10 May 2019

Euro Area Research

Inflation under the microscope: simmering, not boiling

- **The picture of underlying inflation pressures is not as hopeless as it seems and we still see strong arguments for core inflation to reach 1.3-1.4% by year-end.**
- **We believe the market is underestimating the rise in core inflation in H2 19.**
- **We doubt that the projected gradual rise in core inflation is enough to convince the ECB to bring rate hikes back on to the table for 2020.**

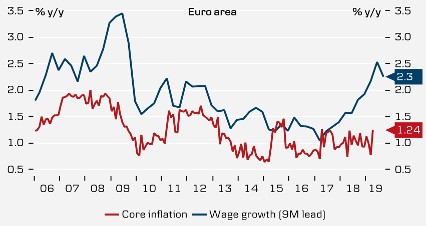
Something's brewing

After months of gloom and continued inflation disappointments, the April HICP report finally brought some relief for the ECB on the inflation front: core inflation surged to 1.24% from 0.77% in March. **However, caution must be applied when interpreting the high core inflation number, which to a large degree has been driven by the different timing of Easter in 2018 (March) and 2019 (April).** During the Easter holiday season, package tours, airfares and accommodation services experience marked price swings. In March inflation rates for package tours and transport services dropped steeply, accounting for 0.18pp of the total 0.22pp fall in service price inflation during the month. The final April HICP details will not be released until 17 May, but we expect these categories to have driven more or less the entirety of the 0.47pp increase in core inflation. Furthermore, with the introduction of the *new methodology* to calculate German package tours, the Easter effect has become even more pronounced, adding volatility to core inflation movements.

The real underlying inflation picture will be revealed in the coming months, once calendar effects cease to exert their distorting influence. Despite the rise in core inflation, the disconnection between high wage growth and overall subdued inflation pressures remains prominent (see Chart 1). Historically, wage growth has translated into core inflation with a 6-12M lag, but with wages rising steadily since mid-2016 and no imminent underlying inflation pressures, questions about the 'death' of the Phillips curve have resurfaced. **What has delayed the pass-through from wages to inflation? An important factor in our view was the economic slowdown in H2 18**, which made firms more reluctant to transfer higher input costs to consumer prices, fearing loss of market share in the current fragile economic environment. An additional headwind came from the stronger effective EUR, which held goods price inflation at bay.

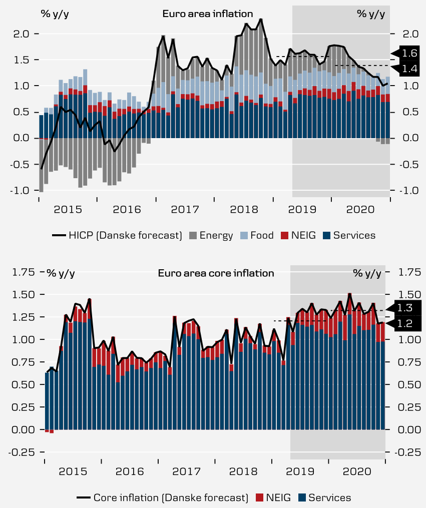
In *Euro Area Research: Is the Phillips curve finally coming alive in 2019?*, we discussed the drivers and pre-conditions for an uptick in core inflation. **With clouds over the growth outlook clearing somewhat as of late, unit labour costs rising and firms' margins being squeezed, we still see strong arguments for the core inflation Phillips curve to steepen in the coming quarters, with core inflation reaching rates of 1.3-1.4% by year-end (for forecast details see p. 4-6). However, we emphasise that it will be a gradual uptrend** (see Chart 2), as the current economic environment remains fragile. Goods price inflation is set to remain stuck below its long-term average of 0.6% in the near term, leaving service price inflation as the main catalyst for a wage-driven rise in core inflation.

Chart 1. Will the core inflation gap persist in 2019?



Source: Eurostat, Macrobond, Danske Bank

Chart 2: A gradual uptrend in core inflation



Source: Eurostat, Macrobond, Danske Bank

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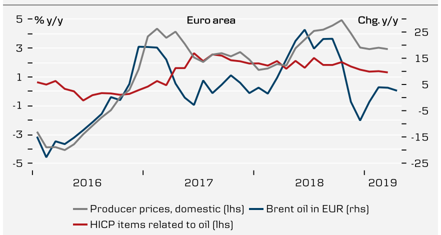
Core inflation rise still on the cards

A broad range of underlying inflation measures has yet to show a sustained move higher (see Chart 3), but in our view the picture of underlying inflation pressures is not as hopeless as it appears at first glance. **We currently see three key arguments for a pick-up in core inflation** in the coming months.

