CUSHMAN & WAKEFIELD



Perspectives on

European Inflation

July 2022



As the pandemic's influence started to ease in 2021, new symptoms of economic reopening, pent-up demand, and overwhelmed global supply chains began to emerge. The dreaded "i-word" was suddenly spoken, after a decade of being so subdued that it was barely worth watching from month to month. Inflation has now reached levels not recorded in decades and is becoming widespread. In this research piece, we explore causes of the current bout of inflation and how it differs by region. In European Commercial Real Estate Versus Inflation, we explore how commercial real estate (CRE) has historically held up to inflation across Europe.

Key Takeaways

- Inflation is being driven by supply-demand imbalances. Currently, most inflation in Europe is tied to the supply side of the economy: energy prices, reopening effects and supply chain bottlenecks throughout Europe and the UK account for 65% to 75% of headline inflation. In Europe and the UK, food prices account for 18% and 10% of headline inflation, respectively.
- Unlike the U.S., continental Europe's demand recovery has been anemic, pointing to fundamentally different economic contexts that are driving the inflation backdrop. In the UK, there is more evidence of a demand-side recovery, particularly in non-durable and semi-durable goods.
- The Russia-Ukraine conflict has meaningfully impacted commodities-related inflation.
- Central banks are responding to the current inflation environment, although the European Central Bank (ECB) has generally been the most reticent to pivot to a more hawkish stance.

Taking Stock: The Inflation Situation

Inflation has ramped up significantly in the last six months, not just across the advanced economies but also across the majority of emerging markets and developing economies. Year-over-year headline consumer price indices in the latest months reached 7.7% in Canada, 7.8% in the UK,[1] 8.1% across the euro area and 8.6% in the U.S. A few key factors have driven these trends, but the ultimate theme has been of supply-demand imbalance:

1. Global production, which was pummeled by lockdowns at the height of the pandemic, has not been ramping up fast enough.

2. Compositional shift in consumer spending during the pandemic, away from services like travel and entertainment toward goods, which are more import-intensive in the West.

3. Level shift in consumer demand from stimulus, although this occurred to varying degrees across countries and regions.

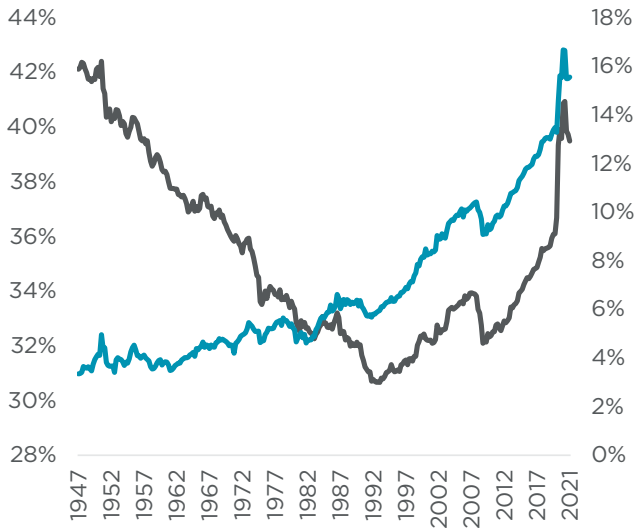
4. Supply chains that remain stressed by changes in spending patterns and limits on bandwidth. Bandwidth issues span both key international trade routes and domestic industries.

5. More recently, the Russian invasion of Ukraine has exacerbated supply chain and trade-related logjams, particularly in commodity markets.

