INFLATION - "THE NUMBER 1 ENEMY" AND ITS CONSEQUENCES FOR THE EUROPEAN ECONOMY

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Abstract: *With the pandemic abating and the prospect of further lockdown episodes fading, the whole world was looking forward to the strong recovery predicted for 2022. In addition to economic growth, forecasts were generally agreed that inflation, which had risen in the previous months, would begin to fall as the basic effects of the short period of deflation of the pandemic. Not only, for a number of reasons, were these expectations not fully fulfilled, but February 2022 pushed events in a totally unexpected direction, ushering in an era of difficulties of an unprecedented complexity in the last decades of European history . While the direct consequences of the war in Ukraine on the insurance industry remain rather minor, the indirect consequences, such as volatility in capital markets or weaker growth prospects, weigh much more heavily. Among these, the galloping inflation that has hit all the world's economies is "Enemy No. 1" on a global scale, its impact on the insurance business being complex and substantial.*

Key words*: inflation, economy, insurance, energy crisis, cost*

INTRODUCTION

Inflation is a major imbalance present in the economy of any country, represented by a generalized increase in prices and the simultaneous decrease in the purchasing power of the national currency. Inflation is a final indicator, which shows at the end of the fiscal year whether the government's monetary, fiscal, legislative, etc. policies, along with the policies of the Central Bank, coordinate and lead to a stability of consumer prices. [2]

High and prolonged inflation is often the consequence of loose monetary policy. If the money supply increases transactions too much in relation to the volume of activities carried out in the economy, the value of a monetary unit decreases; in other words, the purchasing power of the currency decreases and prices rise. This relationship between the money supply and the size of the economy is extensively explained by the quantity theory of money, which is one of the oldest economic theories. Other causes of inflation are supply and demand variations. Supply-side shocks disrupt production (natural disasters) or increase costs (rising oil prices) and thereby reduce aggregate supply, causing "cost-push inflation". [1]

The main causes of inflation are: currency inflation (the excessive issuance of currency over the real supply of goods and services); inflation by demand (the excess of aggregate demand over aggregate supply); cost inflation (increase in production costs, independent of aggregate demand); imported inflation; inflation through structures. [14]

If the nominal income of families, which in modern economies is expressed and realized in monetary form, rises more slowly than prices rise, the economic situation of the population worsens, because it can afford to buy fewer goods and services. In other words, the purchasing power or real income of the population – nominal income adjusted for inflation – falls. However, real income is a quantitative indicator that provides information about the standard of living (proxy indicator): when real income increases, the standard of living increases - and vice versa. [9]

Prices often fluctuate due to a variety of factors like supply and demand, inflation, global events, and technological advances. [4]

The annual inflation rate in the EU reached the historical level in 2022, the highest level ever recorded, and tripled compared to 2021, when the annual value was 2.9%, according to the data analyzed for the study.[10]

Following data collected and centralized from international databases, in the case of the EU, the highest price increases in 2022 were recorded in the housing, water, electricity, natural gas and other fuels category, with an average increase of 18%.[8]

This is followed by transport prices, which registered an average increase of 12.1%, while the prices of food and non-alcoholic beverages increased by 11.9%.

All other product categories registered increases between 2% and 8.1% in 2022, except for the price of communications, which decreased by 0.1%. [14]

The year 2022 represented a turning point, the outlook for inflation changed suddenly, as the economy was simultaneously affected by two types of shocks. First, the euro area has been subject to an unprecedented series of negative supply shocks caused by pandemic disruptions in supply chains, Russia's unjustified invasion of Ukraine, and the ensuing energy crisis.[13]

These developments have led to significant increases in production costs in all sectors of the economy.

Second, the post-pandemic reopening of the economy generated a positive demand shock that allowed firms to pass on cost increases in prices at a much faster and more robust pace than in the past.[12]

The situation is also difficult when it comes to the field of insurance. There are several risk factors at play and they influence each other. What we know from the pandemic is that insurers have both the space and the toolset to get through the tough times, and they are doing so against the backdrop of a very robust regulatory system that we are determined to keep relevant and up-to-date. [16]

With interest rates already significantly higher and signs of recession visible, there is a growing consensus that inflation will soon peak.