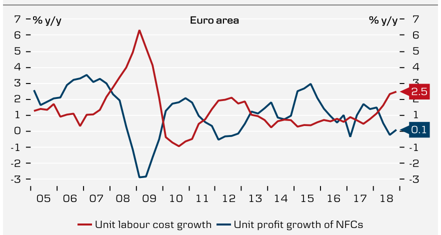
- **Firstly, some of the sub-components of the services HICP**, such as services related to recreation and personal care, **have already gained some momentum since 2018.** It is the largest category in service price inflation, accounting for 17% of core inflation and 12% of the total HICP and has historically been quite responsive to movements in the output gap (see Chart 4). The recent uptick in this important sub-category suggests that there is already evidence of strengthening underlying inflation pressures and we expect to see inflation rates in recreation services converging back to their long-term average of 2.25% by end-2020, supported by the positive output gap.
- Secondly, for non-energy industrial goods (NEIG) movements in the exchange rate and import prices play a crucial role. Since the start of 2019, the **effective EUR** has on average depreciated by some 0.5% and is increasingly **turning into a tailwind to core inflation in 2019 from a headwind in 2018**. Indeed, accelerating import prices for consumer goods have pointed to a turnaround in durable goods price inflation for some months now (see Chart 5).
- Thirdly, **global oil prices have risen markedly**. So far, Brent oil in EUR terms is up by almost 40% since the start of the year, peaking at EUR66/bbl at the end of April. The indirect effect of the oil price development has been quite muted in 2018, with core inflation items for which oil is an important input factor (such as transport services) barely showing any reaction to the spikes in energy and producer price inflation (see Chart 6). However, there is reason to believe that this pattern could change, because the current oil price rise takes place in an environment in which firms' margins are already significantly squeezed by rising wage costs (see Chart 7). An **oil price shock might therefore be the final missing ingredient to 'tip the scale', causing firms to finally start passing on higher input costs** (see Chart 8) **to consumer prices**, thereby leading core inflation to finally pick up some speed in 2019.

Chart 6. Indirect effect of oil price rise on core inflation has been muted so far



Source: Eurostat, Macrobond, Danske Bank

Chart 7. Firms' margins are feeling the pinch from higher labour costs

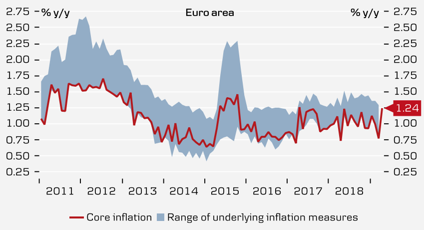


Source: Eurostat, ECB, Macrobond, Danske Bank

Market is underestimating the rise in core inflation

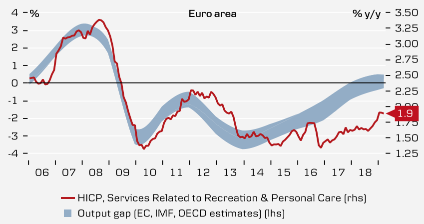
Apart from the missing link between wage growth and core inflation, another area of increasing concern for the ECB has been the fall in market-based inflation expectations over recent months. **While oil prices and inflation expectations moved in close tandem from 2014-18, this relationship seems to have weakened as of late**, with 2y2y and 5y5y inflation swaps defying the upward trend in the oil price (see Chart 9). That might also reflect that markets view the recent oil price move as supply-side driven and temporary, with the short end of the oil forward curve reaction much more pronounced. **Overall - so far at least – second-round effects from the oil price rise remain limited**.