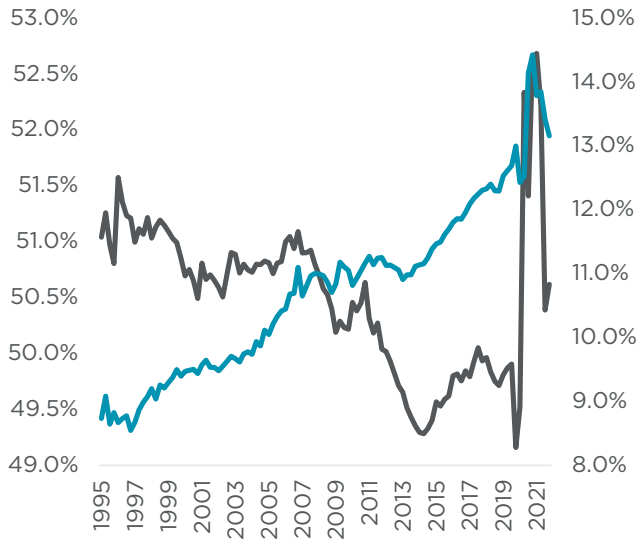
In 2020, factory activity and trade flows ground to a halt as governments imposed lockdowns and significant restrictions on businesses and individuals. While motivated to contain COVID-19, the side effects of these actions were longer lasting. Manufacturing capacity and production take time to recover after such a shock: production fell 10.3% peak-to-trough globally from Q4 2019 to Q2 2020. As of Q1 2022, global manufacturing output was only 6.7% above its immediate pre-pandemic level. On its own, this would be an indicator of a healthy and rapid recovery[2], however production levels are not keeping up with the global demand recovery.



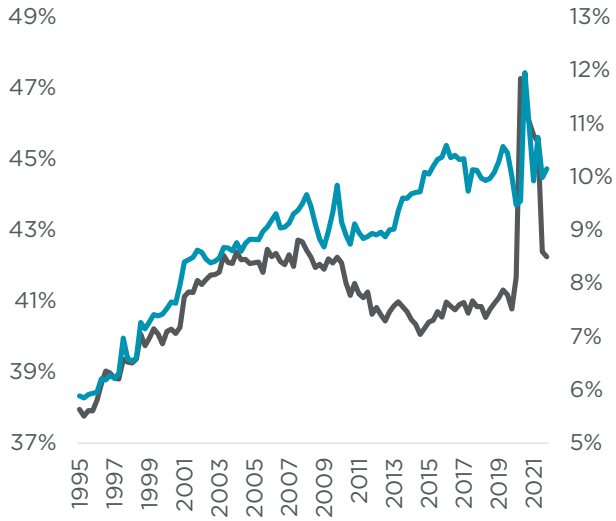
United States



Europe



United Kingdom



Both the level and nature of consumer spending shifted during the pandemic. At first glance, one could mistakenly believe that with real global and European[3] consumer spending only 2.2% above and 1.3% below pre-pandemic levels respectively, this imbalance would be a non-issue. Those overall figures disguise nominal demand for physical products, including the immediate and swift upswing in spending on goods—and within goods, on more durable or semi-durable goods. In the U.S., the share of spending on goods climbed from 36% to 41% in 2020. In Europe[4], it grew from 50% to 53%, and in the UK from 41% to 47%—an average increase of about five percentage points. Although these shares are receding from pandemic highs as services spending picks up, the movement in relative demand is one reason why the total value and volume of imports are above 2019 levels.

In fact, the total value of trade imports over the latest 12 months is 20.6% and 17.6% above levels in the immediate 12 months pre-COVID in the U.S. and the euro area, respectively. In the UK, trade volumes are up by a slightly less robust 5.5%. But in terms of volumes—what affects physical capacity and bandwidth of supply chains—global trade imports[5] are 10.6% above December 2019 levels. In the euro area, import volumes are 10.0% higher.

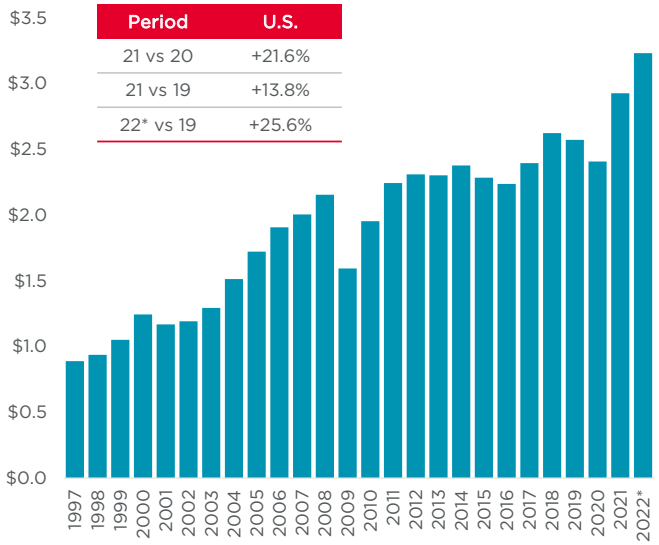
% Total Goods (Durable + Semi-durable + Non-durable)