MATERIALS AND METHODS

To carry out this study, the authors documented themselves and consulted many specialized books, consulted Eurostat databases, current financial reports, consulted and extracted data from the International Monetary Fund, but we also consulted various scientific works in this field very important and current. All data were extracted exclusively for the Euro area under study, EU data for the analyzed topic. [2,3,5]

Data collection was quite a difficult process, but in the end it was possible to create a database necessary for this study. After collecting this data, it was necessary to centralize it and analyze it thoroughly. After the analysis, the data were highlighted graphically, and at the end we were able to present some conclusions. [1.7]

RESEARCH RESULTS

Throughout 2021, many of the world's economies have maintained a positive trend, registering increasingly higher growth rates and tending towards the recovery of GDP levels from before the Covid pandemic. [11]

Fiscal and monetary stimulus provided in 2020 and 2021 by governments and central banks in response to the pandemic helped the economic recovery, but also laid the foundations for an inflationary trend that worsened continuously in the second half of the year. [9]

The increase in demand for goods, amid the recovery from the recession and the recovery of the labor market, has put pressure on supply flows already weakened by the restrictions imposed by the pandemic.

The imbalance created between demand and supply was, in fact, a strong factor for amplifying the inflationary trend. [15]

Even without the impact of the conflict in Ukraine, the increase in inflation was inevitable, but the increase in fuel and energy prices, which became very visible in Q3 2021, accelerated the phenomenon, so that inflation rates reached unprecedented values in recent decades in 2022 (Figure 1.).[10]

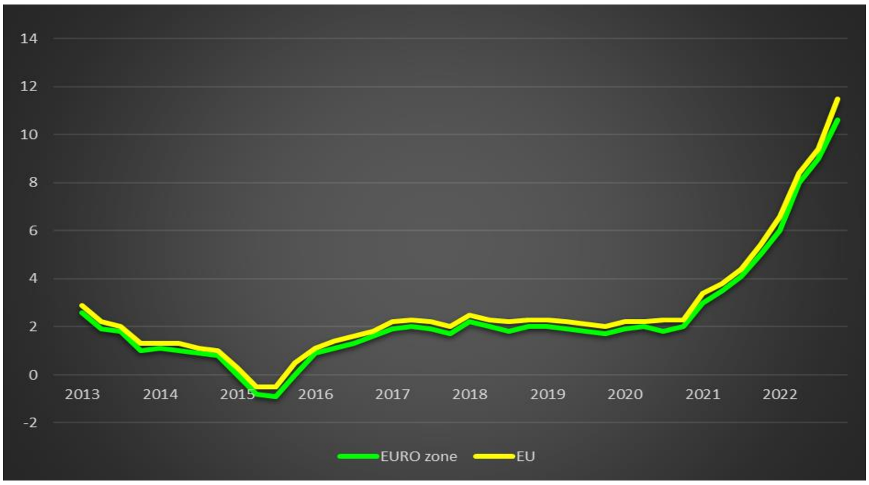

Figure 1. The evolution of the annual inflation rate (%) in the period 2013-2022

Source: Authors' processing according to Eurostat [7]

According to data provided by the EC (European Commission) database, Eurostat, the annual inflation rate across the European Union was 11.5% in October 2022, up from 10.9% in September and 4.4% the previous year. [7, 19]

For the Eurozone, the value of the indicator was 10.6% in October 2022, up from 9.9% in September and 4.1% a year ago.

