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Institutional Investing

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Analyse

EUR inflation: the target is close, but holding it will be difficult

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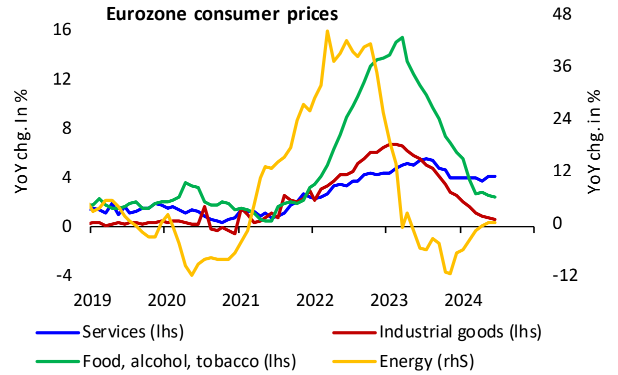
First successes in the fight against inflation

The war in Ukraine, the flood of money from central banks and the expansive fiscal policy during the coronavirus pandemic have triggered the biggest wave of inflation in 50 years in many western industrialised countries. The initial surge has now subsided. This applies not least to the Eurozone. Here, the inflation rate has more than quadrupled from 10.6% to 2.5% recently. At the same time, the core inflation rate (excluding energy and food) has halved from 5.7% to 2.9%. The exciting question now is whether the last mile on the road to price stability can be mastered. This would be the case if the ECB's inflation target (2.0%) is met again on a sustained basis.

Figure 1: Services slow down disinflation



Sources: Eurostat, BANTLEON

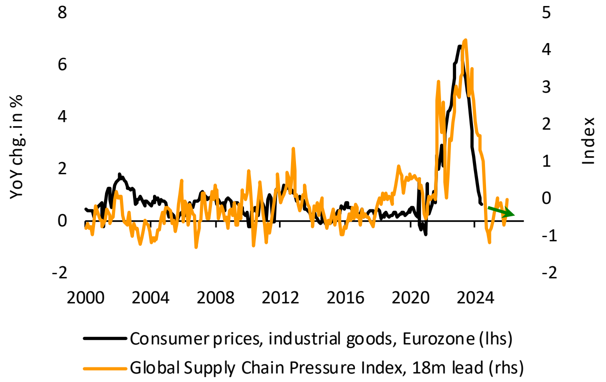
The greatest inflationary pressure in recent years has undoubtedly come from energy and food. Much has now changed for the better here. Starting from high double-digit figures, year-on-year inflation has fallen to 0.2% (energy) and 2.0% (food, see Figure 1). Thanks to favourable base effects, the annual rate for energy prices should even slip back into negative territory in late summer 2024. We also see downside potential for food prices in the short term – provided, of course, that no new (weather) shock occurs.

Inflation for industrial goods close to zero

However, the decisive factor is whether fundamental price pressure will continue to ease. In the following, we will therefore focus on core inflation (share of the total basket of goods: 71%), the two most important components of which have gone their separate ways since the beginning of the year. Industrial goods (share of the core index: 37%), which include cars, furniture, electrical appliances, computers, clothing, etc., have been experiencing a steep disinflation trend for 16 months. Inflation in this group has therefore fallen from 6.8% to 0.7% (see Figure 1).

The situation is different for services (share of the core index: 63%), whose inflation rate has stagnated at around 4.0% for the past eight months following a brief period of disinflation. **This means that service prices are now by far the biggest driver of inflation** (see Figure 1) **and the real worry child on the road to price stability.** This is all the more true as the seasonally adjusted index is even signalling increasing inflationary pressure – the annualised annual rate has recently been above 4.0% for the most part.

Figure 2: Relaxation in supply chains



Sources: Eurostat, FRB of New York, BANTLEON

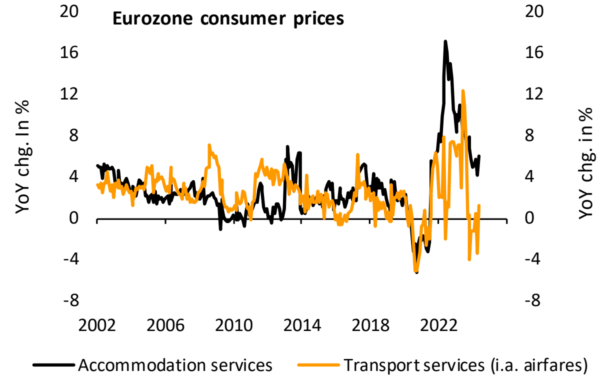
It is hardly surprising that there is a wide gap between inflation for industrial goods and services. The prices of industrial goods are significantly influenced by raw material and import prices as well as global supply conditions. Following the shocks of recent years (including the pandemic and the war in Ukraine), there has now been a noticeable easing of the situation. This is demonstrated particularly impressively by the Federal Reserve Bank of New York's global supply chain index, which points to a complete normalisation in the international exchange of goods (see Figure 2).

