Global surge in inflation
Is it here to stay? What should business leaders do?

Ira Kalish and Michael Wolf
We examine the reasons that are driving the recent surge in inflation and offer strategies for businesses to thrive in these uncertain times.

ONE OF THE biggest surprises of 2021 was the sudden and rapid surge in consumer price inflation in most major economies (figure 1). As 2021 came to an end, many global business leaders were wondering whether this signaled the dawn of a new inflationary era or whether the surge is merely a temporary side effect of recovery-related disruptions following the worst of the pandemic. Moreover, the surge in inflation raised questions as to how best to prepare for what might come.

In this article, we examine what has happened with respect to inflation, how and why it happened, likely scenarios going forward, and how businesses can plan under such uncertain circumstances.

**What is inflation?**

Inflation is a general increase in prices that results in a decline in the purchasing power of money. It is not simply a rise in some prices, which merely results in a change in the relative prices of different goods and services. Serious inflation occurs when most prices are rising rapidly at the same time, as happened in many developed economies in the 1970s. Governments measure inflation by examining the prices in a broad basket of goods and services that consumers purchase on a regular basis. The basket is weighted according to how people spend their money.
What causes inflation?

There are several factors that can drive inflation. Nobel Prize–winning economist Milton Friedman wrote, “Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output.” In other words, too many dollars chasing too few goods. However, if the quantity of money rises and people don’t spend it, then it might not be inflationary.

Another factor, which is the source of the current debate, is fiscal policy. If governments borrow and spend money that is otherwise being saved, it can cause the economy to overheat if the planned spending exceeds the difference between actual and potential output. Inflation can also rise due to a depreciating currency, which boosts import prices, and due to rising commodity prices, as happened in the 1970s when the price of oil skyrocketed. Rapid changes in supply and demand conditions that result in shortages and disruption of various parts of major supply chains can also drive inflation.

Finally, inflation is susceptible to and can be exacerbated by market psychology. That is, if people expect high inflation, they will behave in ways that reinforce high inflation—and vice versa. For example, if workers expect high inflation, they will be more likely to demand big wage increases. If businesses expect high inflation, they will be more likely to pass cost increases on to their customers in the form of high prices. And if consumers expect high inflation, they will be more amenable to paying higher prices. Thus, from the perspective of central banks, it is critical to act and communicate in ways that properly anchor expectations of inflation.

Why do we even worry about inflation?

If wages rise in line with inflation, then purchasing power remains unchanged. Therefore, why do we even care about inflation? While the answer to this question could fill several books, here is a brief explanation of why inflation is considered a problem.

First, not all workers have sufficient leverage to obtain wage gains in line with inflation. Thus, inflation often results in shifts in income distribution, with some workers experiencing a decline in real purchasing power while others experience gains.

Second, when inflation is endemic, it creates uncertainty for investors who then require a risk premium to part with their money. Some countries with histories of high inflation have unusually high borrowing costs that, in turn, suppress business investment. This hurts economic growth.

Third, inflation makes it more difficult for consumers to discern price differences, thereby reducing their price sensitivity. That, in turn, reduces the need for businesses to be efficient or to invest in productivity improvements. It is no accident that the inflationary 1970s were a period of low productivity growth.

Periods of high inflation create several challenges for businesses. For one, input costs, including those related to labor and procuring intermediate goods, begin to rise, squeezing profit margins. To offset these higher costs, businesses need to balance raising their own prices with maintaining competitiveness in the market. Higher wages and a tightening labor market lead to increased turnover, forcing firms to redouble efforts to attract and
retain talent. In addition, inflationary environments typically cause central banks to tighten monetary conditions, which raise real interest rates and initially exacerbate the higher costs business face. Tighter monetary conditions also slow economic growth and raise the risk of triggering a recession if the central bank overshoots. Once the central bank has intervened and demand slows, businesses must find ways to cut costs to make up for weaker sales growth.

Still, a little bit of inflation is often seen as greasing the wheels of commerce. Deflation (falling prices), on the other hand, is considered damaging. It results in high inflation-adjusted borrowing costs. In addition, because wages tend to be sticky, deflation results in rising inflation-adjusted wages that can suppress job growth and business profitability.