These figures reflect reaching an all-time high for the period since the introduction of the single European currency. The lowest annual rates were recorded in France (7.1%), Spain (7.3%) and Malta (7.4%), while the highest values were recorded in Estonia (22.5%), Lithuania (22.1%) and Hungary (21.9%) (Figure 2). [12]

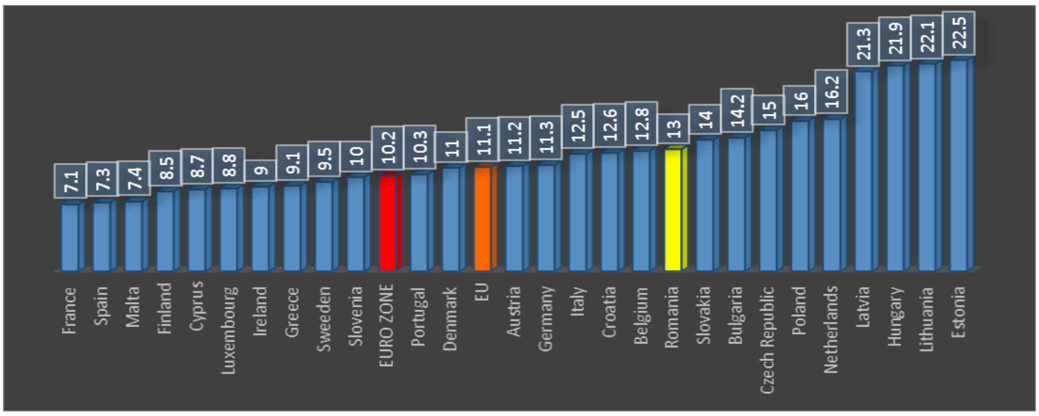

Figure 2. Annual inflation rate in European countries - October 2022 (%)

Source: Authors' processing according to Eurostat [7]

Compared to September, annual inflation fell in 11 Member States, remained stable in 3 and rose in 13. In October, the biggest contributor to the euro area's annual inflation rate came from energy (+4.44 percentage points, pp), followed by food, alcohol and tobacco (+2.74 pp), services (+1 .82 pp) and non-energy industrial goods (+1.62 pp). [13]

According to data recently published by the International Monetary Fund (IMF), about half of the increase in core inflation in Europe remains unexplained by traditional growth factors (Figure 3, 4).

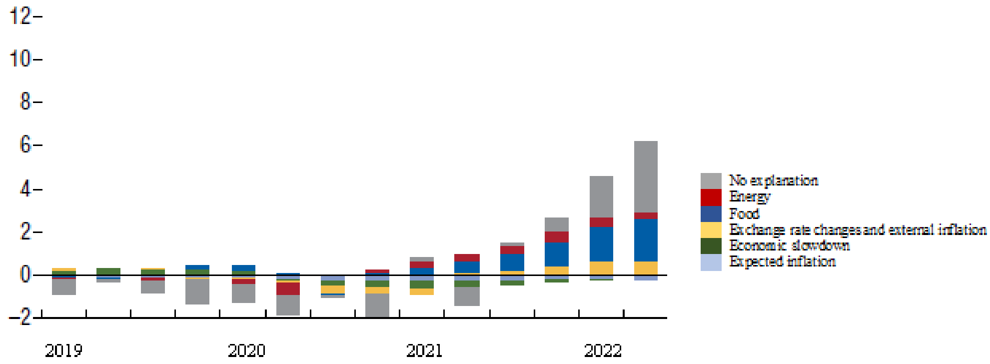

Figure 3. The unexplained inflation. Core inflation in advanced European economies
Source: Authors' processing based on IMF data, 20.01.2024 [9,10]

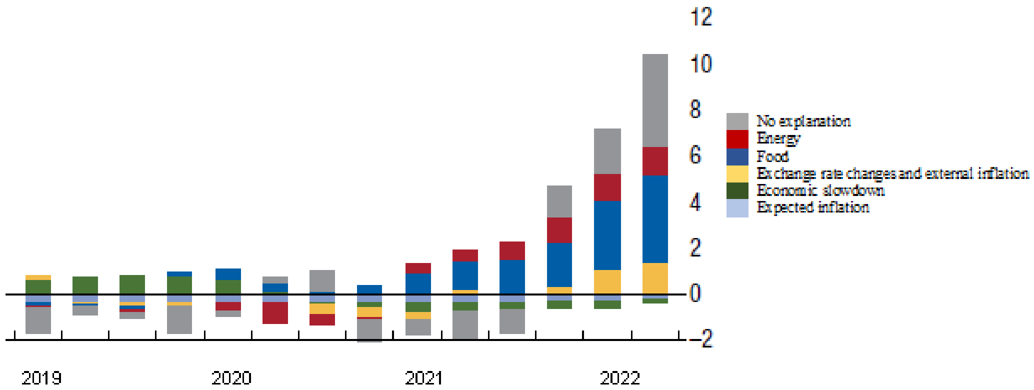

Figure 4. The unexplained inflation. Core inflation in emerging European economies
Source: Authors' processing based on IMF data 20.01.2024 [9,10]

