Mercer

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Protect your people's purchasing power

Managing international employees' expectations in times of high inflation

For the past decade, inflation has remained subdued in most developed economies. The successive economic shocks triggered by the coronavirus pandemic and the crisis in Ukraine, however, have brought a return to higher inflation. Employees are increasingly concerned about their purchasing power, and their expectations for salary raises are heightening. Companies often need to perform a balancing act of controlling costs while attracting and retaining talent at competitive salaries. Adding the impact of higher inflation on internationally mobile employees further complicates the exercise.

What is inflation?

Inflation, in its simplest definition, is the change in prices for goods and services over a given time period.[1]

The Consumer Price Index (CPI) is one measurement of inflation, capturing price changes associated with a specific market basket of goods and services over a specific period. CPI data can be reported in multiple ways including as average figures or as end-of-period figures. There are many different sources for CPI data, each with its own methodology.

Inflation affects the purchasing power of employees — in other words, the value of goods or services that they can afford to buy. This impact is both objective (erosion of purchasing power) and subjective. Employees' perception of inflation is largely based on the prices of a limited number of goods and services that they consume on a regular basis, as well as relevant information that they obtain via news outlets. The different ways to calculate inflation indices (items included, periods covered, etc.) add to the complexity. The perception of inflation matters because it can drive employees' decisions regarding their personal wealth and employment (e.g., requesting salary increases or even changing jobs).

[1] For more details, consult the IMF article, "Inflation: Prices on the Rise."

What causes inflation?

Inflation can result from multiple factors:

- Lack of availability of goods and services (supply issues)
- High demand for goods and services (demand issues)
- Currency devaluation (cost of imported goods increases)
- Monetary policy (low interest rates, central banks pumping more money into the economy)

In 2022, the COVID-19 pandemic and the crisis in Ukraine have had an influence on these different factors and have driven inflation in many markets.

Many countries have changed their approach and started to treat COVID-19 as endemic, but some continue to impose measures to reach the "zero COVID" state (e.g., China). Restrictions and lockdowns weaken supply chains globally and create supply issues.

Major turbulence in global natural gas, gasoline and energy markets started even before Russia's invasion of Ukraine. Prices of gas and gasoline rose and caused significant increases in the costs of living, even in countries with traditionally low inflation in many markets.

The crisis in Ukraine is exerting considerable influence on mineral and agricultural markets due to the significance of both involved parties on global supply.

In addition, periods of upheaval and geopolitical stress tend to augment currency fluctuations. As also experienced at the beginning of the pandemic, the crisis in Ukraine has reinforced the US dollar compared to other major currencies, especially European ones (with the exception of the Swiss franc, which is considered a safe haven).

Many of the factors affecting the supply of raw materials and goods are temporary in nature; as disruptions continue, however, they are progressively prompting companies to raise their prices, which ultimately affects the end consumers. In turn, this is prompting employees to ask for salary increases so that they can protect their purchasing power. When this happens, temporary inflation can become long-term structural inflation.

Mercer solution: Global Compensation Planning Report

The 2022 Global Compensation Planning Report (GCPR) offers everything you need to know about salary increases, economic indicators, mandatory pay schemes and more. With salary increase and economic data that cover the past, current and upcoming years, this report is a critical resource for HR professionals responsible for the annual compensation planning process. The report covers the following areas:

- GDP, inflation, unemployment rates
- Salary review frequency
- Mandatory pay increase schemes
- Actual, budgeted or forecasted salary increase budgets
- Promotional salary increases

The inflation/salary increase gap

In the 1970s, salaries were much more likely to be aligned with inflation and the burden of rising costs was carried by companies, not just by employees. As inflation has stabilized in developed economies over the past couple of decades, we have seen salary increases disconnected from inflation figures. We are witnessing a gap between inflation and salary increases, leading to a loss of purchasing power for employees.

Rising inflation presents new challenges for current pay practices. On the one hand, not addressing shrinking employee purchasing power could create retention issues at a time when competition for skilled talent is fierce. On the other hand, altering pay practices to factor in inflation leads to a permanent increase in longer term operating costs.