Chart 3. Underlying inflation measures are moving sideways



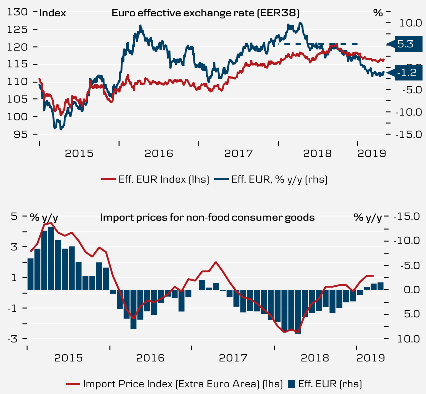
Source: Eurostat, Macrobond, Danske Bank
Details on page 13 here

Chart 4. Prices for services related to recreation & personal care have moved up



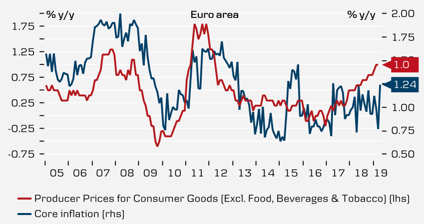
Source: Eurostat, Macrobond, Danske Bank

Chart 5. Nominal effective EUR is turning into a core inflation tailwind



Source: ECB, Macrobond, Danske Bank

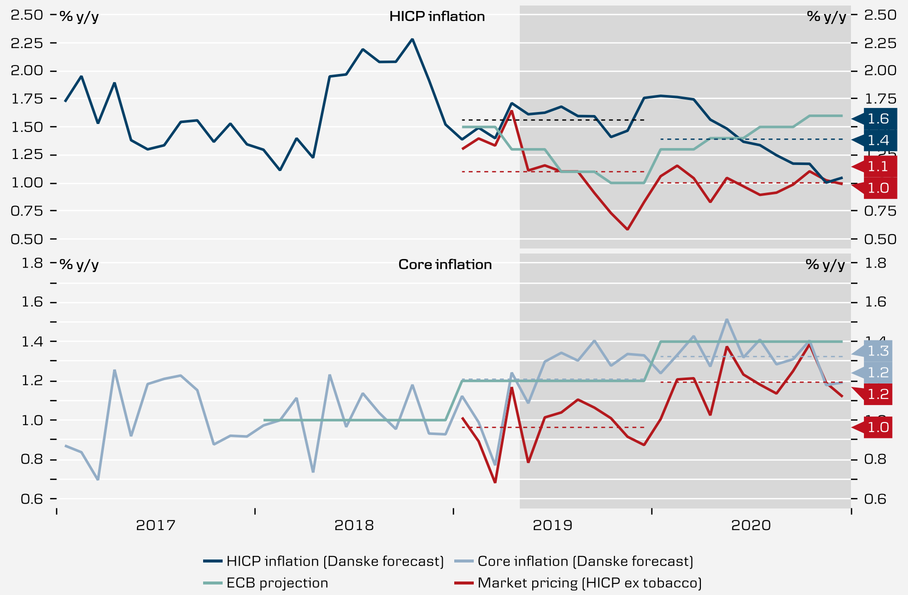
Chart 8. Inflationary pressures are building at earlier stages of the pricing chain



Source: Eurostat, Macrobond, Danske Bank

Markets generally remain very sceptical about any core inflation uptick in the current economic environment, in line with the very subdued ECB pricing (see Chart 10). **In our view, current inflation market pricing** (see Chart 11) **remains too low and we see scope for repricing in inflation-related products, especially in H2 19.** That said, a convincing turnaround in the European macro data and especially higher realised core inflation rates still hold the key for a sustained repricing in the inflation market.

Chart 11. Markets remain sceptical about any core inflation uptick



Assumptions: Oil at USD72/bbl in 2019 and USD80/bbl in 2020; EUR/USD at 1.13 in 2019 and 1.19 in 2020. Market core inflation pricing is derived using market pricing for Brent oil and EUR/USD forwards.

Source: Eurostat, ECB, Macrobond, Danske Bank

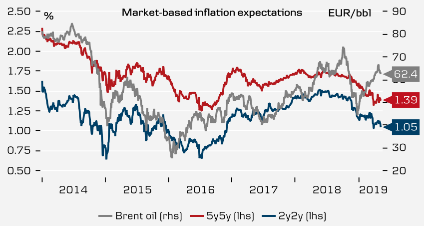
ECB policy normalisation remains on hold

The ECB has been somewhat less confident on the inflation outlook recently, pointing to structural changes in the pass-through from wages to inflation. That said, the narrative has been quite clear: the inflation pick-up has been delayed, not derailed. **We agree with Draghi that the structural conditions for pass-through from wages to prices remain in place** (and will continue to do so in the future with no risk of an imminent euro area recession). However, in light of the slowing expansion pace, core inflation rates at 1.6% on average in 2021 as projected by ECB still seem optimistic to us.

