

# US vs. Europe inflation – Same, but different

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## Executive summary

- In the third quarter of 2021, it became clear that the US faced a secular rise in inflation beyond levels anticipated by policymakers. In December 2021, annual US consumer price inflation rose at a 7% year-on-year pace, the largest jump since June 1982. The US Federal Reserve (Fed) is now scrambling to catch up
- In our view, catching up will require the US Federal Reserve to raise policy rates faster and further than financial markets currently anticipate.
- What does this mean for investors in Europe? Does the eurozone follow where the US leads on inflation? With eurozone consumer price (CPI) inflation running at 5.1% year-on-year in January, is the inflation genie also out of the bottle on the old continent?
- In our view, for a number of reasons, the inflation outlook in continental Europe differs profoundly from that in the US. In this paper, we explain why.

## Inflation angst in the eurozone

With eurozone consumer prices having risen by 5.1% year-on-year in January, the eurozone is gripped by inflation angst. The headline in the French weekly news magazine, *Le Point*, on 27 January was 'Inflation – La grande menace'. In Germany, where anxiety over inflation is never far away, the soaring energy and food prices that have pushed eurozone inflation to two-and-a-half times the ECB's 2% target have prompted strident calls for a faster withdrawal of the central bank's stimulus policies.

**Exhibit 1: Consumer prices in the eurozone rose by a record 5.1% in January**



Source: Bloomberg, BNP Paribas Asset Management, as at 3 February 2022

The eurozone's latest inflation data defied expectations of a fall in inflation. Earlier in January, European Central Bank (ECB) chief economist, Philip Lane, said the central bank expected inflation pressures to ease over the course of 2022 and the case for raising rates *'is not there'*. President Christine Lagarde previously rejected calls to raise interest rates more quickly than planned in response to record inflation, saying the ECB had *'every reason not to act as quickly or as ruthlessly'* as the Fed.



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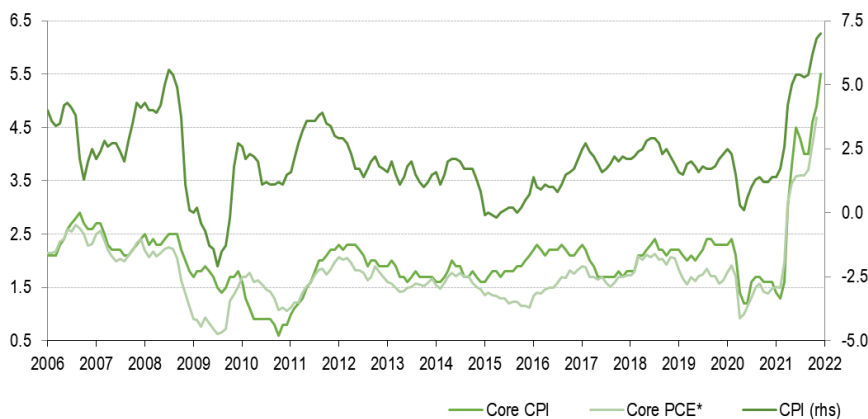
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On 20 January, Lagarde had reiterated the ECB's December forecasts that inflation in the bloc would stabilise and 'gradually fall' to below its target by the end of the year: *"It will fall less than we all had all envisaged a year ago, including all the world's economists, but it will fall."*

However, at the ECB's first monetary policy meeting of 2022, on 3 February, Lagarde said the bank was *'much closer to target'* on inflation and refused to rule out tightening of policy in 2022. She did again stress that official rates will not be raised until the ECB forecasts that inflation will stay above 2% for much of the next two years. Even then it will only do so once it stops net asset purchases. There has been criticism of the ECB's decision to raise the pace of purchases under a longstanding programme from EUR 20 billion a month to EUR 40 billion a month to partly offset the ending of purchases under its EUR 1.85 trillion pandemic emergency purchase programme in March. The ECB is due to publish new quarterly inflation forecasts in March.