This suggests that there may be less economic fragility and, consequently, more underlying inflationary pressures than is commonly believed in Europe, meaning that there is a risk that analysts' expectations of seeing inflation ease in 2023 to be refuted.

European policymakers are faced with the need for tough trade-offs and difficult policy choices, managing a toxic mix of weak growth and high inflation that could worsen.

The solution could lie in a mix between tightening macroeconomic policies to reduce inflation and measures to support vulnerable households and viable firms to cope with the energy crisis. At the same time, given the extremely high volatility, the governors should be prepared to adjust policies in both directions in response to how the situation evolves. What these adjustments will look like depends on what the incoming data will indicate: higher inflation, a deepening recession – which would warrant some policy reconsideration – or both. [3,18]

According to the latest World Economic Outlook issued by the IMF, Europe's advanced economies will grow by just 0.6%, while emerging economies (excluding Turkey and countries in conflict, Belarus, Russia, Ukraine) will expand by 1.7%, both figures reflecting a significant worsening of expectations for next year. This winter, more than half of eurozone countries will experience technical recessions, with at least two consecutive quarters of declining output. [9,10,17]

Croatia, Poland and Romania will follow a similar trend. From this perspective, it is relevant that in the emerging economies of Central and Eastern Europe the contribution of the energy and food-alcohol-tobacco segments to the increase in inflation is noticeably higher than in the advanced economies. Coupled with the much higher share of this type of expenditure in the household budget, this fact leads to a visible increase in the risk of impoverishment of the population, which can accentuate the decrease in domestic demand and increase the risk of recession.[8]

As for inflation, although the phenomenon is expected to moderate next year, it will remain significantly above the central bank's targets, at around 6% and 12%, respectively, in advanced and emerging European economies. The reality could be even worse in a scenario that would combine a total shutdown of Russian natural gas supplies with a cold winter that would require further energy rationing, resulting in a deepening recession and a possible worsening of the inflationary trend. Even if such a pessimistic scenario does not materialize, inflation could remain elevated for a longer time.[12]

Most of the rise in inflation so far is driven by high commodity prices – primarily energy, but also food, especially in the Western Balkans. While these prices may remain high for some time, there is hope that they will stop rising and thus contribute to a steady decline in inflation throughout 2023 (Figure 5).[15]