The risks of significant salary increases are:

- There is no return to the starting point — the increase is permanent
- Salaries are used as the basis for different calculations (short-term incentives, pensions) — base salary increases will cascade into other parts of the reward package
- They create expectations among employees — the latest salary increase is the new reference point for what an employee will expect next year
- There is a risk of inflated fixed costs just ahead of harder times as well as generation of an inflation spiral

Aside from salary increases, other possible options may include (if relevant):

- One-off payments in the form of attraction or retention bonuses
- Increases in the form of lump sums instead of applying a percentage increase
- More frequent reviews (e.g., quarterly)
- Payment of allowances designed to cover goods and services having the highest price increases (e.g., fuel allowance, coupons)
- Applying greater differentiation by employee groups: this could be done to support low-paid workers who are most at risk as well as retain top talent by adopting skill-based pay practices

Mercer solution: Total Remuneration Survey (TRS)

The Mercer Total Remuneration Surveys (TRS) provide high-quality and comprehensive market data on compensation and benefits from around the globe. From base salary and short-term incentives to benefits and total remuneration, evaluate your competitive position across the full rewards package.

140+

countries

400,000

jobs at all levels

40,000

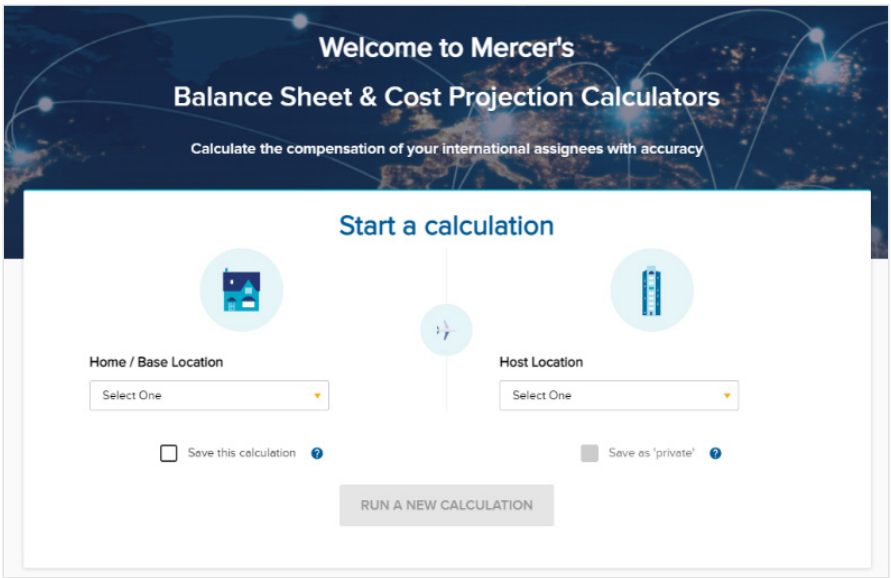
participating organizations worldwide

20 million

incumbents around the world

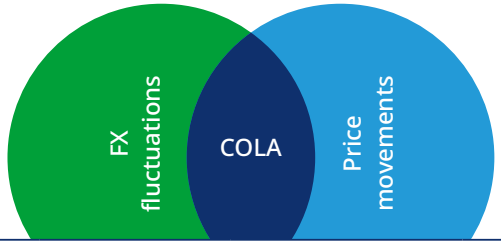
Cost-of-living issues for international assignees

International assignees compensated using a home-country approach (balance sheet) typically receive a cost-of-living allowance to maintain purchasing power in their destination countries. This allowance is calculated by applying a cost-of-living index differential to part of an employee's net salary (the "spendable income" — that is, the amount the employee spends on goods and services used on a daily basis in the host location).



For illustrative purposes only.

Both inflation and exchange rate fluctuations directly influence the purchasing power of mobile employees.



Home **Host** **Home** **Host**

Appreciation of the home currency or devaluation of the host currency will cause a **decrease in the index** and the cost of living allowance (COLA).

Higher inflation in the home city than in the host city will reduce the COL index, and therefore reduce the COLA.

Devaluation of the home currency or appreciation of the host currency will increase the COL index and the COLA.

Higher inflation in the host city than in the home city will increase the COL index, and therefore increase the COLA.

Source: Mercer, 2022.

Mercer solution: Balance Sheet Calculator 2.0

Mercer's Balance Sheet Calculator 2.0 makes the balance sheet process easy by integrating Mercer's powerful cost-of-living, tax, education and quality-of-living solutions with the flexibility, speed and accuracy you need to create international compensation statements.

Price movements

The cost-of-living index change is driven by the price *differential* between the home and the host locations. The objective is to equalize the purchasing power of international assignees between the home and the host locations.