Clear signs that the US and UK are edging towards tighter monetary policy have contributed to pushing German Bund yields higher this year. On 3 February the Bank of England (BoE) raised its main policy rate to 0.5 %, less than two months after lifting it to 0.25 %, while investors are pricing in five rate rises from the Federal Reserve in 2022. On 19 January, Germany's 10-year Bund yield turned positive for the first time since 2019.

**Exhibit 2: US CPI inflation - Above 7% for the first time in almost 40 years**



Source: Bloomberg, BNP Paribas Asset Management, as of 03/02/2022

\*PCE Personal consumption expenditures

Financial markets now anticipate that persistently high inflation will oblige the ECB to raise interest rates several times in 2022. Market pricing implies an increase in the ECB's deposit rate to above 0.10% — from its current rate of minus 0.50% — by December. This translates into almost two 0.25 percentage point rate rises. The yield of 10-year German Bunds rose close to a 3-year high of 0.14% as President Lagarde spoke on 3 February, suggesting a generalised rise in bond yields is underway.

It is however questionable, in our view, whether higher policy rates would be appropriate at a time when high eurozone inflation is primarily eroding real incomes and purchasing power rather than reflecting an economy that is overheating due to excessive demand.

## MAJOR DIFFERENCES BETWEEN THE EUROZONE AND THE US WITH REGARD TO THE OUTLOOK FOR INFLATION

### US fiscal stimulus during the Covid crisis was excessive

Under former President Donald Trump and his successor, Joe Biden, the US tackled the fallout from the Covid-19 shock with massive fiscal stimulus. The resulting strength in personal incomes, despite the furloughing of millions of workers during the pandemic, strongly suggests that the fiscal stimulus provided by the federal government may have been larger than was warranted by the output gap.

Fourth quarter 2021 US GDP growth was strong, at 1.7%. For the full year, the economy grew by 5.7% at a seasonally-adjusted annual rate (saar).

This paints a picture of an economy continuing to enjoy above-trend growth, generating solid employment gains and closing the employment gap versus pre-pandemic levels. Aggregate demand was supported by:

- An extremely accommodative monetary policy stance
- The overhang of several emergency fiscal stimulus packages
- Inventory restocking
- Renewed capital spending
- Robust residential investment
- Feedback from solid employment gains.

With pandemic risks to the US economy receding, ISM business sentiment surveys indicating expansion, and consumer confidence remaining solid (despite a surge in headline and core inflation), it appears the US economy has taken off much more strongly than that of Europe.

### **Mind the gap in the eurozone**

GDP growth in the US is now well past its end-2019 level and is closing in on the pre-pandemic trend line. Meanwhile, the eurozone has only just re-established end-2019 levels of GDP growth, with the trend line still at least two years away. In other words, the output gap in the US economy is closing rapidly, while in the eurozone, it has remained large, partly because it was already big when the pandemic began, but also due to a slower recovery.

### **Extraordinary initial US fiscal stimulus...**

For context, the magnitude of the initial 2021 fiscal impulse (made up of USD 900 billion in December 2020 and USD 1.9 trillion in March 2021) is roughly comparable to the USD 2.3 trillion of support provided in early 2020. It dwarfs the fiscal assistance provided after the 2008/9 Global Financial Crisis (GFC). Putting aside the additional infrastructure plans that have been proposed, the initial 2021 stimulus package, at around 13% of GDP, was eye-popping in scale.

Indeed, former Treasury Secretary Larry Summers, and former IMF Chief Economist Olivier Blanchard (listen to him [here](#), speaking at our Investment Symposium in November 2021), have accused the Biden administration of irresponsibility.

In February 2021, Blanchard estimated the US economy's demand gap at between USD 680 billion and USD 900 billion. This was prior to the acceleration in the vaccine rollout and easing of social restrictions. Of course, the ultimate impact of the fiscal packages on aggregate demand depends on the (highly uncertain) multipliers involved, but Blanchard's assessment was that USD 2.8 trillion in fiscal measures was highly likely to be substantially excessive, and ran the risk of severely overheating the economy and stoking inflation.