The April core inflation jump combined with a stronger than expected Q1 GDP growth rate at 0.4% q/q, on balance weakens the case for more ECB easing measures ahead. That said, we stress that the ECB does not react to single data points and the coming months will reveal the true underlying inflation dynamics, which the ECB is focused on in terms of determining its policy stance. In that light **we expect the current easing bias to prevail even after the June meeting**.

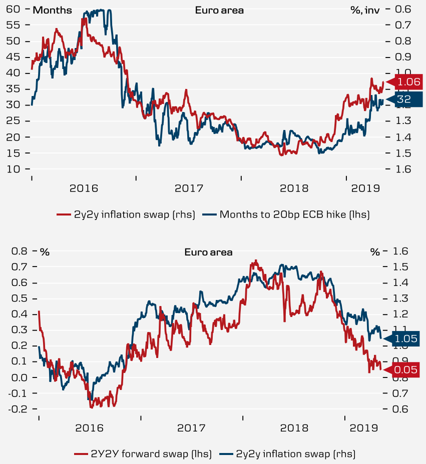
Will the projected gradual rise in core inflation be enough to convince the ECB to bring interest rate hike discussions back to the table for 2020? We doubt it. First of all, the ECB looks at the medium term - where we project core inflation pressures to peak at 1.5% and abate somewhat - and secondly, the unofficial ECB reaction function has changed during the past years, incorporating inflation as well as GDP growth, bank profitability and financial market awareness. Therefore, we believe that **before the ECB will resume its policy normalisation (including a first rate hike), we need to see a pick-up in realised underlying inflation as well as medium-term inflation expectations**.

Chart 9. Inflation markets have ignored the oil price rise



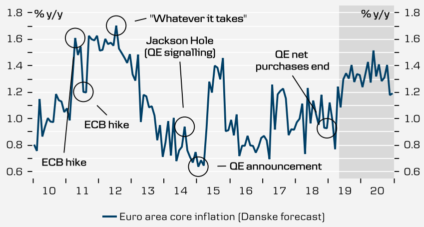
Source: Bloomberg, Macrobond, Danske Bank

Chart 10. Inflation and ECB pricing are strongly related



Source: Bloomberg, Danske Bank

Chart 12. Pick-up in core inflation not enough to justify rate hike



Source: Eurostat, Macrobond, Danske Bank

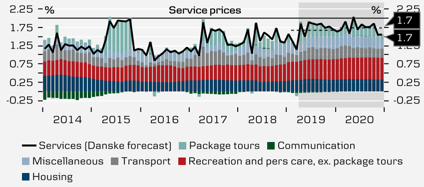
Core inflation forecast details

Services: preconditions for wage pass-through are in place

We expect service price inflation to be the main catalyst for a pick-up in underlying inflation pressures and project it at 1.7% in both 2019 and 2020 (see Chart 13).

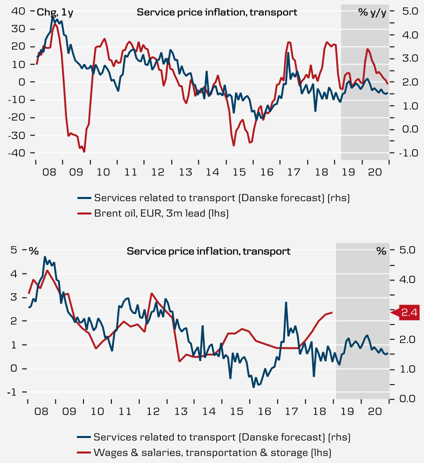
- As mentioned above we have already seen a marked acceleration in prices for **services related to recreation and personal care** at the end of 2018 and we expect this gradual uptrend to persist supported by the pick-up in economic momentum and strong wage growth (see Chart 15).
- Another category where we expect higher wages to leave their mark is **services related to transport**. At 2.4% in Q4 18, wage growth in transportation and storage has reached the highest level since late-2012 and at the same time firms are additionally challenged by the impact from rising oil prices, which are an important input cost factor in the transport sector. This strengthens the case for inflation in transport services to grind higher in the coming months (see Chart 14), as firms start to pass on higher input costs to consumer prices. Together, services related to recreation, personal care and transport account for 27% of core inflation and higher inflation rates in these sub-categories will be an important driver for the expected acceleration in core inflation.
- However, it is not all categories of service price inflation that will be a tailwind to core inflation. First and foremost, inflation rates in **services related to housing** should remain subdued amid the ECB's 'low for longer' environment (see Chart 16), while **communication services** are also likely to stay a drag on core inflation in the coming months, despite signs of strengthening price pressures in Germany as of late (Chart 17).
- Finally, inflation rates in **miscellaneous services** have been on a gradual uptrend since 2017 and we expect them to linger in a 1.5-1.7% range over the coming year, not least because hospital and financial services exhibit a positive correlation to the output gap (see Chart 18).

