Focal Point

Euro area inflation: recovering, not exploding

February 17, 2021

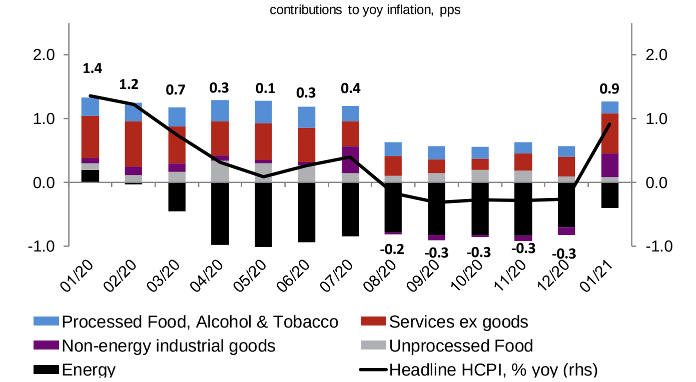
Author: Martin Wolburg

- Euro area headline inflation spiked in January to 0.9% yoy, after it had been in negative territory since August 2020.
- This strong jump was driven by one-off factors, like the end of the temporary German VAT cut, cold weather in Spain, a postponement of French winter sales, a re-weighting of the consumer basket and a lower drag from energy prices.
- While base effects, rising energy prices and the German VAT normalization will lift 2021 inflation in the euro area to 1.5% yoy, underlying inflation pressures will remain muted. The output gap will not be closed before the end of 2022 and there is a substantial crisis-induced slack in the labour market.
- Against this backdrop we see potential for inflation expectations to trend up further but not to soar. We expect the ECB to look through these short-term factors and to maintain a highly accommodative policy stance.

Inflation is back on the radar sceen. Following a decade of persistently low inflation in the advanced economies, markets have now started to flirt with the idea that the lowflation environment will be overcome. This concerns first of all the US where a looming bold fiscal package is set to lead to stronger price dynamics as we addressed in a recent Focal Point. But also in the euro area, January headline inflation jumped by 1.2 pp to 0.9% yoy, exceeding the market expectation of 0.5% yoy after five months in negative territory. In the coming months consumer price increases will gain momentum. Yet the inflation spike should prove temporary in the euro area. One-off effects and base effects from oil prices as well as the temporary German VAT cut will by then have run their course. We will also argue that economic slack will remain in 2022. Therefore, inflation will not jump but rather moderately trend higher medium term.

EA: Flash HCPI Breakdown

contributions to yoy inflation, pps

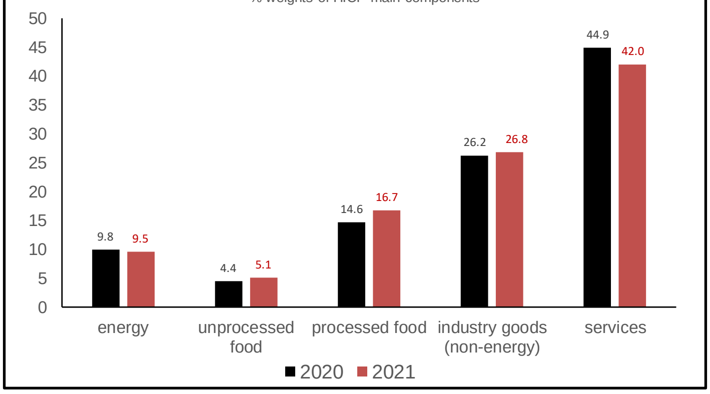


Sales, winter weather and new weighting scheme

Unforeseen one-off factors in some countries account for much of the latest inflation jump. First, French January sales were reported to have been postponed to February while price cuts happened already around the black Friday and were in January less strong than in previous years. Second, given unusually strong winter weather, especially in Spain, energy prices jumped sharply. Euro area energy prices advanced by 3.8% mom, the strongest monthly increase in more than a decade causing the disinflationary contribution from energy prices to fall to the lowest since February last year.

