C40·CENTRE CITY CLIMATE POLICY AND ECONOMY

Cities Economic Outlook

#1
08.2023

Corporate profits have been driving high inflation in Europe since 2022, new analysis finds.

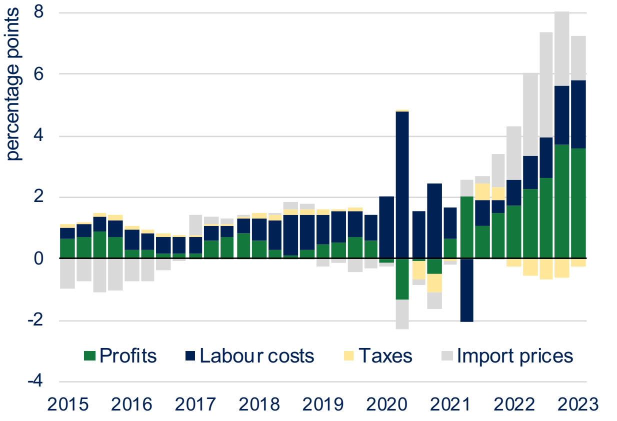
New analysis from the International Monetary Fund (IMF) suggests that around **45% of the increase in prices in Europe since 2022 has been driven by corporate profits**, and only in a smaller proportion by labour costs and imports, similar to what has happened in the USA since 2021. This means that businesses raised their prices by more than the increased cost of imported goods and energy to protect their profits.

Inflation has risen sharply across the world in the past 18 months, affecting household and municipal finances. Initially, this was caused by the price volatility of fossil fuels—exacerbated by Russia's illegal invasion of Ukraine—and by the climate crisis. These shocks caused the price of energy and food to increase globally, with only a few exceptions. Prices have not risen as much in many parts of Asia, while in other countries (e.g., Türkiye and Argentina) these new shocks compounded pre-existing high inflation.

45% **share of European inflation since 2022 attributable to corporate profits**

In response, **central banks increased their base interest rates**, hoping to slow further price increases by making it more expensive for people to spend and save. This inflation-targeting approach works bluntly in ordinary times and it is ill-suited for extra-ordinary ones, when soaring corporate profits should be targeted. **Current inflation levels have not been experienced in generations—they need a response that includes city-led initiatives alongside macroeconomic intervention**, akin to what happened during the COVID-19 pandemic. **The central banks' approach does not tackle the root cause of inflation**, instead it exacerbates issues such as housing affordability (by increasing the cost of mortgages) and it makes green investment more expensive to finance.

Profits are driving inflation higher in Europe



Source: Eurostat, OECD, IMF calculations

It is hard to tell how long higher inflation will last. The early causes (the energy and food price shocks) suggested higher prices could be transitory, but it is now considered unlikely that it will return to the broadly low pre-pandemic levels in the near future.

As inflation falls, it is only the rate of increase in prices that will slow, their levels will remain elevated. It is crucial not to shift the blame of higher prices on workers who will be negotiating for better pay to keep up with the higher cost of living. As visible in the chart above, future inflation levels will depend on whether corporations accept to lower their profits to absorb the necessary increases in labour costs or if they pass on these costs to consumers, raising prices further.

From retrofitting affordable housing to installing renewable energy and investing in public transport, **mayors know what the solutions to the cost of living crisis are, but they need resources and freedom to deliver them at scale.** Their efforts will remain an uphill battle until national governments decide to adopt a more nuanced, locally-led approach.

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