% Durable Goods Only (RHS)

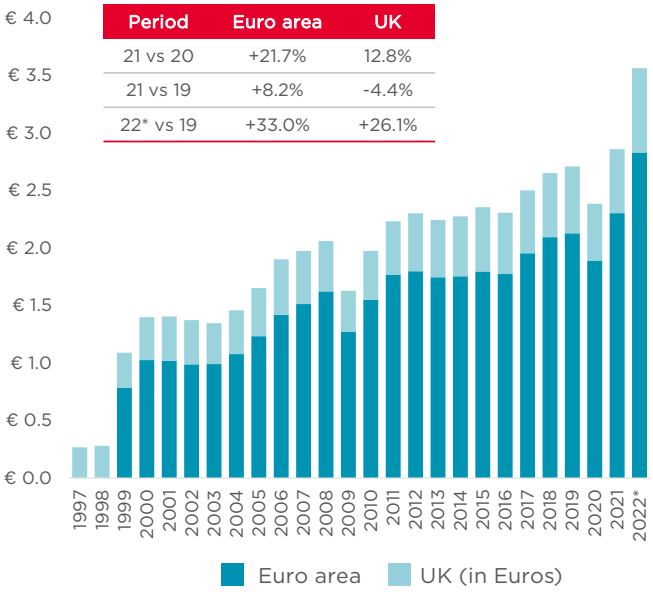
Source: U.S. Bureau of Economic Analysis, Eurostat, UK Office of National Statistics

Note: The U.S. does not break out semi-durable goods. *Europe includes subtotal of 18 countries that provide detailed data on types of consumer spending. See footnote 4 for more information.

U.S. Goods Trade (Value, Tril.)



Euro area Goods Trade (Value, Tril.)



Source: U.S. Bureau of Economic Analysis, U.S. Census Bureau, Moody's Analytics, European Commission, Eurostat, UK Office of National Statistics

Note: *2022 shows Q1 at an annualized rate. Euro area imports data begin in 1999.

This is an important feature of the current landscape to keep in mind as *inflation-adjusted levels* of spending on goods throughout continental Europe are not above pre-pandemic highs, whereas in the UK and U.S., they are. However, a key difference between the U.S. and UK is the extent of this recovery. In the UK, goods spending in the most recent four quarters was only 1.0% above its pre-pandemic trend, while in the U.S. it was 9.7% above its pre-pandemic trend over that same timeframe. In the UK, this recovery has been led by non-durable and semi-durable goods, with durable goods lagging, both below pre-pandemic levels and pre-pandemic trend levels. In contrast, durable goods spending in the U.S. is 26.3% above pre-pandemic levels and 13.2% above its pre-pandemic trend level.

Europe's consumer backdrop is a stark contrast, where goods spending has not only *not* fully recovered to pre-pandemic levels—it is still 3.4% lower—but relative to the pre-pandemic trend, it is 8.1% lower, with variation at the country level. Durable, non-durable and semi-durable goods spending are all below pre-pandemic levels and well off pre-pandemic trend levels. As we explore later in this report, this is partly tied to varying degrees of stimulus and has led to a much higher concentration of European inflation being tied to energy versus other demand-pull factors.

The strong demand recovery—with shades of grey depending on the region—has also been driving demand for labor. In the U.S., this has pushed the unemployment rate back to 3.6%, only 10 bps higher than the pre-pandemic rate. Private sector wage growth (as measured by the Employment Cost Index) correspondingly accelerated to 5.0% in Q1 2022 on a year-over-year basis, the fastest rate since 1990. In the UK, the unemployment rate increased slightly to 3.8%—in line with the pre-pandemic low (achieved in late 2019). In Europe, it is at 6.2%, 100 bps below its pre-pandemic low (achieved in March 2020). Average total weekly pay[6] rose by 6.8% year-over-year in the latest UK data (April 2022). Although a slight slowdown from the 7% average of the previous three months, it is still well above the post-GFC average of 2.2%. Wages and salaries grew by only 3.7% as of Q1 2022 in the euro area. Still, these are elevated rates of labor cost appreciation relative to the prior expansion.