By way of comparison, whereas the Obama administration's post-GFC stimulus was about half as large as the output shortfall, the Biden stimulus was three times as large as the projected shortfall. Relative to the size of the gap being addressed, it was six times as large.

### **...followed by more spending on infrastructure**

In mid-November 2021, the Biden administration passed a USD 1.0 trillion infrastructure package, securing an uncommonly bipartisan 69 to 30 vote in the Senate. It contains spending plans to upgrade the electrical grid, build climate change resilience, and repair roads and bridges.

However, the administration has so far been less successful in passing the accompanying USD 3.5 trillion social spending plan, known as the 'Build-Back-Better' plan. Unrelenting opposition from Senator Manchin (Democrat, West Virginia) prevented even a downsized USD 1.75 trillion bill from reaching the President's desk.

The BBB bill focuses largely on social spending projects, including education, healthcare, eldercare and childcare, as well as some climate change provisions. Senator Manchin's objections to the plan were its cost and its impact on the deficit at a time of already high inflation. Nevertheless, the administration has vowed to revise the plan and seek its passage in Q1 2022.

It is true that part of the income support made available in the US was necessary given the absence of the sort of safety nets provided for the unemployed in the eurozone. Nonetheless, the US fiscal response seems, as argued by Summers and Blanchard, to have been excessive. As US unemployment was historically low going into the pandemic, there was no way that potential output could match the extra demand this policy generated.

### **Meanwhile, in Europe...**

Across Europe, massive furlough schemes were implemented in March 2020, with governments picking up the wage bill of employees made redundant during the pandemic. 'Whatever the cost' was a common rallying cry, with almost all governments adopting similar policies and the ECB standing by to assist.

Yet the overall cost was limited. Although, for example, almost 40% of the French workforce was covered by the furlough scheme at the pandemic's peak, its ultimate cost amounted to only 1.4% of GDP. Once public health improved and people returned to work, furlough costs quickly dwindled. In the eurozone, the total fiscal cost of supporting households and firms remained at 3%-4% of GDP, far less than in the US. Household revenues were held level rather than increasing, so there was no trigger for demand to balloon.

### ....employees retained their contracts during the Covid crisis

Furloughed workers in Europe retained their labour contracts and the associated employment security during the Covid crisis, although temporary workers and those on fixed-term contracts were vulnerable, and those entering the labour force also struggled. Generally, however, European states acted as a buffer, shielding both employees and employers from the full force of the shock.

For this reason, the size of Europe's pre-pandemic labour force was largely unchanged in the wake of the pandemic. This contrasts with the US where, with employee contracts terminated, around 2.7 million workers disappeared during the crisis (the US unemployment rate has fallen to 3.9% with the number of voluntary job-quitters reaching a 10-year high in November 2021). This aggravated bottlenecks in an economy where a surge in demand met restricted supply hampered by a shortage of staff.

Many people took the opportunity during the pandemic to reconsider their situations and working lives, with some deciding to change professions, employer or career. In the US a larger increase in household wealth coupled with a retirement system largely based on private pension schemes potentially facilitate earlier retirement. Europe has not seen workforce withdrawal on the same scale as in the US. It appears the European social model has broadly ensured continued participation by employees whose contractual relations with their employers have been maintained.

### The US Federal Reserve: Looking in the rear-view mirror

The adoption of an average inflation-targeting (AIT) framework in August 2020 meant the Fed has been reactive rather than proactive in countering inflation pressures. When Chair Jerome Powell unveiled the strategy, the aim was to achieve prolonged above-target inflation after a period of below-target inflation along with 'maximum employment'.

In retrospect, it is clear that such a bold strategy should have gone hand-in-hand with a cautious fiscal policy. However, Congress and two presidents decided to enact huge stimulus. Running the economy hot at a time of severe supply bottlenecks has created 'demand pull' inflation as consumers spend their excess savings. As a result, the Fed found itself forced to pivot precipitously in Q4 2021.

