Medium-term inflation outlook: Is the world heading for a “regime shift” after almost four decades of low inflation?

Inflation has been challenging since the economic recovery from the COVID-19 recession started in late 2020. Record-high levels of inflation rates have not only become a burden to consumers, financial markets and central banks, but also affected (re)insurers’ profits given substantial underestimation taking place in 2021 and 2022. Therefore, focussing on the medium-term inflation outlook is highly relevant from a (re)insurer’s perspective. In the following, we provide an assessment.

Inflation on decline, but towards what levels in 2025 and beyond?

Over the last two years, advanced economies have been experiencing a period of record-high inflation, with CPI inflation rates rising to peak levels not seen for at least 40 years (see fig. 1). In some countries, e.g. in Germany, price changes were the strongest since the 1950s. Inflation dynamics had been strongly affected by two major crises occurring in quick succession, i.e. the COVID-19 pandemic (with severe global supply chain problems as well as strong economic policy reaction, especially massive fiscal stimulus) and Russia’s invasion of Ukraine with its shock effects on energy and commodity prices. The distortions this brought to both goods and services markets and the huge imbalances between supply and demand have been at the root of the current inflation problem.

Inflation numbers in general have been declining now since late 2022, driven by both normalising supply conditions and overall weaker demand, as well as lower energy prices. However, both the short-term and the longer-term outlook remain affected by major uncertainties. While there is a broad consensus that CPI inflation in 2024 will on average be lower than in 2023 (see fig. 2 for our current forecast), this outlook is fraught with risks, ranging from a renewed energy price surge or continued high wage increases (resulting in higher than expected inflation) to a potential recession (which could drive inflation even lower than anticipated). In any case, it is very likely that 2024 will be yet another year where annual average inflation still exceeds target levels set by central banks. Robust labour markets and strong wage growth despite monetary tightening are a major driver for this expected outcome.

Although we assume that the shock effects to inflation will level off over the next 12-18 months, current uncertainties in the inflation environment could also be driven by a potential change in underlying, structural drivers of the world economy. The period of low inflation over the last 40 years was marked by “structural

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**Fig. 1:** CPI inflation, average of G7 economies, 1971-2023 (monthly data, y-o-y in %)

**Fig. 2:** Annual average CPI inflation, G7 economies, 2019-2024 (in %)
disinflation”, as globalisation, demographics, digitalisation and deregulation all helped to shift inflation lower. In addition, central banks became more independent from governments and became more effective in maintaining price stability.

These drivers could be about to change now. First, as geopolitical conflicts, above all between the US and China, are intensifying, globalisation with its disinflationary effects has likely come to an end and could reverse, leading to higher inflation. Second, demographic change and especially the ageing of Western societies is expected to cause continued shortages in labour markets, a potentially inflation-lifting effect at least over the medium term. Third, an era of market deregulation that increased competition and drove down prices is now likely to be followed by re-regulation, thereby also contributing to higher inflation. Fourth, among past drivers of disinflation, only digitisation and automation will likely continue to exhibit inflation-dampening effects. In addition, decarbonisation and the transformation to net-zero economies are expected to affect inflation as well, especially as carbon pricing will make fossil-fuel intensive products more expensive over the coming years. Only in the longer term, i.e. when the benefits of low-price renewable energy sources can be reaped, will inflation-dampening effects play out.

Overall, this argues for an upwards drift in inflation rates over the next years (see tab. 1). However, the strength of this shift is hard to quantify. Only in some cases, e.g. with regard to globalisation, useful estimates of past disinflationary effects do exist. Assuming a reversion of historical trends can then help to derive an assessment of expected future inflation effects. For the other drivers, though, there are no reasonable estimates available. Assessing future inflation thus should be built on scenarios. In our view, there are two relevant scenarios to consider.

**Two scenarios for the medium-term inflation outlook**

Acknowledging that future inflation rates on average will quite likely be higher than historical levels leads to the question of the consequences for monetary policy in particular and economic policies more broadly. Will major central banks come under pressure to raise their inflation targets? Even if, as described above, structural drivers are predominantly pointing to upwards pressure on CPI inflation, their combined quantitative effect could still remain limited. This could be the case since some of these inflationary forces (e.g. decarbonisation) might need a longer time horizon to play out or because there are mitigating effects as well (e.g. trade diversion reducing the inflationary impact of less globalisation).

Thus, in our first scenario, we assume that the quantitative impact of structural changes would only be moderate, even though average inflation over 2025-2030 would still be slightly above the 2% level that most central banks use a target – and in any case be higher than before 2020 (see fig. 3). CPI inflation rates would come down further in 2025 and at least temporarily fall below 2%, driven by the delayed effects of current monetary policy tightening and continued weak economic growth. However, given that we are likely to remain in an environment of elevated uncertainties (not only but predominantly driven by geopolitical uncertainties), macroeconomic volatility could stay high as well, thus inducing ups and downs of inflation in the years thereafter. Under these conditions and assuming that CPI inflation would not move too high again, central banks could still argue that their targets remained within reach – without risking their credibility to be questioned or any need for fundamentally changing the monetary policy setup.

In the second scenario, the structural changes are assumed to have stronger quantitative effects. CPI inflation would then be even more elevated and could reach levels of around 3% on average over 2025-2030 in our view (see fig. 3). Central banks would be in a more challenging environment under this scenario, as prolonged above 2% inflation rates could lead to concerns on financial markets as well as in the broader public about central banks’ credibility. As a consequence, risks premiums – and thus yields – of longer-term bonds could then
move upwards, implying continued elevated borrowing costs. In addition, inflation expectations of households and firms could shift upwards as well, which would further entrench inflation at higher levels. Under these circumstances, it would be a tough job for central banks to convincingly communicate potential changes in their monetary policy frameworks. Adjusting inflation targets upwards to align them with a changed inflation reality would then be an option.

As the first scenario is in line with the predominant view among macroeconomic forecasters, i.e. that medium-term CPI inflation will be close to 2%, we use it as our baseline scenario. Our current forecast of 2.1% average inflation in 2025-2030 for the G7 economies fits into this perspective. It should be noted again, though, that even in this case inflation would clearly be above levels seen during the last decade (2011-2020: 1.4% p.a.).

However, it is important to note that the second “elevated inflation” scenario has a reasonable likelihood – in our view of roughly 30% – and thus should not be considered a tail risk. (Re)insurers should therefore be prepared for the risk of a prolonged period of higher inflation, which, if realised, would affect long-tail lines of business in particular. Of course, other scenarios than those mentioned above could play out as well, including a return to (very) low inflation rates – which in our view is much less likely than a scenario of ~3% inflation –, but also including a broader economic crisis that would lead to even higher (and potentially much higher) inflation rates.

Constantly assessing inflation risks thus remains a key task for economists. This e.g. implies to look for indications which structural changes – and at what speed and strength – will play out in the coming years, and use this to update inflation forecasts. It also refers to monitoring central bank actions and communications, as monetary policy will remain a very decisive factor for the inflation outlook.