What happened in 2021?

After a sharp decline in global GDP in 2020 due to the pandemic, 2021 was a year of recovery. The receding of the pandemic, accompanied by the introduction of successful vaccines, led to a rebound in consumer and business demand. Moreover, the US government implemented a massive program of spending (US$1.9 trillion) meant to stimulate economic recovery, in part by handing out cash to millions of households. Although US households saved most of the cash received, the stimulus did contribute to a significant increase in overall spending. However, in the United States and elsewhere, recovery was disproportionately driven by the demand for goods rather than services. After witnessing a sharp decline in 2020, spending on consumer-facing services remained largely suppressed in 2021. Household spending on goods, in contrast, expanded rapidly (figure 2).

FIGURE 2

Spending on consumer-facing services remained suppressed in 2021 while household spending on goods expanded

US consumer spending (index January 2019 = 100)

Source: Bureau of Economic Analysis, accessed via Haver Analytics.
In the United States, real (inflation-adjusted) consumer spending increased 4.4% from February 2020 to November 2021. However, real spending on goods increased 16.2% during the same period, thereby contributing to stress on supply chains. That, in turn, contributed to the relatively high inflation for goods. Meanwhile, real spending on services in the United States remained muted, down 0.8% from February 2020 to November 2021. The numbers in several other countries are not as stark, but the pattern is similar. Thus, there was a global pattern of consumers shifting away from services toward goods, with the United States in the vanguard.

The surge in global demand for goods was a challenge for businesses as they continued to face supply chain disruptions due to the pandemic. The result was a surge in commodity prices, input costs, and the cost of shipping (figure 3). Prices of goods soared, even as prices of services remained relatively muted. The result, in many major economies, was a sharp increase in overall inflation. For example, in the United States, consumer prices were up 6.8% in November 2021 versus a year earlier. However, prices of durable goods were up 14.9% and prices of nondurables were up 10.7%, while prices of services were up only 3.8%. In the United Kingdom, prices of goods were up 6.4% while prices of services were up 3%. In Germany, the figures were 7.9% and 2.9%, respectively. In Canada, the figures were 6.9% and 2.9%.
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**FIGURE 3**

Supply chain disruptions have led to a surge in commodity prices and shipping costs

Bloomberg Commodity Spot Index (January 7, 1991 = 100)

Sources: *Wall Street Journal*, accessed via Haver Analytics, for the Bloomberg Commodity Spot Index; Refinitiv, for the Baltic Dry Index.
Notably, inflation remained relatively muted in much of Asia. However, unusually, the increase in inflation was disproportionately due to the surge in the prices of goods. For example, in Japan, the figures were 1.9% versus −1.8%, respectively (figure 4).

It should be noted that this pattern of surging goods prices and relatively stable prices of services is unusual and runs contrary to what has been prevalent for several decades. During the last major episode of high inflation in the 1970s, prices of goods and services mostly moved together. In the last several decades, it has generally been the case that prices of services increased faster than those of goods. This largely reflected relatively bigger improvements in the productivity of goods production. The current and historically unusual situation simply reflects temporary supply chain disruptions rather than broader factors such as monetary and fiscal stimulus.

The current global surge in inflation will be temporary and will likely abate by the end of 2023. Although the trajectory of inflation will vary by country, and inflation may remain elevated in some countries, the pattern will likely be consistent across most major economies.

FIGURE 4
Prices of goods witnessed a greater increase compared to services in 2021
Inflation for services vs. goods (YoY % change, November 2021)

Notes: *Brazil’s inflation rates are for tradeable and non-tradeable goods, respectively, for goods and services. **Mexico’s numbers exclude the energy sector. ***Calculated using November 2021 relative importance.

Source: National statistical agencies data, accessed via Haver Analytics.
What can we expect going forward?

At Deloitte, our baseline forecast is that the current global surge in inflation will be temporary and will likely abate by the end of 2023. Although the trajectory of inflation will vary by country, and inflation may remain elevated in some countries, the pattern will likely be consistent across most major economies. Our reasoning is that, since the surge in inflation is mostly related to supply chain issues, a likely and gradual resolution of those issues will lead to lower inflation.