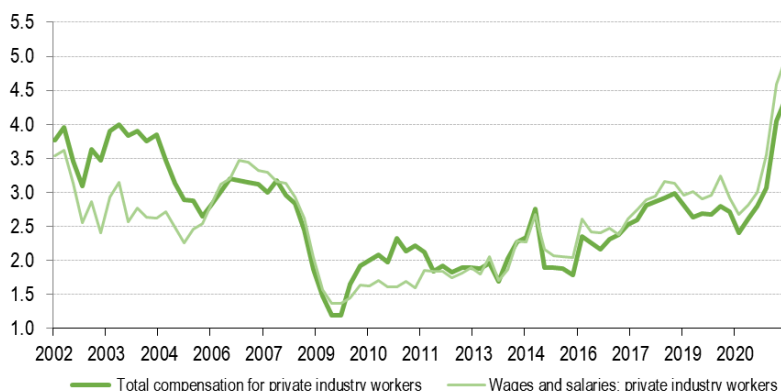
The degree of coordination between fiscal and monetary authorities, as well as the easiness of each component, was almost unprecedented in peacetime. What is extraordinary is that the aim of the exercise appears to have been to generate a (mild) economic boom, rather than a 'soft landing'.

It may be that the Fed was too focused on yesterday's battle – preventing the economy falling into a deflationary trap – and thus overlooked the risks of an excessively accommodative policy at a time of fiscal stimulus.

### Wage inflation apparent in the US

The tightness in the US labour market is becoming apparent in compensation metrics, with the employment cost index and the Atlanta Fed Wage Tracker confirming anecdotal evidence that employers are having to raise wages and improve working conditions to attract workers, especially in low-skill sectors. For example, the most recent fourth quarter ECI showed wages rising at 4.5% year-on-year, while the wage tracker for December showed wages for prime-age workers climbing at 4.5% YoY.

**Exhibit 3: US labour costs, as measured in the employment cost index (ECI), are rising fast**



Source: fred.stlouisfed.org, BNP Paribas Asset Management, as at 04/02/2022

US labour costs have risen sharply, contributing to the rapid rise in inflation. The latest employment cost index (ECI) report, which tracks wages and benefits paid by employers, showed wages rose 4.5% in the 12 months through December 2021, nearly double the pace for the same period in 2020.

Recent inflation data has shown a sharp acceleration in services prices (outside of healthcare and transport). If strong demand and limited labour supply force wages higher, and those wage increases leak into services, it could be the first sign of a significant wage-price spiral.

The experience of the decade prior to the pandemic was that wages rose only slowly during the expansion because labour force participation steadily rose as inactive workers re-joined the labour force once jobs became available. The current situation appears different. [JOLTS job openings](#) stand at more than 10 million with not enough qualified applicants to fill them, and firms are having to raise wages. In short, the labour supply has become less elastic, as many older workers are opting for retirement or choosing to wait until the pandemic has passed before returning to work.

### In the eurozone, inflation is still mainly energy price-driven

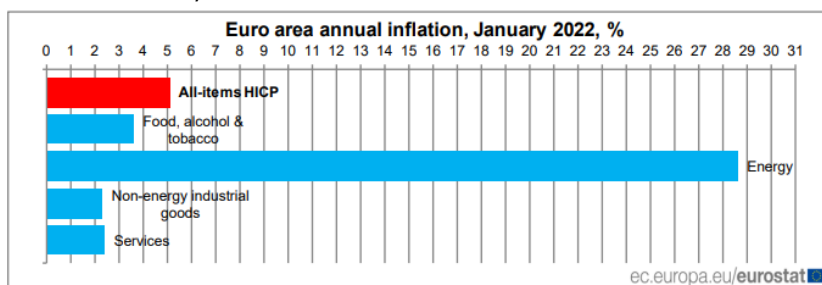
With eurozone inflation at a record high due to rising energy costs and the economy reopening, wage growth is crucial for the ECB to ponder.

