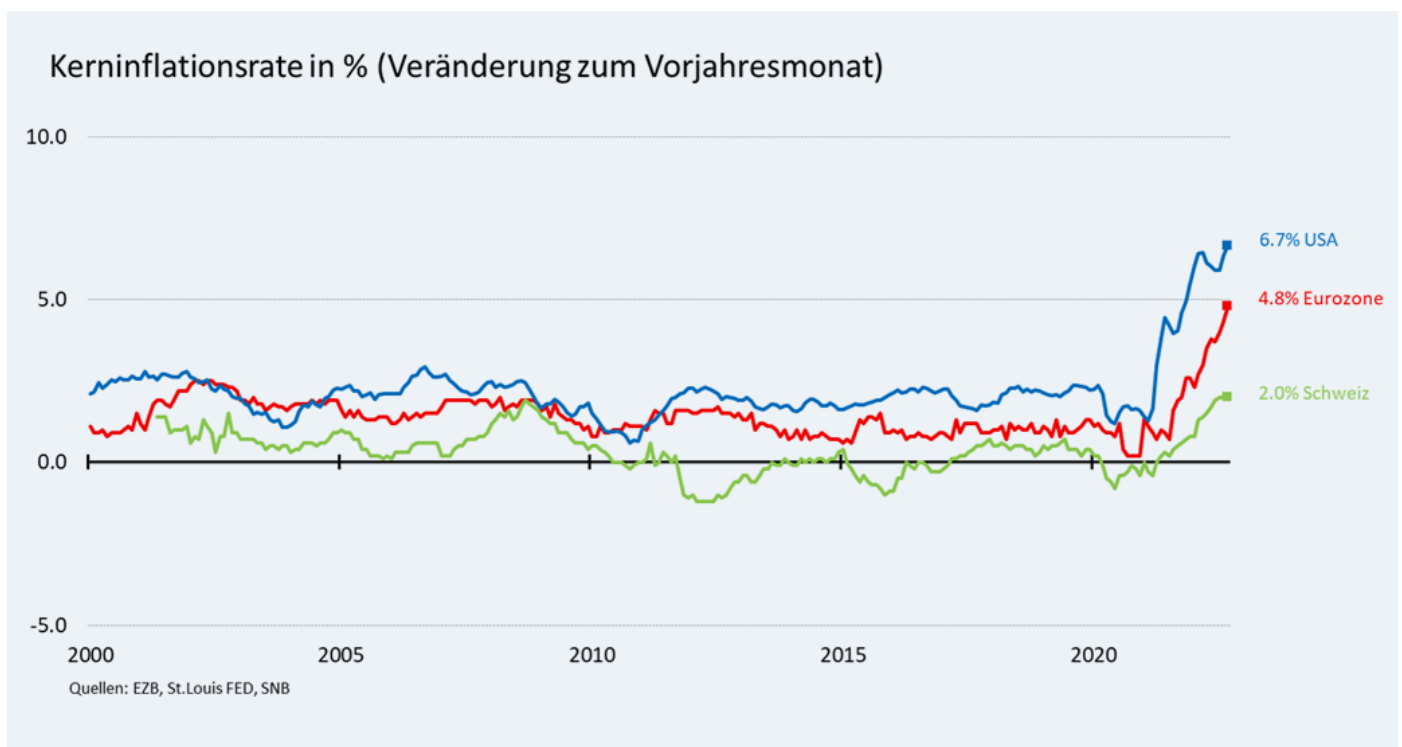
## Core inflation sends a clear signal

Two or more wage rounds are necessary to assess whether a wage-price spiral is underway. Since such negotiations usually take place only once a year, it is too early for this assessment. Yet there are indicators that paint a rather reliable picture much sooner. An important trigger is a dried-up labour market, as aggressive wage demands have good chances. From this point of view, the situation is very clear. For instance, in the US, there are currently two job openings for every unemployed person, which is a very high figure since there are usually far more unemployed people than job openings. The labour market conditions for a wage-price spiral are therefore indisputably met in the USA.