On both the demand and supply side of things, we are starting to see some improvements that should, over time, reduce supply chain stress. For example, real consumer spending on goods in the United States has already declined since March. The same is true in the United Kingdom as well as some other countries. Although spending in the United States remains far above the prepandemic level, the current direction of spending is likely to be helpful in alleviating inflationary pressures. Moreover, the withdrawal of monetary and fiscal stimulus is likely to dampen demand in the coming year.

Notably, both monetary and fiscal policy in the United States will be contractionary in the coming year, thereby reducing inflationary pressures. In fact, the US Office of Management and Budget estimates that 2022 will see the largest fiscal contraction since the end of World War II. Thus, while the surge in inflation in 2021 can partly be attributed to a shift in fiscal policy, the reversal of that policy is likely to mean considerably less government support for demand and, consequently, for inflation (figure 5). Outside of the United States, fiscal policy has not been as expansive and, consequently, not as effective in terms of consumer demand and inflationary pressure. However, in many advanced economies, monetary policy is gradually becoming less expansive. This reflects central banks’ recognition of strong underlying growth as well as increased inflation risk.

Additionally, advanced economies have faced significant labor shortages, not least in the United States. This stems in part from a decline in labor force participation and a reduction in cross-border migration. A shortage of labor would normally lead to a surge in wages. Although wages have accelerated, they have not risen sufficiently to drive inflation (figure 6). In fact, in the United States, wage growth has trailed price increases. Thus, so far, a labor shortage has not likely played a role in generating inflation.

Meanwhile, there are indications that supply chain efficiency is starting to improve. For example, industrial production in Japan, Singapore, and South Korea is rising rapidly, especially the production of automobiles, which had been stymied by a shortage of semiconductors. The fact that the industry is starting to revive suggests that shortages are abating. In addition, the cost of shipping containers has fallen from a recent peak, suggesting that transportation bottlenecks are easing. Finally, recent surveys of purchasing managers of manufacturing companies suggest that, although supply chain problems remain significant, they are no longer worsening and may be in fact receding. That is, it could be that a corner has been turned. Specifically, the latest global survey found that, “although price inflation and supply chain pressures remain a constraint on growth, there was better news on these fronts with tentative signs that these headwinds were also past their respective peaks.”
FIGURE 5
Most countries will see a decline in government’s contribution to GDP in 2022
Governments’ budget balance forecasted for 2021 minus the balance in 2022

Source: Oxford Economics.

FIGURE 6
Wages in most major economies have not grown sufficiently to drive inflation
Real wage growth (YoY % change, Q3 2021)

Source: Oxford Economics.
Importantly, investors are evidently comfortable with this scenario. The so-called “breakeven” rate, which is an excellent proxy for bond investor expectations of future inflation, tells an interesting story. On balance, the breakeven rates now suggest that investors expect modest inflation in the coming years (figure 7). Moreover, in the United States, the United Kingdom, and Germany, the five-year breakeven exceeds the 10-year breakeven, indicating that investors expect a short-term surge in inflation followed by lower inflation. What this means is that investors accept the argument made by major central banks that current inflation is temporary and likely to abate as supply chain problems diminish. Of course, investors could be wrong.

For a discussion of alternative inflation scenarios, as well as the implications for business, see The inflation outlook: Four futures for US inflation.

Inflation outlook for major economies

Here are comments from some of our regional economists:

- For the United States, we expect that average consumer price inflation will decline from 4.7% in 2021 to 4.2% in 2022. Consumer demand for goods will ease and supply chain difficulties will diminish. Monetary policy will gradually tighten, and fiscal policy will be dramatically less expansionary than in 2021, with a substantial decline in the fiscal deficit. The labor market will remain tight, but labor force participation will gradually improve—provided that the virus begins to recede.

- In the United Kingdom, inflation is likely to ease by next year. Growing capacity and the exhaustion of pent-up demand will bring supply and demand into better balance, thereby reducing inflationary pressures. Some idiosyncratic, COVID-19–fuelled price surges, such as for haircuts, have eased—in time, many more will. Also, after last year’s increases, year-on-year commodity price inflation will ease, helped partly by a softening in Chinese growth relative to trend. Arithmetically, this will dampen inflation. Finally, broad money growth has collapsed after the explosion in 2020–21, thereby reducing a potential source of inflation.