Outside of the initial shock to global manufacturing and the rapid changes in consumer behavior, broader supply chain issues emerged as the economy reopened and production and trade started to recover. These issues include a scarcity of raw materials, variations in required quarantining for port and maritime ship workers, sporadic port and facility closures throughout Asia Pacific (which continue today in Greater China), a dearth of chassis[7] available at the right time in the right place to unload incoming containers and labor shortages. In addition, historically low warehouse and distribution vacancy rates have exacerbated the effort to free up bandwidth throughout the transportation sector, as there is little excess space in which to store incoming goods. Unfortunately, manufacturers do not expect these supply chain challenges to go away soon, with most reporting 2023 at the earliest.

Regional Differences in Inflation

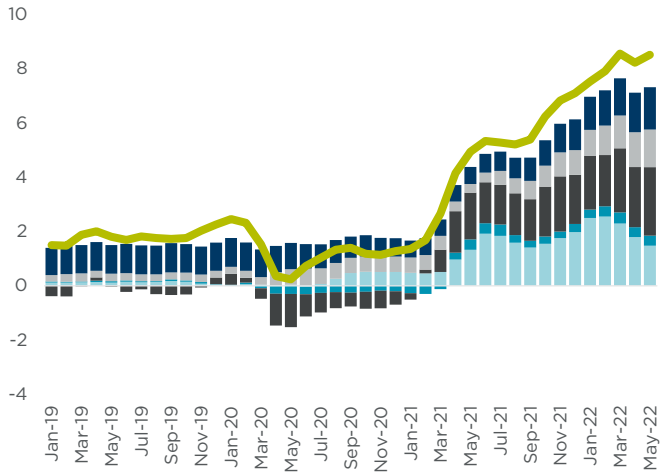
At the core of the present inflation situation is a tremendous variation in how much influence demand (demand-pull) versus supply (cost-push) effects are having, and which effect is dominating, or if they are equally problematic. Central banks consider some inflation part of a healthy functioning economy—in the West, this is about 2%, which indicates that both supply and demand are expanding in tandem. Today, both supply and demand are contributing to headline price increases, but to different degrees.

As mentioned earlier, aggregate demand from consumers, who represent about 70% of the U.S. economy, 66% of the UK economy and 54% of the European economy, has recovered unevenly. It may not be a surprise that the U.S. stands out as far ahead, especially in terms of goods demand, after providing 25% of pre-pandemic GDP in the form of direct fiscal stimulus, around 40% of which went directly to household income support. In the UK, direct stimulus totaled 16% of pre-pandemic GDP. These two nations rank first and third respectively (with Japan in second) for the greatest amount of direct fiscal aid provided during the pandemic. In continental Europe (excluding the UK), direct fiscal stimulus totaled 8.8% of pre-pandemic GDP, with some countries providing less than 1% (Croatia, Romania) and others providing low double-digit support (Austria, Malta, Italy, France, Portugal and Germany). There is likely a link between the (size and type of) aid provided, changes in consumer behavior and the demand-side outcomes, although these are difficult to empirically disentangle.

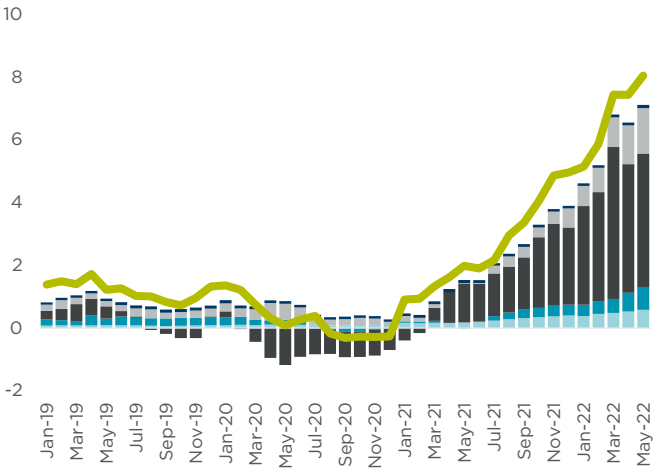
Interestingly, though, demand-pull inflation does not explain most of the inflation being observed across the West. The effects of reopening, supply chain/materials bottlenecks[8] and energy prices account for anywhere from 45% (in Canada) to 74% (in the UK) of all price increases. (These forces represented 51% of headline inflation in the U.S. and 69% in continental Europe.) The impact of reopening *should* fade as the base period (spring/summer 2021) is dropped from year-over-year calculations. Such effects are adding 40 bps to overall inflation in the U.S., 58 bps in the euro area, and 86 bps in the UK.[9] Supply chain issues are adding 148 bps to inflation in the U.S., 70 bps in the euro area and 206 bps in the UK. Finally, energy prices are fueling 252, 428 and 284 bps of headline inflation in the U.S., euro area and UK respectively. This means that for the euro area, 54% of total inflation is due solely to energy prices, versus only 28% in the U.S. and 36% in the UK. It is not surprising, with comparatively subdued demand backdrop in continental Europe (at least compared to the U.S. and UK) and greater relative reliance on imported oil and gas, that a greater proportion of price increases is tied to energy.