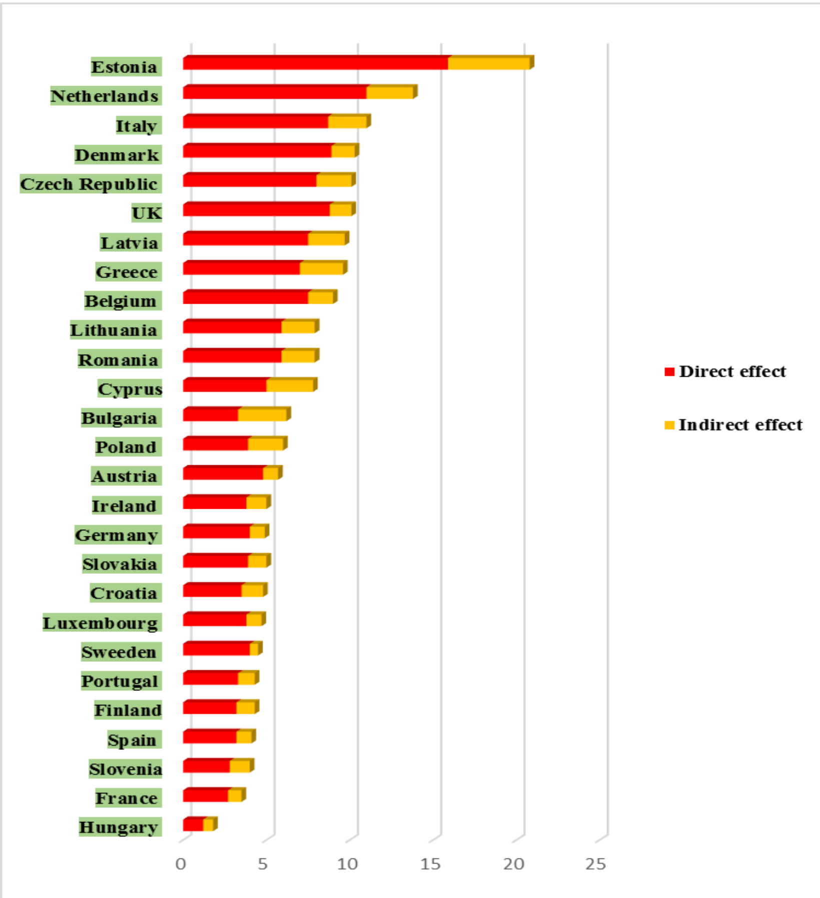

Figure 5. The increase in the cost of living caused by the energy crisis in 2022 (percentage of the average basket/household)

Source: Authors' processing based on IMF data, 25.02.2024 [9, 10]

Inflation and insurance

If inflation has been defined as Enemy No. 1 in the re/insurance business as well, it is the result of the complex impact it has on the economics of the insurance business.

Claims inflation is probably the factor with the most significant impact on insurance. The increase in claims costs is primarily due to the increase in the cost of repairs, materials and labor, as well as the increase in the cost of third-party liability for property damage.[2]

Inflation raises both the value of property damages and the amount of damages awarded in court cases or compensation for loss of income as wages rise. It also increases the cost of legal and other services, rescue and recovery costs in personal injury cases, and most other costs involved in processing a claim.[6]

Last but not least, the cost of medical care is increasing for those who need ongoing care after an accident. The result of combining all these factors is an escalation of insurers' expenses with claims paid, but also a necessary increase in claims reserves and a change in the risk transfer policy to the reinsurance sector, in the sense of ceding a higher share of premiums in reinsurance. This last element puts additional pressure on the available reinsurance capacity, leading to a tightening of reinsurance conditions, including its price. [5,9]

Ultimately, in order to keep operations sustainable, all these increased costs feed back into increasing the level of insurance premiums paid by direct customers. It is easy to imagine that, face to face with customers whose financial resources are affected by the increase in the cost of all products and services, the "expensive" insurance is a little popular.[13]

In this equation, insurance companies are obliged to look for solutions that mitigate "premium inflation" as much as possible. Digital technologies gain increased relevance in this context, offering either the possibility of reducing operating costs or of better risk control. The current reality shows that the price of car insurance has already seen significant increases in many markets. In the US, official statistics show an increase in the average price for car insurance by around 12.9% over the past 12 months. In Europe, the phenomenon has already been felt quite strongly in Great Britain, where the average premium for car insurance has increased by around 14% in the last year, but it is also visible in other markets of the European Union. In Italy, the average RCA premium increased by 18.12% in October 2022 compared to April 2022. [6]

Reported to October 2021, the increase was even 24.20%. In CEE markets, the phenomenon manifests itself somewhat more timidly, being tempered to a certain extent by intense competition in the car insurance market and by the pressure exerted by much weaker local purchasing power. Even so, the trend was clear, especially since in some markets of the region, such as Poland, the impact of inflation was amplified by changes of a legislative nature, which led to additional increases in claims expenses. In the Czech Republic, the increase AIL (Auto Civil Liability) rates was 6-7%, while the costs of spare parts and repair labor also increased by 20-30% compared to the beginning of the year. [9,10]

Poland is also expecting massive insurance price increases, especially in early 2023, especially following the introduction of new motor insurance claims settlement rules, which could lead to claims inflation of up to 19-27 % in the first quarter of next year.