Without wage growth, there is little prospect of inflation moving sustainably higher as labour costs are key determinants of services prices. These account for 42% of the inflation basket, and are more closely linked to domestic economic activity than external shocks that the ECB cannot influence.

Solid wage growth is also a necessary condition for the second test of the ECB's forward guidance (*"that realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at 2% over the medium term"*).

The current spike in eurozone inflation is overwhelmingly due to rising energy prices (Exhibit 4), supply bottlenecks and a change in the German VAT rate. This is all 'cost push' inflation, rather than the 'demand pull' inflation in the US, where demand has ballooned as the economy has been run hot.

### Exhibit 4: Among the main components of eurozone inflation, energy is expected to have the highest annual rate in January (28.6%, after 25.9% in December)



In an interview on 25 January, [ECB Chief Economist Philip Lane](#) acknowledged that an increase in the cost of living may be a factor in wage negotiations. The question is to what extent. Energy is a direct cost to the consumer, but also a cost to firms. The ECB will be examining how much of the higher prices might show up in higher prices for food and other goods and services. So far, according to Lane, the ECB is not (yet?) seeing a big response in terms of wage levels.

The magnitude of any rise in wages will determine the ECB's response. In the eurozone, for inflation to be around 2%, and based on a typical increase in labour productivity of about 1%, wages should be growing at around 3% a year on average. Wage growth, admittedly distorted by the pandemic, has been weak. The growth rate in negotiated wages fell to just 1.5% in 2021, compared with 1.9% in 2020.

Our Macro Research Team expects labour market and high inflation to prompt more aggressive wage demands in the 2022 wage bargaining rounds.

### How will the ECB respond to all this?

On the one hand, the spike in energy prices is weighing on disposable incomes and reducing real wages, posing a headwind to consumer spending. If the increase were temporary, the ECB would likely choose to look through the energy price spike. On the other hand, the strength of energy prices may not be entirely transitory if (1) underinvestment in productive capacity means supply will be unable to meet resurgent demand post pandemic, and (2) the costs of the energy transition push prices higher over the next few years.

In addition, higher inflation numbers also reflect intransigent blockages in the global supply chain which may not be resolved for months. Although these drivers are global rather than domestic, the ECB increasingly worries that inflation expectations and wages may respond and kick-start second-round effects. While it made no promises, February's council meeting opened the door to a faster withdrawal of accommodation via an earlier end to asset purchases and earlier rate rises.

## Conclusion – Fundamental differences between Europe and the US

Global supply factors related to supply chain disruptions and energy markets are clearly associated with recent rises in key measures of inflation across advanced economies. The persistence of this inflationary pressure is due to global supply factors such as production or shipping bottlenecks and input prices. They are mostly global in nature and as they are supply, rather than demand related, domestic monetary policy actions are likely to have only a limited effect on them. In short, the sooner there is an easing of tensions in supply chains, the faster we will see inflationary pressures fading everywhere.

**Beyond these global factors there are fundamental differences, particularly in labour markets that lead us to believe it is inappropriate to transpose the outlook for inflation in the US on to the eurozone** (the UK's situation being, not for the first time, somewhere between the two). We see the US economy as being at or already below full employment. The US labour market is very tight with around 10.5 million open positions.

Chair Powell's comments following the late January FOMC meeting suggest to us that US policymakers have concluded US inflation is becoming cyclical and persistent. We therefore expect the FOMC to raise the federal funds rate by at least 0.25% at each of the 7 meetings in 2022 and continue in 2023 until US policy rates reach 2.5% (the Fed's view of neutral). With core inflation forecasts above target for throughout their forecast horizon and likely to be revised higher, should wages not moderate in coming months, it is entirely possible that rates may have to go into restrictive territory.

President Lagarde, meanwhile, adopted an unambiguously hawkish tone about upside inflation risks in the eurozone at the ECB's press conference on 3 February. Policy action is not imminent but the ECB clearly sees inflation risks as now being skewed to the upside. She noted that inflation concerns were "unanimous" among members of the Governing Council, as recent high headline data, still driven by energy, shows broader inflationary pressures extending to core items in the basket.