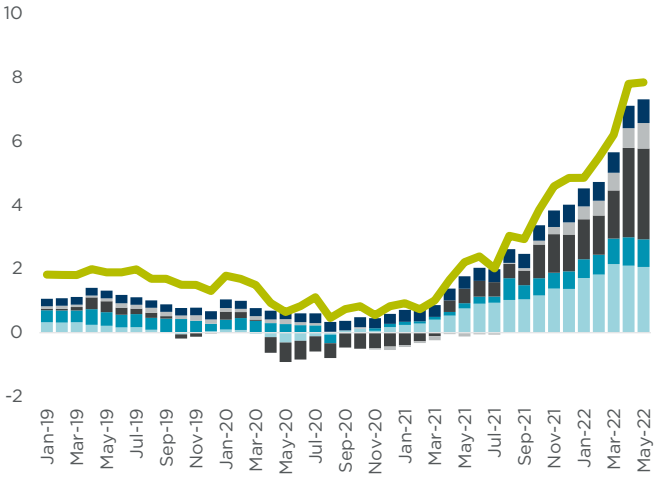
U.S. CPI Inflation



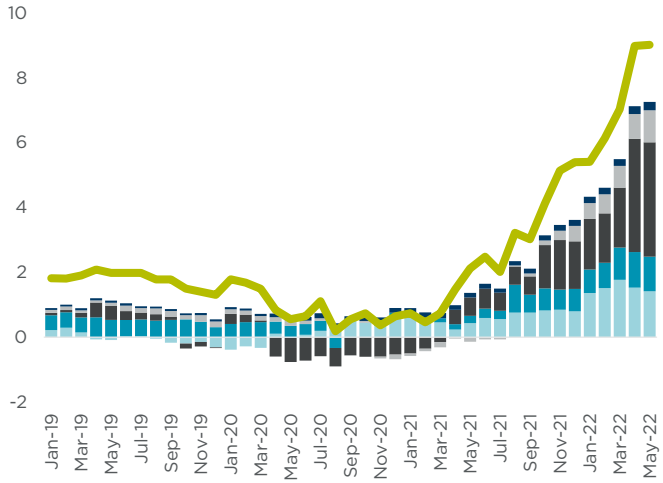
Euro area CPI Inflation



UK Inflation: U.S. Comparable (incl OER)



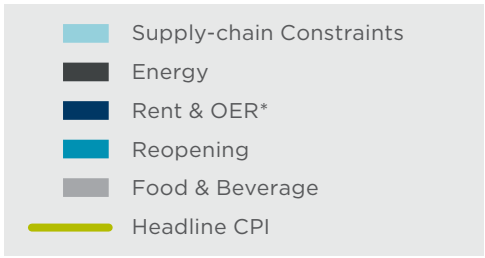
UK Inflation: Euro area Comparable (excl OER)



Source: U.S. Bureau of Labor Statistics, Eurostat, UK Office of National Statistics, Moody's Analytics, Bloomberg, Cushman & Wakefield Research calculations.

Note: **Europe does not include OER** (owner's equivalent rent for owner-occupied housing) equivalents, thus the weights for housing in the HICP are much lower than the weight of housing in the U.S. Eurostat has offered some background on this and appears to be working on a solution to this discrepancy.