- In Germany, inflation will probably recede in 2022, because some important base effects will disappear (especially the reversal of the German value-added tax cut) and supply chains should work more smoothly, at least in the second half of the year. Also, falling shipping costs might lower inflation. However, it is unlikely that inflation will fall to its prepandemic level. According to a Deloitte survey, European CFOs expect an inflation rate of 2.7% for 2022.

Meanwhile, medium-term inflation pressures are likely to rise for three reasons. First, current inflation increases will find their way into next years’ collective bargaining rounds. Second, given the

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**Figure 7**

Current breakeven rates point to modest inflation in the medium term

Breakeven rates (December 2021)

<table>
<thead>
<tr>
<th>Country</th>
<th>5-year</th>
<th>10-year</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>3.0%</td>
<td>2.5%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>4.5%</td>
<td>4.0%</td>
</tr>
<tr>
<td>Germany</td>
<td>2.5%</td>
<td>2.0%</td>
</tr>
</tbody>
</table>

Sources: Bank of England; US Federal Reserve Board; Deutsche Bundesbank, all accessed via Haver Analytics.
transformation of the energy system toward climate neutrality, energy prices are likely to keep on rising. Third, current labor shortages are likely to intensify as demographic change sets in. The Eurozone, and Germany in particular, is faced with a declining workforce in the years to come.

• In Canada, supply chain constraints and energy prices that are pressuring inflation are expected to continue in the first half of 2022 before easing back a bit. We expect inflation to be at 3.7% in 2022, which is still higher than the target set by the Bank of Canada. Inflation should eventually slow down with the Bank of Canada raising its policy rate amid less pressure from the supply side and from gasoline prices. However, we do not expect inflation to reach its 2% target before the end of 2023.

What should businesses do?

Several strategies will be useful regardless of how inflation evolves. Creating ways to lower costs and reduce disruptions to operations are almost always good ideas. For example, given that interest rates remain incredibly low in most major economies, rebalancing portfolios and locking in at today’s cost of capital can prevent higher financing costs as interest rate variability rises with the persistence of inflation. In addition, building a well-diversified and resilient supply chain today will help minimize future disruptions when more bottlenecks appear in the supply chain. However, the cost of building resilience in the supply chain must be consistent with the risk to operations. Although high labor turnover is often associated with high-inflation environments, it can occur under other scenarios as well. Investing in systems such as training capabilities, talent pipelines, and labor-saving automation can smooth operations during such periods. Developing the internal capability to monitor how external economic factors and internal KPIs are evolving will allow businesses to take more decisive action to deal with changes in the inflationary environment.

In high-inflation environments, businesses should consider other strategies as well. The higher costs and slower growth associated with inflationary periods make cost reduction more important. For example, locking in supply prices or becoming more vertically integrated may be necessary to avoid higher input costs. In addition, using labor as a service or offshore labor can limit wage costs. Higher interest rates should warrant a move to shorter-term debt obligations to avoid higher financing costs when rates eventually fall again. Similarly, a reduction in accounts receivable and an increase in accounts payable will minimize revenue lost to inflation and real (inflation-adjusted) costs to suppliers and contractors. High inflation may also warrant building price inflators into long-term contracts and raising prices in step with inflation rates. More aggressive acquisitions should be considered to reduce costs or gain market share.

Conclusion

As 2022 begins, inflation is top of mind for business leaders, political leaders, central bankers, investors, and ordinary consumers. This was not true just a year ago. Things have changed very quickly. The question now is whether they will change quickly yet again. In this article, we have offered a perspective on how things might unfold in the coming year and beyond. We have also offered some actions and strategies that businesses can utilize to plan for the future and minimize disruption. Nevertheless, the reality is that the degree of uncertainty remains very high, and it will likely continue to remain high, at least for a while. The challenge for business leaders will be to manage this uncertainty in a way that allows their businesses to thrive.
Endnotes


18. Data from Japan Ministry of Economy, Trade, and Industry; Department of Statistics Singapore; and Statistics Korea.


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