Euro area HICP weights

% weights of HICP main components



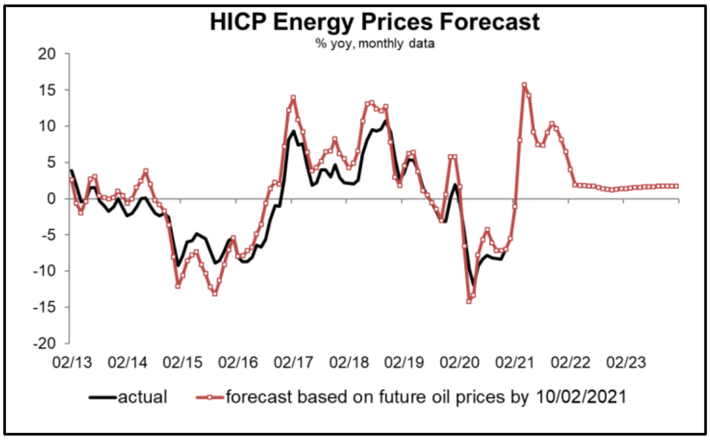
At the outset of the year Eurostat also regularly revises the weights of the consumer basket. This year there are significant changes as statisticians assess the impact of the Covid-19 crisis on household consumption patterns. As shown by the graph above, the weight of services has come down by about 3 pp on. a reduced weight of travel-related items like air fares, package holidays and accommodation. Cumulatively these items had a weight in the HICP of only 4.4% in 2020 but due to strong price decreases they dragged down monthly annual inflation by about -0.2 pp in the last months of 2020. While a lower weight of these items in the basket tends to reduce inflation, variations in the seasonal factor will contribute to volatility throughout the year.

Temporary German VAT cut is over

Over the course of 2021 inflation will also be supported by the end of the temporary German VAT rate cut. It had been temporarily cut from 19% to 16% over the course of H2/2020. Its reversal translates into an increase of the euro area inflation by up to 0.8 pp, depending on whether retailers decided to maintain their margin or to accept some squeeze. Based on past behaviour, calculations suggest that euro area inflation could be lifted by about 0.3 pp. As a result, annual inflation rates will become strongly affected from the VAT-effect in the second half of the year. However, the breakdown of the German PMIs for January reports a margin squeeze compared to December suggesting that firms might increase prices only reluctantly or some might even restrain from it for the time being. Moreover, at the outset of the year in Germany a CO2 fuel tax was introduced, which increased the price of a litre of petrol by about 7 cents. Therefore, these specific factors pushed up German inflation by a whopping 2.3 pp to 1.6% yoy in January, almost twice as much as the 1.2 pp increase for the entire euro area.

Energy price-driven disinflation ends

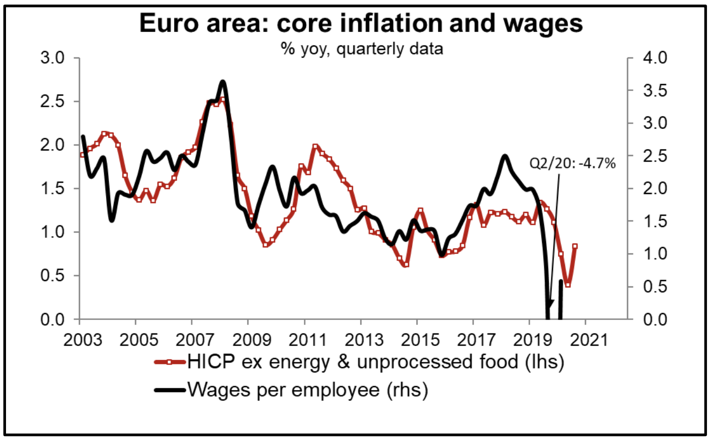
The deep oil price slump at the outset of the pandemic in March 2020 resulted in persistent disinflation from energy prices since then. This plunge will fade out from the annual inflation calculation over the coming months. Moreover, spot oil and future oil prices increased markedly compared to December. The spot price for oil is up by about 10 €/b Brent and future prices have increased across all maturities. The disinflationary drag from energy will thus quickly turn into an inflationary boost. We expect energy inflation to turn positive in March and to peak in April/May with annual increases of about 15% yoy, thereby likely lifting headline inflation by about 1.5 pp. That said, based on current futures energy prices will still contribute on average 0.8 pp to annual inflation in the second half of the year.