Note: UK Office of National Statistics provides inflation breakdowns for the exclusion/inclusion of OER in the 'Rent & OER' category. The right is comparable to euro area inflation and the left is comparable to U.S. inflation.



Owner-Occupied Housing Differences in Headline Inflation[10]

In the U.S., the CPI includes a measure of owner-occupied rent (OER), which is an estimate of what homeowners would pay if they were to rent their own home. Year-over-year inflation in this category decelerated from an average of 3.3% in 2019 to 2.0% in the first five months of 2021. This was in part because the cost of a mortgage declined due to lower interest rates and secondary market interventions within the GSE MBS markets. However, rapidly rising home prices and more recently, higher mortgage rates, are causing OER to increase more precipitously with the latest reading in May 2022 at 5.1% year-over-year. There is certainly more to come on this front, as OER tends to lag trends in the housing and financing markets, but it's important to note that OER is not the same as actual house prices. Given that 65% of U.S. residents are homeowners, OER has a significant weight in the overall CPI (at 23.0%) and is contributing 1.2 percentage points, or 13.8%, of current year-over-year inflation. Combined with housing rental prices (for non-owners), housing costs comprise 30.4% of the U.S. CPI and account for 18.3% of current year-over-year inflation.

In the UK, the Office of National Statistics reports both a headline inflation metric that includes OER (called CPIH) and a measure that excludes it (CPI). In this report, statistics from the CPIH were cited as a default. In the UK CPI index, actual rents paid by renters accounted for 9.4% of the total weight in 2021, and with a year-over-year 3.0% inflation rate in May 2022, this category added only 26 bps to headline CPI growth. In the CPIH index that includes OER, rents had 7.4% weight and OER had an 18.5% weight. With year-over-year inflation of 3.0% and 3.1% in rents and OER respectively, these categories added 21 and 53 bps to headline inflation in the last 12 months, accounting for only 9.5% of total inflation.

In the euro area, headline inflation calculations by **Eurostat do not include a measure of OER**. This is despite 50% to 90% of households being homeowners across various euro area countries (with 16 countries posting a rate of 70% or greater). Thus, housing costs in the euro area's HICP inflation only represent trends in actual rent paid by renters, with a total weight in 2021 of 7.5%. With such a low weighting, and year-over-year inflation of only 1.5% in rents in May 2022, this category is only adding 10 bps to current headline inflation. The ECB reports that if OER was included in inflation from 2012 to 2020, inflation would have been no more than 30 bps higher in any given period. For more information on comparing various countries' inflation measures, click **here**.



Impact of Russia's Invasion of Ukraine

Although Russia's invasion of Ukraine occurred more than four months ago, it is still too early to assess the economic and possible real estate impacts. However, the broad consensus is that economic growth across most regions will take a hit and that inflation will remain higher for longer. While this will most explicitly happen via energy price channels, there is no doubt that other commodities, including certain raw metals, minerals, chemicals and food, will play a role. For central banks, this also means managing a new economic (supply side) shock and greater volatility, in addition to the inflation risks that existed pre-invasion.

Energy Sector Suffering from Same Supply-Demand Imbalances, and More

The energy market is a special source of frustration for those concerned about inflation. Energy and other commodity prices had been rising throughout the entire pandemic recovery. Despite being a net exporter of both oil and natural gas, the U.S. experienced rising energy costs throughout 2021, but to a lesser degree than the UK, and especially continental Europe. In both the U.S. and UK, energy has contributed just 28% and 36% of total inflation, respectively, versus more than 55% in the euro area. Interestingly, much like the U.S. not being immune to global oil price rallies despite being a net exporter (or neutral as it was at the start of 2022), the UK has still recorded dramatic increases in natural gas prices despite relatively low exposure to the Russia-Ukraine war. In the U.S., 8.4% and 2.5% of total oil and gas imports are from Russia, respectively, versus 11% and 4% in the UK and 25% and 40% in the EU.

