THE CURRENT INFLATIONARY SPIRAL:
WHAT'S DRIVING IT?

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This is part two of a three-part series examining inflation and its impact on insurers.

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Jon has provided testimony, authored dozens of comment letters and position papers, and successfully advocated in front of numerous regulatory and standard-setting bodies, such as the National Association of Insurance Commissioners, the International Association of Insurance Supervisors, and the Financial Accounting Standards Board.

Jon began his career at NAMIC as a staff accountant and has developed a passion for implementing innovative ideas and finding better methods to help streamline critical processes and improve efficiencies for the members he serves.

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The National Association of Mutual Insurance Companies consists of more than 1,500 member companies, including seven of the top 10 property/casualty insurers in the United States. NAMIC member companies write $357 billion in annual premiums and represent 69 percent of homeowners, 56 percent of automobile, and 31 percent of the business insurance markets.

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As we moved through 2022, it became increasingly clear the inflationary pressures seen in 2020 and 2021 had settled in for an extended stay. Consumers and businesses scrambled to compensate for skyrocketing costs and inflation levels not seen since the early 1980s. Analysts and commentators warned that the "zero inflation" era seen over the previous decade had come to an end. Now, with some signs suggesting that inflationary pressures have somewhat stabilized for many sectors of the market, it's instructive to examine what's been driving them.

UNANTICIPATED "SHOCK" EVENTS – COVID AND UKRAINE

COVID's 2020 sting left many Americans either unable due to governmental lockdowns or restrictions or unwilling because of varying individual perceptions of risk to purchase services. In contrast, consumer demand for goods soared, driven by work from home, the desire for personal comfort, and an abundance of disposable income saved by not consuming services or in-person entertainment. Into the mix came the Federal Reserve in 2020, slashing its policy rate from 2.25% to zero and a massive fiscal stimulus package from Congress and the Trump administration. By mid-2020, real disposable income had expanded on a four-quarter basis at a mid-teens rate while real gross domestic product contracted. Never had this country given itself so much more than it had produced, in turn dislodging a long-term trend of subdued goods prices caused by globalization and technological advances.[1]

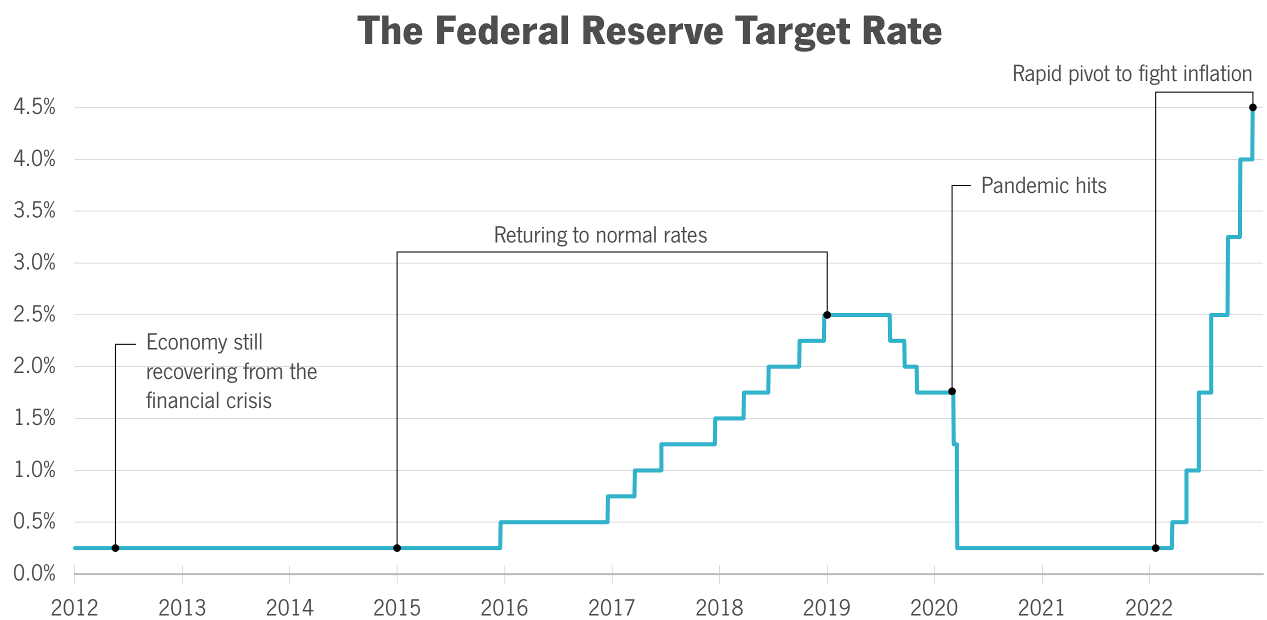
Through 2021 many held the view that as the pandemic subsided, inflation would prove transitory, with Federal Reserve Chair Jerome Powell commenting that "[t]here is little reason to think" that global deflationary forces "have suddenly reversed or abated."[2]