An upward trend in core inflation, along with expectations of further improvements in the labour market and inflation expectations stabilising around target, suggest the ECB now sees inflation as settling at elevated levels for some time, potentially a pre-condition for a rate hike. Particularly noteworthy was a shift in language on rate hikes, as Lagarde no longer referred to a hike in 2022 as "highly unlikely", but rather stressed that any decision will be data driven.

However, in our view, on account of a significantly larger output gap and greater slack in labour markets, the ECB is not about to embark on a cycle of rate hikes of the same magnitude that we expect from the Federal Reserve. While the European labour market is tightening, real wage gains are unlikely to outpace productivity gains by much – wage increases will be part of the price finding adjustment rather than the trigger for a wage-price spiral. In the US, in contrast, the acute shortage of workers is far more conducive to a wage acceleration that could lead to significant pass through and second-order effects. Correspondingly, while the ECB may take its foot off the accelerator in coming months, we think the Fed is far more likely to be the central bank that needs to tap the brakes. Nevertheless, with the ECB, Federal Reserve and Bank of England now all heading towards a wind-down of their balance sheets and higher policy rates, investors should prepare for higher real yields and a reversal of portfolio balance effects.



## Jenny Yiu

### Head of Inflation

Jenny is Head of the Inflation team and a member of the Rates Committee. She is responsible for the growth and development of Inflation Strategies, as well as overseeing BNPP AM's global inflation-linked bond portfolios and generating alpha ideas within rates and inflation markets for implementation across applicable portfolios. Jenny joined Fischer Francis Trees & Watts (FFTW), a predecessor of BNPP AM, in 2005 and is based in New York.

Prior to joining us, Jenny worked at HSBC Hong Kong as a Trader in Treasury & Capital Markets, making markets in secondary HKD corporate fixed income products and bringing out primary structured and plain vanilla HKD fixed income issuance along with the origination desk. Jenny also worked at HSBC in London where she gained capital market experience on the Market Risk Management, Debt Capital Markets, Eurobond Trading and Structured Credit Trading desks.

Jenny has 19 years of investment experience. She holds a BS in Economics with a concentration in Finance, magna cum laude from The Wharton School of the University of Pennsylvania. She is a CFA charterholder.



## Cedric Scholtes

### Head of Global Sovereign, Inflation and Rates

Cedric is responsible for the growth and development of both the Inflation and Sovereign strategies, and is the lead portfolio manager for US Inflation-Linked Bond portfolios, as well as US Treasury portfolios. Cedric has oversight responsibility of the investment process across Sovereign and Inflation-Linked Bond portfolios and oversees risk utilisation and performance of the flagship portfolios of the strategy products and portfolios with a rates component. Cedric chairs the Rates Committee, which is composed of specialists from different fixed income product groups, who are charged with generating alpha in sovereign, derivative and inflation markets for implementation across applicable portfolios.

Cedric joined FFTW, a predecessor of BNPP AM, in 2006 as a portfolio manager and is based in Paris. Cedric joined from Goldman Sachs, where his responsibilities included taking proprietary positions and market-making in index-linked markets, as well as enhancing the desk's analytical capabilities. Prior to working at Goldman Sachs, Cedric spent five years at the Bank of England, two of which on secondment to the Federal Reserve Bank of New York. At the Bank of England, Cedric spent two years in the Foreign Exchange Division, helping to manage the UK Treasury's foreign exchange reserves. Prior to that, he was a Research Economist in the Monetary Analysis Division, researching fixed income markets. Cedric has published articles on nominal and inflation-linked debt markets in Bank of England, BIS and IMF periodicals, and RiskBooks.

Cedric has 22 years of investment experience. He holds an MSc in Finance and Economics from Warwick Business School, an MSc in Economics from the London School of Economics, and an MA/BA in Economics from Cambridge University.



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