However, there is one measure that is regarded the most reliable leading indicator for the danger of wage-price spirals: the so-called core inflation. It

measures the rate of change of a consumer price index that does not include the categories of goods with particularly volatile prices: energy and food. If inflation rises but core inflation remains stable, this means that price increases are limited to the part of goods that is usually volatile and thus do not spill over to other sectors; if, on the other hand, core inflation also rises, we are dealing with a broad-based inflation process. The result of this spillover from price volatile categories to all sectors is rising inflation expectations, which lead to higher wage demands in all sectors of the economy and thus pull up all goods prices.

As the chart below shows, the recent development of core inflation leaves little doubt that the hypothesis of a temporary increase in inflation driven by energy prices can unfortunately be dismissed.



Prior to the pandemic, core inflation in all three currency areas (US, Eurozone, Switzerland) was stable and persistently around 2% or below. Since then it has risen very sharply, especially in the US, but also in the Eurozone, and is far above acceptable levels. Inflation is therefore by no means limited to

energy and food (which are not included here), but has reached other sectors of the economy. This data leaves little doubt that in the US and in the Eurozone inflation expectations have risen significantly in the meantime and have set in motion a self-enforcing wage-price spiral.





## What about Switzerland?

In Switzerland, too, inflation has now reached uncomfortable heights, but at around 3.5% it is well below those levels of almost 10% which we observe in the US and the Eurozone. Rising inflation expectations are also showing much less evidence. The labour market has also dried up considerably in this country: the number of job vacancies has recently fallen at an exceptional rate and is now at about 80% of the unemployed. Nevertheless, the chart on core inflation shows that we cannot speak of a broad-based inflation process yet. Although the value has risen noticeably, it remains just within the acceptable range of 2%. One factor in particular is responsible for Switzerland's exceptional position so far: The strong appreciation of the franc in recent months, which has had a dampening effect on prices. In addition, Swiss employer-employee relations have traditionally been characterized by a certain degree of wage moderation compared to other countries. This can be seen at present, as there are few signs of wage demands overshooting. However, this is a snapshot and depends heavily on price developments in the coming months.



## Monetary policy reactions

For a long time, central banks hesitated, but by now the resolute fight against inflation is the clear priority practically everywhere. Key interest rates have been raised since this summer, sometimes in significant steps, and most central banks have clearly indicated that they are willing to take further large interest rate steps. This determination is very positive as the development of inflation expectations will crucially depend on how credibly monetary policy signals that they are serious. As before, key interest rates, as well as long-term market interest rates, are significantly lower than inflation everywhere. Thus, despite monetary tightening, current (but not necessarily expected future) real interest rates are still negative and thus have a stimulating effect.

It is therefore inevitable that interest rates must continue to rise, but this depends on the inflation dynamics of the coming months. The ideal scenario would be an imminent reversal of the trend with clearly falling inflation rates, which would require only a few more interest rate hikes. However, an ongoing rise in prices is likely, in which case interest rates would still have to rise sharply in order to break the momentum in the long term.

From the Swiss point of view, it needs to be stated that although the monetary policy environment is challenging, our economy is once again proving to be surprisingly resilient. In an international comparison, our country remains well positioned in macroeconomic terms.

## About the author of the Brunetti View

Prof. Dr. Aymo Brunetti is Professor of Economic Policy and Regional Economics at the Department of Economics of the University of Bern. Up until 2019 he also headed up the Federal Advisory Council for the Future of the Swiss Financial Centre (Beirat des Bundes für die Zukunft des schweizer Finanzplatzes). He was previously Head of the Economic Policy Directorate of the State Secretariat for Economic Affairs (SECO) and informal national chief economist. From 2012–13, he chaired a group of experts led by the Swiss Minister of Finance, which drew up proposals for overcoming the challenges facing the Swiss wealth management industry. He was then Chair of the high-ranking Expert Group of the Federal Government and commissioned a report on the advancement of Swiss financial market strategy.



## Publisher:

Tareno Ltd  
St. Jakobs-Strasse 18  
CH-4052 Basel

Phone +41 61 282 28 00

Tareno Ltd  
Claridenstrasse 34  
CH-8002 Zurich

Phone +41 44 283 28 00

info@tareno.ch  
www.tareno.ch

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