Russia's February 2022 invasion of Ukraine obliterated that prevailing view. Supplies of energy and specialized goods were disrupted, and commodity prices nudged upward. Economic sanctions further tangled already-stressed supply chains. The net result? Higher demand for goods with lower, and more costly, supply.[3]

THE FEDERAL RESERVE

In mid-December 2022, the Federal Reserve approved an interest rate increase of 0.5 percentage point while signaling plans to lift rates in smaller increments through the spring as it works to combat inflation.[4] The announcement followed four consecutive larger increases and raised the federal funds rate to a range between 4.25% and 4.5%, a 15-year high.[5] Considered one of the most important interest rates in the U.S. economy, the federal funds rate influences short-term interest rates for everything from home loans to credit cards.[6]

[1] https://www.wsj.com/articles/inflation-2022-what-happens-next-11670867683
[2] https://www.wsj.com/articles/powell-says-fed-could-start-scaling-back-stimulus-this-year-11630072789?mod=article_inline
[3] https://www.wsj.com/articles/inflation-2022-what-happens-next-11670867683
[4] https://www.wsj.com/articles/fed-raises-rate-by-0-5-percentage-point-signals-more-increases-likely-11671044561?mod=economy_more_pos23
[5] Ibid.
[6] https://www.investopedia.com/terms/f/federalfundsrate.asp



Note: Show the midpoint of the federal-funds target range since 2012
Source: Federal Reserve

Analysts posit that the smaller future increase reflects the Fed's belief that the heavy lifting necessary to mitigate inflation's initial sting has taken hold, that future private-sector spending will be restrained, and that it will be able to steer the economy toward its stated dual goals: keeping inflation at 2% annually and maintaining maximum employment. However, quelling inflation carries the risk of teetering the economy toward recession. Cutting rates too soon once unemployment rises risks a repeat of the Fed's "stop-and-go" tightening of the 1970s, which resulted in prolonged inflation coupled with high unemployment and gave rise to the dramatic Fed rate increases of the early 1980s.[7]