Prices might increase in the home location as well as in the host location, a situation international assignees might not be aware of as they focus only on the prices in their assignment location. Mobile employees, like their local peers, may see their purchasing power go down — not because the cost-of-living allowance in their expatriate package is too low, but because of the gap between their salary increases and inflation in their own country.

The different types of inflation indices available publicly may also confuse international assignees. Local inflation indices usually cover a wider range of goods and services than cost-of-living indices that focus on what matters for relocated employees. Education and housing costs are frequently included in local inflation indices, whereas international assignees usually receive a separate allowance to cover these costs.

Definition

	Mercer Market Basket Index Inflation	CPI Consumer Price Index
What?	Mercer's **expatriate** market basket Measures Mercer's cost-of-living spendable	Defined **local-national** market basket Measures spendable and housing and education cost
When?	Prices in different countries **at one time**	Shows movement in one country **over time**
Where?	**City** by city	**Country** or regional level

Source: Mercer, 2022.

Exchange rates

Exchange rate fluctuations constitute the second factor driving changes in the cost-of-living indices for international assignees: an appreciation of an assignee's home currency makes goods and services more affordable in the host location. The cost-of-living index goes down to reflect the fact that the assignee needs a smaller allowance. On the contrary, when the host currency strengthens compared to the home currency, the cost-of-living allowance needs to go up.

Different types of exchange rates can be used: spot rates, averages and fixed rates. Each type of exchange rate has pros and cons.

	Advantages	Disadvantages
Spot rate	Transparent to employees • Reflects market's views of relative worth of currencies • Individuals tend to make comparisons on a spot basis	• Highly volatile allowance levels
Trailing averages	Common approach • Mitigates short-term volatility	• Volatility in the currency is reduced but not eliminated • An artificial exchange rate is used • Not very transparent to employees
Constant (fixed) rate	• Focuses on differences due to changes in compensation rather than currency fluctuations	• Not transparent to employees

The two factors of exchange rate changes and inflation differentials can push the cost-of-living indices in the same direction, or they can counter-balance each other. In recent years, exchange rate fluctuations have had more of an effect on cost-of-living indices than inflation, except in some emerging countries that are experiencing hyper-inflation. This is no longer the case, however, due to high inflation in developed economies. In 2022, both inflation and exchange rates have an important impact on fluctuations in cost-of-living indices.

Mercer solution: Cost-of-living information solutions

Based on an international basket of goods and services reflecting realistic spending habits established through years of extensive expatriate research, we believe Mercer's cost-of-living surveys provide all the key elements you need to set fair cost-of-living allowances, as well as the supporting information required so that all stakeholders can understand the compensation package.

Communications about cost of living: finding the right balance

In normal circumstances, companies review their cost-of-living allowances once or twice a year. The objective is to protect the purchasing power of assignees while avoiding a sense of uncertainty that would result from more frequent updates. During a crisis, mobile employees do not want to have financial worries on top of health and safety concerns. Their perceptions of their subjective purchasing power are driven by headlines in the news and prices they see in a few shops. They often need reassurance even if there is little change in the cost of living in their locations.

Such perceptions should not automatically lead to changes in assignment packages, but they might justify additional communication efforts. A fluctuation threshold can be used to assess the need for an update or at least for a new communication — some companies trigger a review when there is a fluctuation of more than 10% in the exchange rate or inflation differential. This review might lead to a change in the cost-of-living allowance. Or, if the fluctuation is judged temporary and the situation is still unstable, a change might be deferred until the next Mercer Cost of Living data release or the next planned cost-of-living allowance adjustment.

Contact us

Do you need support designing and managing compensation for your mobile employees? Get in touch with Mercer and leverage our expertise and solutions to help protect your people's purchasing power effectively and efficiently.

mobility@mercer.com

https://mobilityexchange.mercer.com/contact-us

Mercer solution: Differential Change Analysis (DCA)

The DCA is a unique "pay statement" that provides expatriates with an easy-to-understand explanation of changes to their goods and services differential.

Mercer solution: Policy review

Behind every successful global mobility program is a well-thought-out policy that addresses business objectives, assignee expectations and market opportunities. But formalizing a global mobility policy takes time and careful analysis. Mercer has experience in mobility policy design and review for small, medium and large organizations. Understanding interdependencies and the impact of policy decisions and changes is critical for a successful implementation.

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