Faced with inflationary pressure and having to maintain an acceptable price level for local purchasing power, insurance providers will have to fight on multiple fronts to stay, as much as possible, in the area of a positive financial result. The challenge will be particularly strong in the car insurance segment, the business with the largest share in the CEE region. [6,11,15]

Beyond the impact on claims costs and insurance prices, inflation is poised to add a new chapter to the underinsurance story: underinsurance.

The price of raw materials and the increase in wages, against the backdrop of galloping inflation, not only increase claims expenses, but also increase the value of insured assets. In Europe, the price of used cars has increased by almost 10% on average over the past year (excluding Turkey, whose inclusion in the calculation of this average would bring the average increase to 17%), boosted by even higher growth in the segment new cars, as well as delayed deliveries caused by the chip crisis. [17]

In construction, the price of materials and components has increased at alarming rates, inevitably driving up the value of new construction as well as repair costs for damaged construction. The examples could easily continue in other areas. In principle, from the perspective of the volume of subscriptions, the result of these changes could materialize in a source of market growth. [4]

Less obvious, however, is a possible collateral effect: the undervaluation of insured assets, especially for the property insurance segment. [6]

A relevant example comes from the Czech Republic, a market with one of the highest home insurance coverage rates. According to the Czech Association of Insurers, only about a third of the insurance contracts have the correct value of the sum insured. From the detailed data, it appears that the most frequent situation is that of an underestimation of the insured amount by 20-49% of the correct value. [16]

This is disturbing. Even more worryingly, 15% of contracts even reach over 50% underinsurance. Thus, in the case of an insured event, customers will, unfortunately, receive at most half of the actual damage", explained a representative of the association. The phenomenon is certainly common to many markets in the region and the galloping inflation only makes it worse. As such, we can no longer talk about the insurance deficit only in terms of the insurance coverage rate, but also of the insufficient level of property insurance.[18]

Another effect of inflation is the increase in demand for reinsurance – a natural trend given the need for insurers to meet solvency parameters, in the context of increasing current and projected claims expenses. This trend puts additional pressure on capital resources from reinsurance and determines a tendency for reinsurance to become "more expensive", which will also be reflected in the price of primary insurance, reducing the affordability of insurance products and, quite possibly, increasing the insurance deficit in the region. [8]

Inflation is putting pressure on household budgets around the world. In the storm of technical information thrown into the public space every day, how do we manage to understand the dimensions of the phenomenon and what the general rate of price increases will mean for each of us? [13]

Headline inflation in the 19 countries that use the euro reached 10.7% in October 2022, the highest rate since the single European currency was introduced. But for food, alcohol and tobacco prices rose more, reaching 13.1% in October 2022.[8]

In other words, if we each calculated a personal inflation rate, we would have to take into account the products we consume the most, mainly belonging to the mentioned category.

European Union statisticians came up with a universal measure - the price of a cup of coffee that each of us drinks at least once a day. Eurostat data shows that the price of a cup of coffee rose by almost a fifth (16.9%) between August 2021-2022. In contrast, the cost of coffee in the EU increased by only 0.5% in the previous year. [12]