Chart 13. Service price inflation to gain momentum



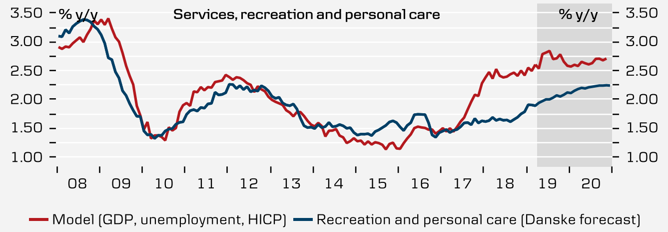
Source: Eurostat, Macrobond, Danske Bank

Chart 14. Higher input costs to leave their mark on transport services



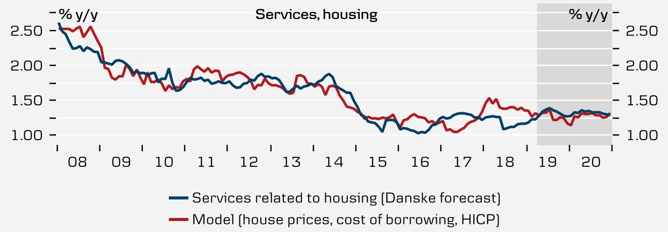
Source: Eurostat, Macrobond, Danske Bank

Chart 15. Closing output gap points to higher prices for services related to recreation and personal care



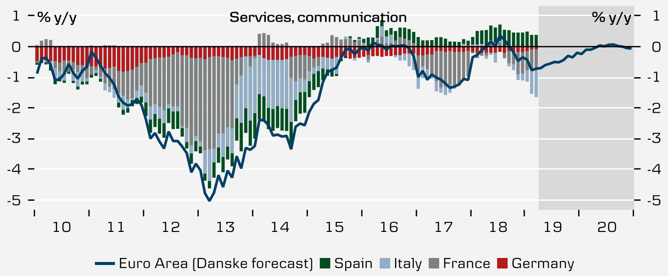
Source: Eurostat, Macrobond, ECB, Danske Bank

Chart 16. Lower rates imply lower housing inflation



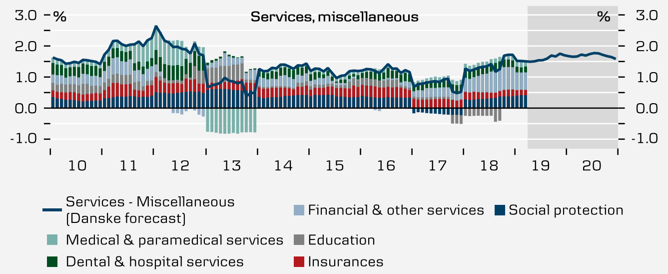
Source: Eurostat, Macrobond, Danske Bank

Chart 17: Inflation in communication services to remain a drag



Source: Eurostat, Macrobond Financial, Danske Bank

Chart 18: Miscellaneous services to trend a bit higher



Source: Eurostat, Macrobond Financial, Danske Bank

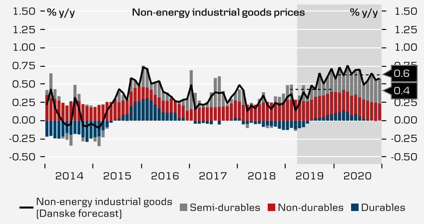
Core inflation forecast details

Non-energy industrial goods (NEIG): currency strength has turned the corner

Although goods price inflation will in our view remain contained compared to service prices, we still expect some acceleration ahead (averaging 0.4% in 2019 and 0.6% in 2020, see Chart 19).