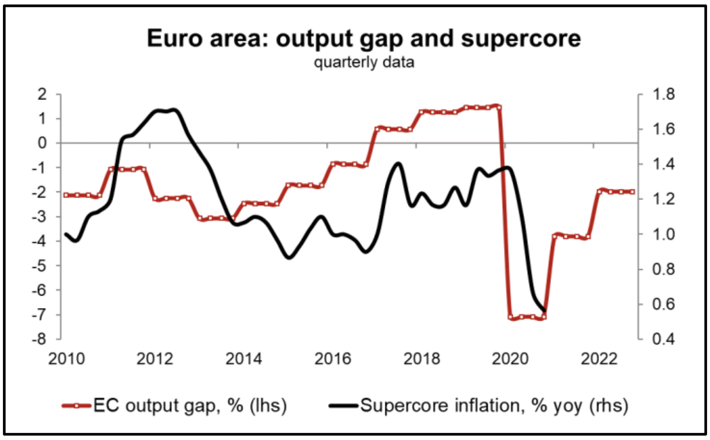
Underlying inflation to remain low

Leaving energy prices aside, price pressure in the euro area will remain low. Underlying inflation (headline inflation without unprocessed food and energy prices) averaged 0.9% yoy in 2020. In January it rose to 1.4% yoy (from 0.4% yoy in December) largely driven by the above-mentioned one-off factors. Looking ahead, we deem it most likely that core inflation will average around a weak 1% yoy in 2021.

One reason is that energy prices feed to goods and services prices with a lag. In 2021 the disinflationary effects from last year's development will still be at work. Also, import prices are currently still disinflationary (-0.9% yoy in Dec.) and we expect them to be dampened by a moderate strengthening of the effective euro exchange rate.



The key reason, however, is that there is a lot of slack in the euro area economy that will be reduced but definitely not fully eliminated over the course of this and also next year. A broad-based and lasting reflation trend needs to be backed by a strengthening labour market and rising wages. But the euro area labour market is still in a dismal situation. While the euro area is currently going through another recession the unemployment rate only rose moderately. It advanced from a pre-crisis reading of 7.2% to only 8.6% by summer 2020 and was at 8.3% in December. Unemployment is artificially held down by government support measures (e.g. furlough and short-time work schemes) and would be as high as 20% by some gauges. Wage growth even contracted in Q2/20 and its latest reading of 0.6% yoy is way below normal. Hence, there is a lot of slack in the labour market that first needs to be unwound until wage growth normalizes lastingly.



Generally speaking, the output gap is unlikely to be closed soon. In our growth scenario we only expect a return to the pre-crisis activity level by the end of 2021. Reaching the potential growth path will not take place this or next year. The IMF and the EC forecast the output gap to stay negative at

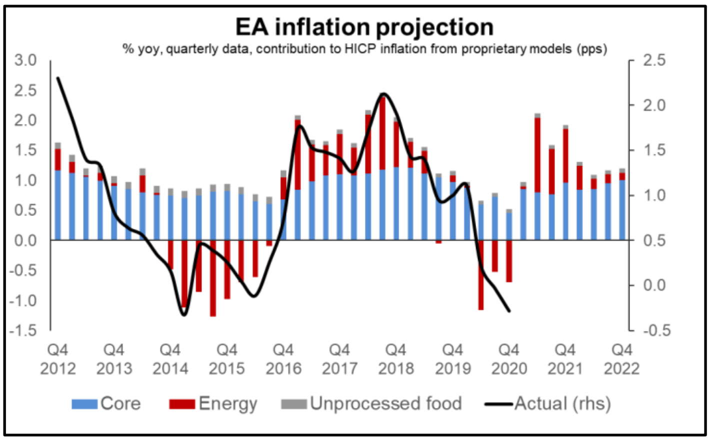
-1.6% or even -2.0% respectively by 2022. This implies that a 'true', namely activity-related, reflation is still distant. The pandemic-induced very low inflation potential is reflected in the ECB's so-called super-core measure of inflation which includes only price dynamics exhibiting a high correlation with the business cycle. Its latest reading (December) is merely 0.5% yoy and we expect it to stay muted.