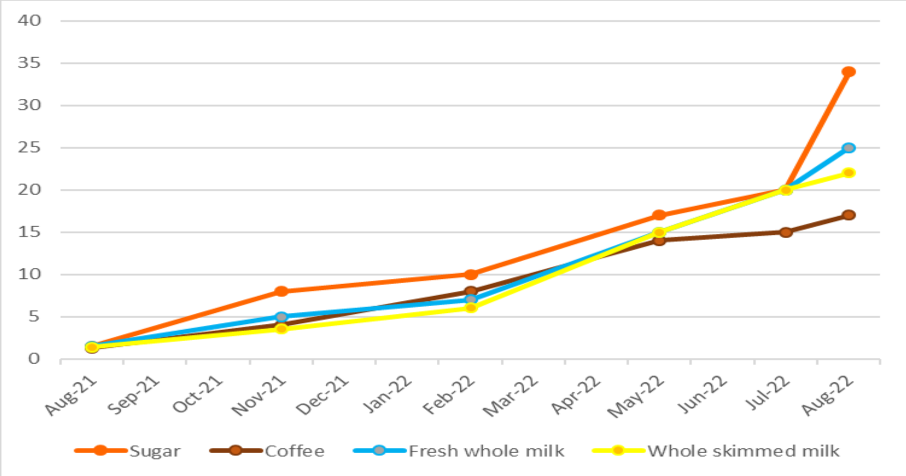

Figure 6. Inflation for coffee products in the EU (%, annual price change rate)

Source: Authors' processing according to Eurostat, 04.03.2024 [7]

The rising costs of especially staples like coffee, milk, and sugar, can indeed transform what was once an affordable habit into something closer to a luxury. For many, the simple pleasure of a morning coffee is becoming an unexpected financial burden due to inflation. [13]

The price of coffee is increasingly volatile, largely driven by disruptions in global supply chains and climate issues affecting major coffee producers. With a more than 20% price hike, dairy products have seen significant inflation due to rising costs of feed, energy, and transportation in the dairy industry. A surge of over 30% in sugar prices is partly the result of supply constraints from key sugar-producing nations, compounded by increasing demand globally. [7,9,10]

These rising costs combine to make your daily coffee much more expensive, especially if you add milk or sugar. Small increases across these ingredients stack up over time, turning a basic morning cup into a significant expense. [10]

The variation of these indicators, from country to country, is uneven. For example, if the Finns have to bear the biggest increase in the price of coffee (44%), the Poles will probably have to give up sugar, the price of which is now more than double from the previous year. [11]

Hungary and Lithuania are the countries where adding milk to coffee costs one and a half times more than in the past. As for the outlook, top global economists polled for the World Economic Forum '22 report said almost unanimously that they expect inflation to remain high in Europe and the United States for the rest of 2022, but they expect inflationary pressures to ease somewhat in 2023. [10]

CONCLUSIONS

The recent price increase has far outstripped wage growth, leaving households with less cash available. People now spend, on average, a larger portion of their monthly income on basic needs, while less is available for savings and investments.

With family budgets at the limit, policyholders will be reluctant to accept substantially higher prices and will instead opt to reduce their insurance coverage. Because of this, there is a fine line that marks the balance between justified price increases and potential business losses. Even if inflationary pressures ease, we must take into account the fact that inflation occurs, with a considerable lag for insurers, in claims.

It therefore remains a force to be reckoned with for the foreseeable future, and insurers should make allowances and set prices accordingly.

Higher claims inevitably lead to higher insurance premiums. But increasing premiums while keeping existing customers may not be easy in today's environment, and bringing in new ones even less so.

In order to mitigate the effect of inflation on claims costs and, implicitly, to avoid as much as possible passing these costs on to price increases, insurers have a set of tools at their disposal. Here's a short list that might help:

» Risk and loss prevention through proactive measures to help clients limit their risk exposure

» Claims management – the use of digital technologies is of real help to speed up claims processing and keep costs to a minimum;

» Supporting clients to limit damages and, implicitly, costs when an insured risk occurs;

» Fraud detection;

»Providing legal advice to corporate clients to prevent the escalation of situations that could lead to compensation claims;

» Identifying suppliers or contractors who can solve customer problems - work or repairs - at a lower cost.

The advance registered during the pandemic in the adoption of digital technologies will certainly help insurers in dealing with the impact of inflation.

Reduction of operating costs, optimization of the claims management process, better risk control, are only some of the expected results. In fact, even from the customer's perspective, digital technologies could bring important benefits, such as reducing costs for car insurance assisted by telematics technologies.

The increasing popularity of these products among customers could in turn drive the deployment of these technologies on an increasingly large scale.

With so many moving parts amid heightened uncertainty, it's best to tread carefully—both capital and liquidity. Now is not the time to let our guard down and narrow our buffer zones. They may be needed to help insurers through the difficult times ahead.

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