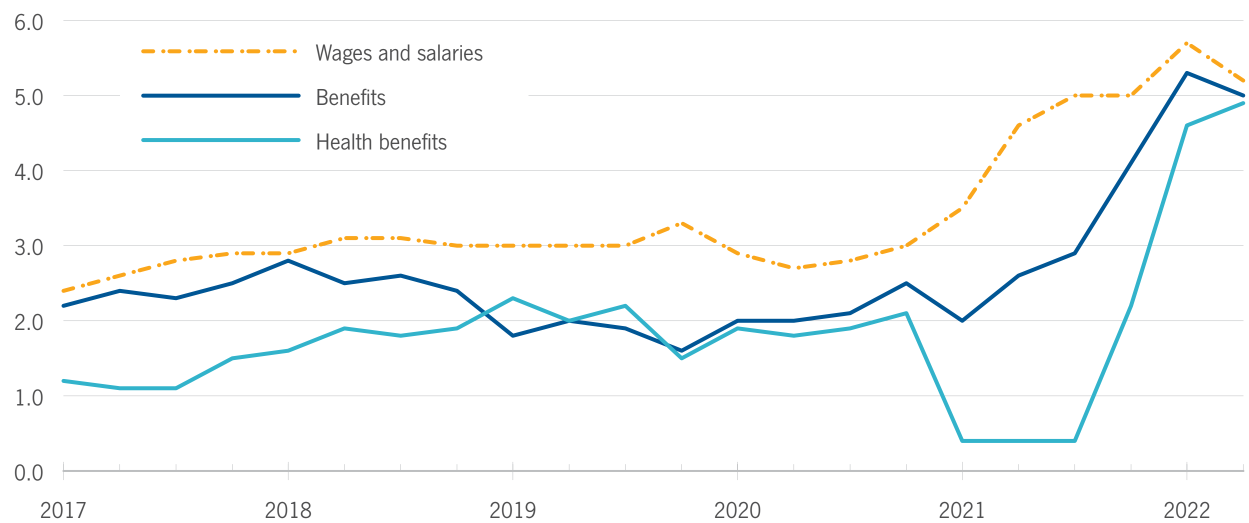
Above all these concerns is another reality: Because inflation data lags behind economic activity, by raising rates too high, the Fed may end up weakening the economy more than anticipated.[8]

[7] https://www.wsj.com/articles/powell-federal-reserve-interest-rates-inflation-11670859520
[8] https://www.wsj.com/articles/for-the-fed-easing-too-soon-risks-repeat-of-stop-and-go-1970s-11657454403

WAGE PRESSURES

With inflation has come a concomitant increase in wages and salaries. According to the Bureau of Labor Statistics, compensation costs for private industry workers increased 4.1% in September 2021 and 5.2% for the 12-month period ending in September 2022.[9] The insurance industry saw an increase of 5.0% in September 2021 and 3.0% in September 2022.[10]

12 Month Percent Change, Current Dollar, Private Industry Workers



Source: https://www.bls.gov/news.release/pdf/eci.pdf

With looming uncertainty as to if and when inflationary pressures might subside, wage increases appear likely to continue for the private and public sectors. For example, the National Association of Insurance Commissioners recently adopted a recommended 8.5% increase in salary recommendations for key insurance department staff, on top of the 4.5% increase recommendation for 2021.[11]

	2018	2019	2020	2021	2022
As Published in "Financial Condition Examiners Handbook"	3.00%	2.00%	1.00%	4.50%	*8.50%
As Published by BLS	2.95%	1.53%	0.99%	5.37%	8.52%
Difference	0.05%	0.47%	0.01%	0.87%	0.02%

**Suggested change*

[9] https://www.bls.gov/news.release/pdf/eci.pdf
[10] Ibid.
[11] https://content.naic.org/sites/default/files/call_materials/Risk-FocusedSurveillanceWG_11-1_Materials.pdf