Russian gas prices have been a unique character in the story of recent changes in European and UK natural gas prices, even pre-invasion. Although the global recovery contributed to price rallies in most commodities throughout 2021, Russian gas flows to Europe declined by 25% year-over-year in Q4 2021. In December 2021, Russia briefly stopped delivering gas through one of its major pipelines (the Yamal pipeline), causing a significant spike in prices. (The reasons for this are not part of the scope of this report.) Indeed, in the last 12 months[11], natural gas prices in Europe rose by 371% versus about 143% in the U.S. Futures prices also show the relative impact of the current situation on regional natural gas prices: with the risk of further supply disruptions due to physical infrastructure risk in Ukraine and political risk in Russia, European gas price futures surged by nearly 120% in early March from the January 2022 price. Since then, futures prices have come back down; however, they were still 395% above January 2021 levels as of mid-June 2022. In the U.S., futures prices were stable throughout the early days of the invasion but increased markedly in May and early June. As of mid-June, futures prices are 55% above January 2022 levels. This means that energy prices will continue to be a source of uncertainty and very likely keep headline inflation elevated in the near-term.



Why Not Runaway Inflation 2.0?

Among the list of anxieties that are expressed today, "hyperflation[12]" or "stagflation[13]" rank near the top. However, there are reasons to believe that these fears are overblown and indeed, the near-term outlook does not envisage either of these taking hold. This is not to say that inflation will not accelerate, but it does mean that these forces are not expected to persist indefinitely. Central banks are not expected to simply remain idle, even if they have been slower to respond than the market has called for. Furthermore, stagflation requires high unemployment, which is the opposite of today's environment, in which tight labor markets are leading to complaints of labor shortages.

- Unlike the 1970s and 1980s, central banks have a better understanding of how inflation expectations play a role in realized inflation. Combined with better measures of real-time market-based and survey-based expectations, relatively more-informed central banks have an improved radar upon which to rely. This is not to say the radar or central banks' actions are perfect. But current 5- to 10-year inflation expectations remain anchored, despite having moved higher since the start of 2022. If this changes, investors will begin to worry about wage-price spirals and hyperinflation.
- Inflation expectations embed views about how central banks will move the policy rate in the future. In the U.S. and UK, policy rate increases are underway, a first step in tightening financial conditions and—a main mechanism through which the economy is affected by monetary policy. The Bank of England commenced balance sheet reduction (quantitative tightening or QT) in March 2022 with the Fed following suit in June 2022. Inflation in both the U.S. and UK is broader across more categories than that in continental Europe.
- In the euro area, the European Central Bank (ECB) turned more hawkish at its latest meeting, stating that they intend to raise interest rates by 25 bps at the July monetary policy meeting, exactly 11 years after the previous rate hike. A further 50-bps increase in September is also likely if the medium-term inflation outlook continues to deteriorate.
- Since raising the policy rate affects broader financial conditions, which then affect aggregate demand, it is important to note that the current environment has led to a few shifts on the long end of the yield curve. First, inflation expectations have caused 10-year sovereign bond yields to increase. Second, the market has moved toward risk-off, pressuring credit spreads among investment-grade corporate bonds, which trade within tight ranges to CRE. In other words, the market is currently doing some of the work for the central banks.
- Many sources of inflation being recorded today are not necessarily expected to be persistent, in that they will not last in perpetuity. Certainly, they have endured longer than originally expected and the war in Ukraine is exacerbating them. But the moment that oil prices stop rising, car prices start to return to earth and food prices stabilize, these will become neutral or disinflationary in inflation calculations. Moreover, inflation emanating from supply chain issues will resolve slowly over the coming years, regardless of rising interest rates. Rising rates will help accelerate the slowdown in demand, including for goods, which should help temper supply-chain driven cost pressure. Most notably though, central banks have limited toolkits when fighting supply-side shocks affecting inflation and the present-day challenge around energy supply is one such shock.