Inflation to peak in spring

Putting all these considerations together, there will be strong swings in headline inflation with energy prices being the key driver. According to our internal models energy prices will add of up to 1.5 pp to the headline inflation push in April and May and another albeit less strong push in autumn. In 2022 energy price dynamics are set to normalize.

In contrast, underlying inflation will stay quite stable. While lifted by the end of the temporary German VAT cut and a change in the HICP basket it will be held down by muted wage growth and still disinflationary import prices. It is important to keep in mind that the interaction of these factors can contribute to unusually high volatility over the course of the year. We expect it to average 1.0% yoy in 2021, slightly up from the 2020 reading of 0.8% yoy.

All in all, we see the need to revise our euro area headline inflation expectation to the upside. For 2021 we now look for an average headline inflation rate of 1.5% while in 2022 a moderation to 1.2% is in the cards. The risks are mainly related to the pandemic and its effect on activity as we discuss in more detail in this recent Focal Point. A further postponement of the post-Covid-19 kick-off could easily reverse the latest oil price increase. In contrast, stronger growth amid higher oil prices constitutes upside risks.

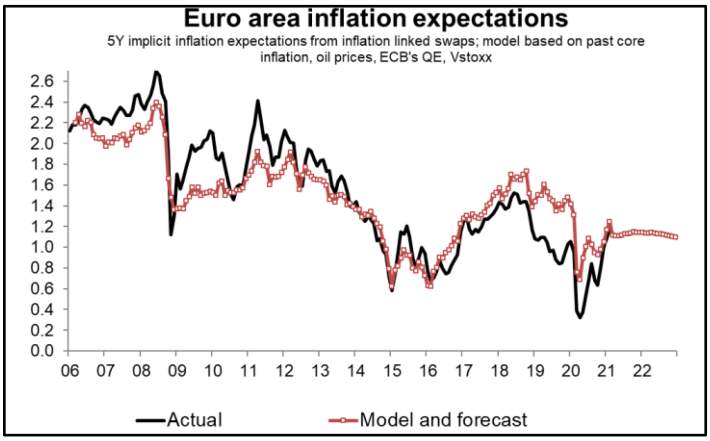


No reason for soaring inflation expectations

After having largely ignored inflation over the past years, financial markets have started to assess the inflation potential as of late. This concerns primarily the US where for instance bond-based 5-year inflation expectations rose by about 30 bps since the start of the year implying an average inflation rate of around 2.4% until 2026. Euro area inflation expectations staged a more limited increase. The 2-year inflation expectation of 1.3% is consistent with our inflation outlook and hence see the rise is backed by fundamentals.

Within five years we see annual inflation rising to 1.7% and look for an average inflation rate of about 1.5% over this horizon. This is more than the 1.2% rate currently priced by markets. In our scenario of ongoing low underlying inflation, oil prices increasing only moderately and overall uncertainty coming down as the post-lockdown recovery starts, we do not expect any further lasting increase of medium-term inflation expectations. This is even the case when accounting for persistent QE by the ECB (see graph below). That said, temporary spikes in inflation expectations cannot be ruled out, e.g. in response to oil prices, the forthcoming ECB strategy review results and inflation developments in the US. In sum, we see some potential for still higher inflation expectations but do not expect them to go through the roof.