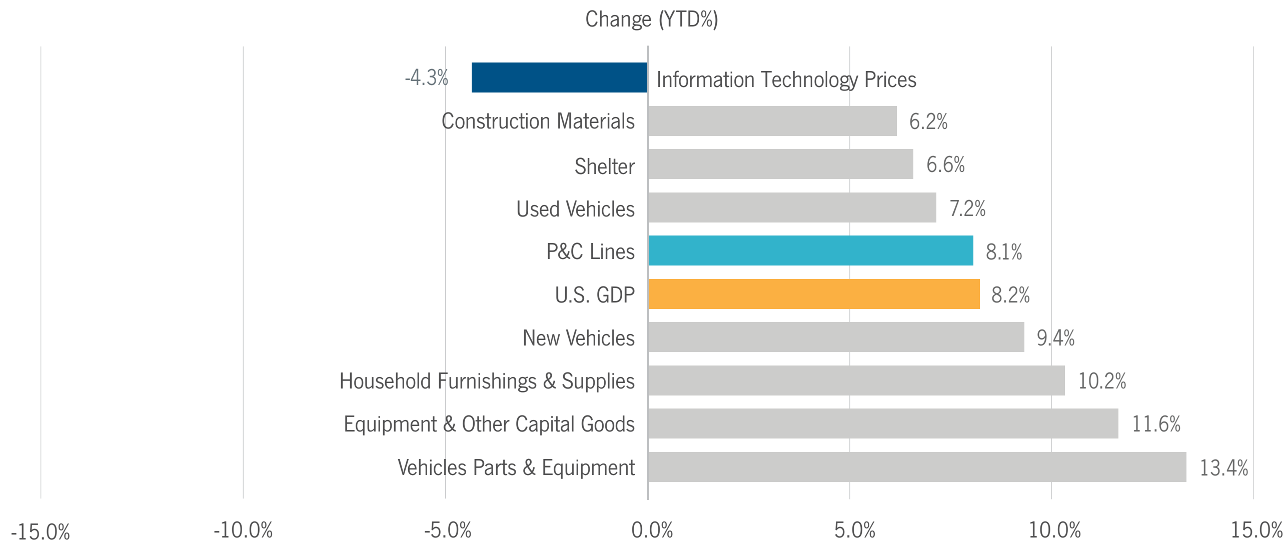
IMPACT ON THE INSURANCE INDUSTRY

More and more individuals and businesses are being impacted by natural catastrophes due in part to sharp increases in populations in areas prone to hurricanes and wildfires. This presents many challenges and opportunities for the insurance industry. Social inflation, too, has added increased pressure on the industry in recent years. Inflation adds to the industry's woes. A recent McKinsey study estimates that in 2021, rising prices contributed roughly an additional $30 billion in loss costs beyond historical loss trends.[12]

There's some thought that increased loss costs may be the norm going forward, with the Insurance Information Institute (III) suggesting that while auto prices and construction materials have come down from pandemic highs, and supply chains show signs of stabilizing, labor costs remain elevated. Moreover, the III warns that we could see a return of stagflation, characterized by low or negative growth coupled with high inflation, in turn depreciating asset values without any growth upside.[13]

What does stagflation mean for the insurance industry? It potentially can impact both sides of the balance sheet and put pressure on insurer profitability. Product lines like homeowners and auto would be impacted by rising prices in construction and car parts, while asset values and capital levels would also be negatively impacted due to potentially lower equity markets and widening credit spreads.

Inflation Key CPI Components 2021–2022



Source: https://economics.iii.org/pdfs/TripleIOutlook-2022-Q4.pdf

[12] https://content.naic.org/sites/default/files/call_materials/Risk-FocusedSurveillanceWG_11-1_Materials.pdf
[13] https://economics.iii.org/pdfs/TripleIOutlook-2022-Q4.pdf

THE FUTURE

There exist divergent views as to what the economic future might hold. The most optimistic view has it that food, energy, and commodity prices stabilize and that inflation recedes in 2023.[14] Another is that the lasting effects from COVID-inspired lockdowns continue to hamper economic well-being, which, when combined with a possibly protracted Eastern European conflict, fuels ongoing inflation. This scenario may cause the Fed to hike rates to a degree that could risk triggering a significant economic contraction, especially if the rate increases are done too swiftly.[15] Still another – and less likely – view is that pandemic- and conflict-related disruptions drive global energy and commodity prices higher so as to cause longer-term elevated inflation beyond the Fed's control, in the process ushering in an era of 1970s-style stagflation.[16]

Forecasts of this type are uncertain, especially in the context of the current unique global economic conditions, related policy responses, and other complex factors. Despite a myriad of challenges the insurance industry – with its risk management and forward-looking mindset – will continue to navigate to support and protect policyholders, meeting the challenges ahead.

[14] https://www.mckinsey.com/~/media/mckinsey/industries/financial%20services/our%20insights/countering%20inflation%20how%20p%20and%20c%20insurers%20can%20build%20resilience/countering-inflation-how-us-p-and-c-insurers-can-build-resilience.pdf?shouldIndex=false

[15] Ibid.

[16] Ibid.

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