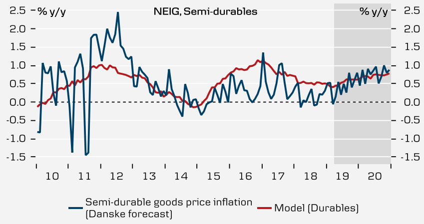
- A key driver for the expected rebound will be the abating effective EUR appreciation, as mentioned above. Since the start of the year, the effective EUR has turned from a headwind to inflation over the past two years into a tailwind. Lags for the pass-through of exchange rate movements to goods prices can be significant, but the impact on **durable goods** – which account for 13% of core inflation - happens relatively quickly with around a 6M lag (see Chart 21). In line with the turn in the effective EUR, import prices for durable goods have already moved up and we expect it to push up durable goods price inflation in the coming months (see Chart 22).
- This in turn should also support a gradual uptrend in **semi-durables,** which usually lag movements in durables prices (see Chart 20). That said, prices are very volatile due to seasonal sales patterns in clothing and footwear, adding an element of uncertainty to the underlying trend in consumer goods prices.
- As Chart 23 shows, **non-durables** should also feel upward pressure from higher oil and producer prices, but we expect the impact to be relatively muted just as in 2018, with non-durable goods price inflation in a 1.0-1.2% range in the coming years.

Chart 19. Goods price inflation remains contained



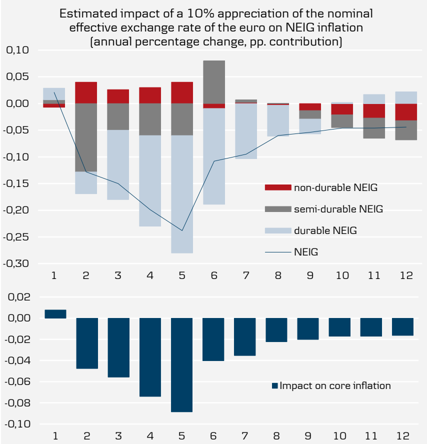
Source: Eurostat, Macrobond, Danske Bank

Chart 20. Semi-durables prices to feel the lift from durables



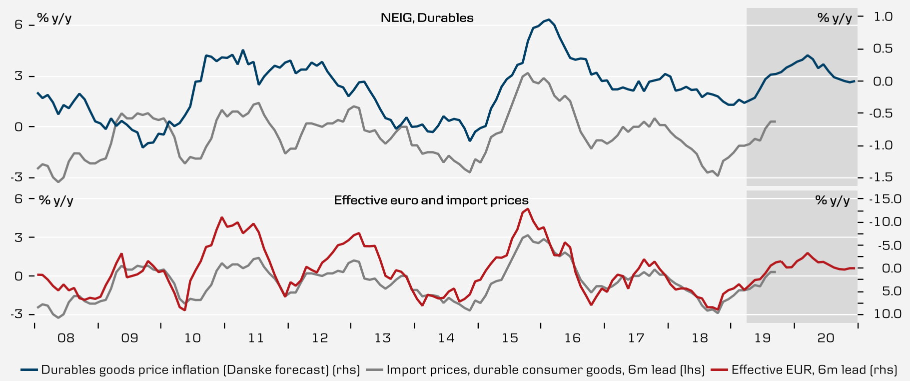
Source: Eurostat, Macrobond, Danske Bank

Chart 21. Durables prices respond with ca. 6M lag to exchange rate movements



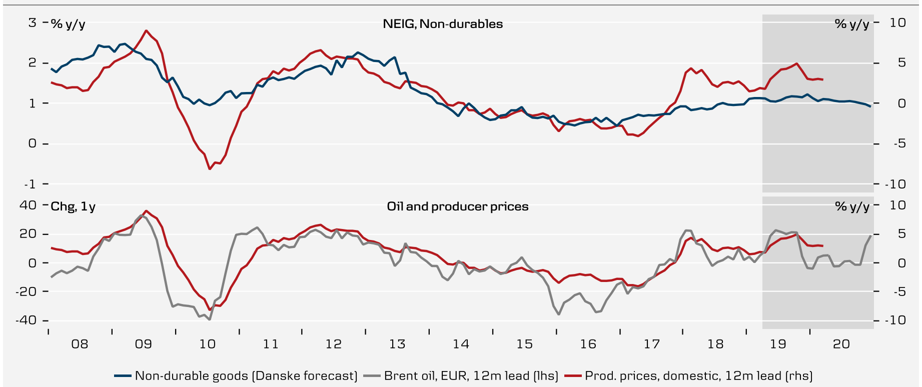
Source: Eurostat and ECB calculations.
The x-axis refers to the quarters following a change in the exchange rate.