Looking further down the road, uncertainties surrounding the inflation outlook increases. As we have discussed elsewhere concerns are growing that ballooning central bank balance sheets may herald a rebound in inflation, tacitly welcomed by highly indebted governments. Deglobalisation, rising bargaining power of workers and increased industrial concentration may favour structurally higher prices over the medium term. On the other hand, closing the output gap will be a lengthy process, fiscal consolidation cannot be ignored forever, and accelerated digitalization is disinflationary, too. We see the emergence of an outright inflation rather as a remote threat. While acknowledging the risk of temporary spikes, we see no backing for soaring inflation expectations either against this backdrop.



Conclusions: EA inflation still a remote threat

We are ahead of an energy-price induced spring inflation spike. Headline inflation rates north of 2% yoy are likely. That said, we will not witness the beginning of a new inflation regime. Underlying inflation will stay very muted given that there is sizeable slack in the economy. Annual inflation is forecast to average 1.5% in 2021 but to recede to 1.2% in 2022. Against this backdrop we see no fundamental reason for inflation expectations to soar.

We see no outright policy implication from the upward revised inflation forecast for the ECB. The March update of the staff macro projections will for sure show higher headline inflation rates for 2021 (December projection: 1.0%) and 2022 (December projection: 1.1%). A more hawkish stance is nevertheless unlikely. First, the projected inflation path will still be below the pre-pandemic one on which the ECB wants to re-embark. Second, the Governing Council will be very aware of the special factors driving this year's inflation increase and look through them as it looked through the deflationary period in the second half of 2020. We continue to see the ECB policy risks tilted to the dovish side and mainly related to an adverse evolution of the pandemic. In any case the ECB is set to maintain a highly accommodative policy stance.

Imprint

Issued by:	**Generali Insurance Asset Management S.p.A. Società di gestione del risparmio, Research Department**
Head of Research:	Vincent Chaigneau (vincent.chaigneau@generali-invest.com)
Head of Macro & Market Research:	Dr. Thomas Hempell, CFA (thomas.hempell@generali-invest.com)
Team:	Elisabeth Assmuth (elisabeth.assmuth@generali-invest.com) Elisa Belgacem (elisa.belgacem@generali-invest.com) Radomír Jáč (radomir.jac@generali.com) Jakub Krátký (jakub.kratky@generali.com) Michele Morganti (michele.morganti@generali-invest.com) Vladimir Oleinikov, CFA (vladimir.oleinikov@generali-invest.com) Dr. Martin Pohl (martin.pohl@generali.com) Dr. Thorsten Runde (thorsten.runde@generali-invest.com) Dr. Christoph Siepmann (christoph.siepmann@generali-invest.com) Dr. Florian Späte, CIIA (florian.spaete@generali-invest.com) Guillaume Tresca (guillaume.tresca@generali-invest.com) Dr. Martin Wolburg, CIIA (martin.wolburg@generali-invest.com) Paolo Zanghieri, PhD (paolo.zanghieri@generali.com)
Head of Insurance and AM Research:	Michele Morganti (michele.morganti@generali-invest.com)
Team:	Raffaella Bagata (raffaella.bagata@generali.com) Alberto Cybo-Ottone, PhD (alberto.cybo@generali.com) Mattia Mammarella (mattia.mammarella@generali-invest.com) Roberto Menegato (roberto.menegato@generali.com) Giovanni Millo, PhD (giovanni.millo@generali.com) Antonio Salera, PhD (antonio.salera@generali.com) Cristiana Settimo (cristiana.settimo@generali.com) Federica Tartara, CFA (federica.tartara@generali.com)

Sources for charts and tables:	Refinitiv/Datastream, Bloomberg, own calculations Version completed: see front page

In Italy:
Generali Insurance Asset Management
S.p.A Società di gestione del risparmio

Piazza Tre Torri
20145 Milano MI, Italy

Piazza Duca degli Abruzzi, 1
34132 Trieste TS, Italy

In France:
Generali Insurance Asset Management
S.p.A Società di gestione del risparmio

2, Rue Pillet-Will
75009 Paris Cedex 09, France

In Germany:
Generali Insurance Asset Management
S.p.A. Società di gestione del risparmio

Tunisstraße 19-23
50667 Cologne, Germany

www.generali-investments.com