- There are a few reasons why energy shocks are different today from the past—not in directional impacts but more so in their scope or magnitude. Importantly, the energy intensity of economic growth has declined substantially. That is, the amount of energy required to generate a dollar/euro/pound of real GDP is much lower today than it was in the 1990s. Since 1990, the UK and Germany have cut their energy intensity (total energy consumption per unit of GDP) by 54% and 46% respectively. This is, in part, thanks to the rise of the knowledge economy. Additionally, the consumer segment spends a smaller share of income on energy and food than it used to. In the UK, for example, 9% of total household consumption was spent on food in 2020, down from 33% in the 1970s. (Energy and food prices tend to be volatile and energy inflation affects food prices.) Consumers drive more than half of GDP in the euro area and more than 60% of GDP in the UK.
- The risks of stagflation have risen as a result of the energy price shock caused by the Russia-Ukraine conflict. This comes at a time when inflation is already high and central banks are reining in the ultra-loose monetary conditions. Rapidly rising commodity and producer prices combined with a shock to growth is not a desirable combination. But for the scenario of stagflation to be realized, it will require more than just an energy price shock to cause stubbornly high inflation, high unemployment and sluggish growth. Although growth forecasts have been revised down and the outlook of inflation has been significantly revised upward, stagflation will be avoided. Economic growth across many parts of the world has slowed but not stagnated, and unemployment rates are at their lowest in decades across many economies. We believe the prompt monetary tightening by central banks will help prevent a prolonged stagflation scenario, and the slowdown in growth will help bring inflation down, but remain above target in many economies in the very near term.

This research paper has provided an overview of how inflation and its causes vary across key Western regions. In European Commercial Real Estate Versus Inflation, we explore how commercial real estate (CRE) across key European countries and asset types has performed relative to inflation.



1 Discussed later in more detail, this is a measure of headline CPI inflation that includes owner's equivalent rent (OER). Without OER, CPI inflation is up 9.0% year-over-year in May 2022.
2 During the GFC, it took 16 quarters to get to the prior 2008 Q2 peak. During COVID-19, it took 9.
3 European consumer spending totals reflect the EU27, Norway, Switzerland and the UK. Underlying figures in real 2010 Euro terms.
4 Underlying details on consumer spending by durable, semi-durable and non-durable status are not available for all countries. Thus, these data reflect a subset of 17 EU nations and Norway accounting for 63% of total European spending—that is, spending in the EU27 plus Switzerland, Norway and UK. When including the UK, since ONS provides such breakdowns, the data cited above account for 79% of European consumer spending.
5 As of March 2022, the latest data available from the CPB World Trade Monitor.
6 The UK Office of National Statistics provides an economy-wide measure of total pay. It does not necessarily depict wage growth that any one individual is experiencing.
7 The undercarriage that transports shipping containers. This issue has been most predominant in the U.S. and throughout parts of APAC.
8 Re-opening includes hotels, restaurants, recreational and sporting events, air traffic and other cultural services. In Europe passenger rail prices were included as well. Supply chain effects include new and used vehicles, vehicle parts and maintenance/repair, audiovisual goods, sporting goods and select textiles.
9 The UK Office of National Statistics provides two versions of inflation, one that includes owner's equivalent rent (OER) and one that does not. While the former is comparable to the U.S. and the latter to the euro area headline indices, respectively, the 86-bps figure is consistent with the version that includes OER since it is a more comprehensive measure of total inflation.
10 The topic of including OER in inflation is nuanced. The reason for excluding OER is namely that homeownership is typically an investment and not a form of consumption. However, there are aspects of homeownership that could be characterized as consumption. Further, many metrics associated with OER are difficult to measure.
11 This looks at the price change year-over-year, smoothing the latest three months. It is the average of prices from March 2022 through May 2022 compared to the same period one year prior. It includes the UK.
12 Hyperinflation is defined as a period of rapid and excessive increases in the prices of goods and services.
13 Stagflation is defined as a period in which the inflation rate is high, economic growth slows, and unemployment remains elevated.

About Cushman & Wakefield

Cushman & Wakefield (NYSE: CWK) is a leading global real estate services firm that delivers exceptional value for real estate occupiers and owners. Cushman & Wakefield is among the largest real estate services firms with approximately 50,000 employees in over 400 offices and approximately 60 countries. In 2021, the firm had revenue of $9.4 billion across core services of property, facilities and project management, leasing, capital markets, and valuation and other services. To learn more, visit www.cushmanwakefield.com or follow @CushWake on Twitter.

Rebecca Rockey
Economist
Global Head of Economic Analysis & Forecasting
Direct: +1 212 841 7508
Mobile: +1 814 360 4858
rebecca.rockey@cushwake.com

Sukhdeep Dhillon
Head of EMEA Forecasting
EMEA Research
Direct: +44 (0) 20 3296 2258
Office: +44 (0) 20 3296 3000
Mobile: +44 (0) 7920 574823
sukhdeep.dhillon@cushwake.com



cushmanwakefield.com

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