Chart 22. Higher import prices will push up durables prices



Source: Eurostat, Macrobond, Danske Bank

Chart 23. Non-durable goods price inflation to stay in a 1.0-1.2% range



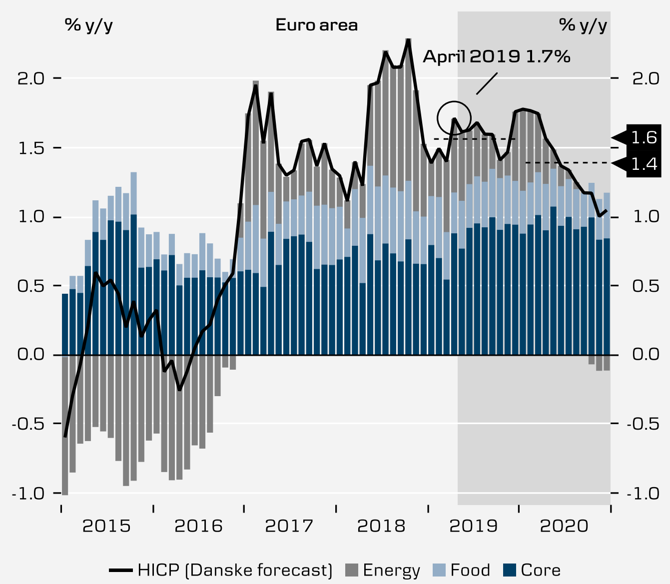
Source: Eurostat, Macrobond, Danske Bank

Overview euro area inflation outlook

	Current	Sparkline (last 6M)	Danske forecast 2019 avg.	2020 avg.	HICP weight	Core weight
HICP	1.71		1.56	1.39		
Energy price inflation	5.43		3.63	1.62	10.1	
Food price inflation	1.53		1.80	1.52	19.0	
HICP ex tobacco	1.33		1.49	1.33	97.7	
Core inflation	1.24		1.21	1.32	70.9	
Non-energy Industrial Goods	0.23		0.43	0.63	26.4	37.2
- Durables	-0.34		-0.07	0.17	9.3	13.1
- Semi-durables	-0.06		0.44	0.77	10.4	14.7
- Non-durables	1.13		1.13	1.04	6.7	9.4
Services	1.86		1.67	1.74	44.5	62.8
- Communication	-0.72		-0.51	-0.03	3.0	4.2
- Housing	1.23		1.30	1.32	11.0	15.5
- Package tours & accommodation	-1.18		3.52	2.91	3.4	4.8
- Recreation & personal care	1.89		2.00	2.20	11.9	16.8
-Transport	1.15		1.68	1.74	7.2	10.2
- Miscellaneous	1.51		1.59	1.70	8.4	11.8

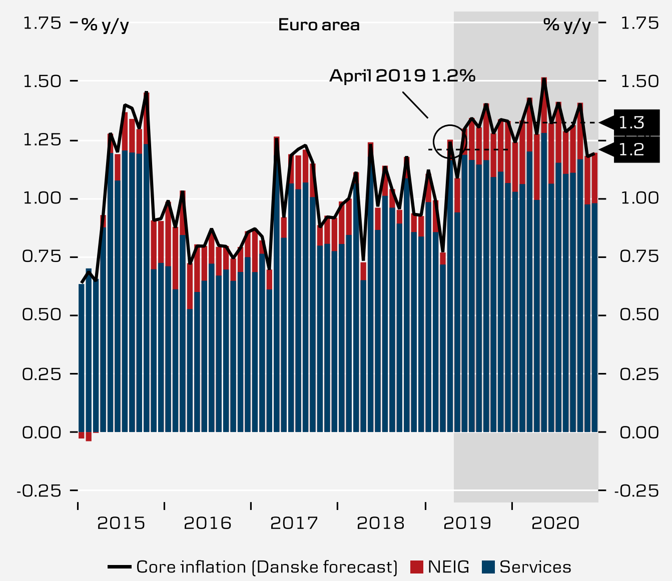
Source: Eurostat, Danske Bank

Euro area headline inflation outlook



Source: Eurostat, Macrobond, Danske Bank

Euro area core inflation outlook



Source: Eurostat, Macrobond, Danske Bank

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