Together with falling import prices, this has made a decisive contribution to disinflation in industrial goods. At 0.7%, the annual rate is now already slightly below the long-term average (1.0%). In view of this, the potential for further declines appears limited. **However, our forecast model for determining the price trend for industrial goods indicates that inflation is very likely to fall to a level of 0.0% to 0.5% by the end of the year.**

Services are the casus crux

The situation for services is more complex. Here too, the easing cost pressure from energy and food prices has made itself felt in some components. Airline tickets, for example, have already begun to normalise and hotel accommodation prices are at least easing (see Figure 3). In other areas, however – above all motor vehicle insurance – the cost pressure from previous years is only now really being passed on (see Figure 4).

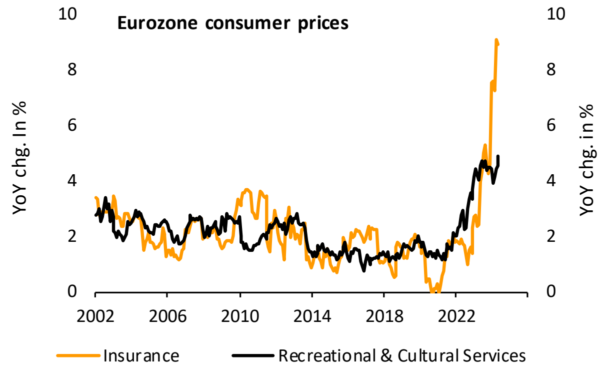
Figure 3: Sporadic disinflation is visible



Sources: Eurostat, BANTLEON

In addition, in most service sectors (e.g. culture and leisure), labour-intensive rather than commodity-intensive services are provided. **Wage pressure is therefore the decisive factor and, unlike in the case of commodities, there is still little sign of easing here.** At the beginning of 2024, wage growth in the Eurozone was still between 4.5% and 5.0% (year-on-year, see Figure 5), with labour productivity declining at the same time.

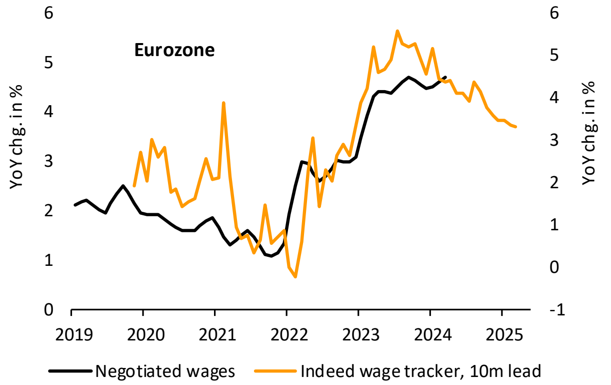
Figure 4: The passing on of costs continues in many places



Sources: Eurostat, BANTLEON

As a result, many companies have continued to utilise the existing pent-up demand – e.g. in leisure and travel consumption – to push through higher prices. In addition, the numerous prominent sporting events (end-of-season football matches, European Football Championships, European Athletics Championships, upcoming Olympic Games, etc.) also encouraged hoteliers in particular to raise prices.

Figure 5: Wage pressure is easing – at least gradually

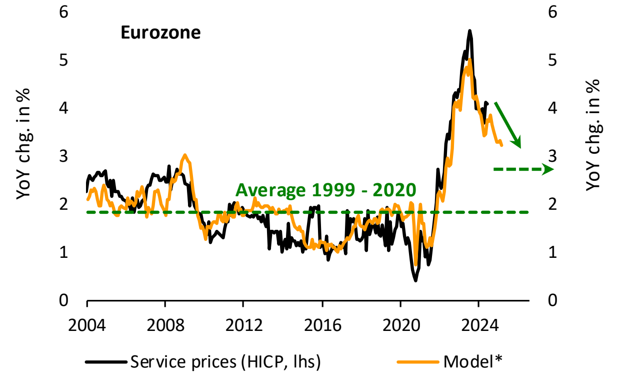


Sources: ECB, Indeed, BANTLEON

Looking ahead, we are nevertheless confident that inflation will fall. As far as wage pressure is concerned, most indicators are now signalling that the peak has been reached and that salary growth will turn into a downward trend in 2024. One of these indicators is the Indeed Wage Tracker (see Figure 5), which analyses salary offers from job advertisements. There is no doubt that the slowdown in wages will be sluggish, as employees are in a strong negotiating position given the record low unemployment rate. **Nevertheless, wage growth should fall towards 3.0% to 3.5% by the beginning of 2025.**

Prominent surveys also point to a less aggressive pricing policy in the coming months. **According to these surveys, sales price expectations – starting from a high level – are declining in almost every service sector.** All of this information is included in our forecast model, which we use to estimate the future rate of service price inflation (see Figure 6). **The trend should therefore be flat on the downside over the next few months.** At the beginning of 2025, we expect the inflation rate for service prices to be around 3.0%.

Figure 6: Inflation in services likely to slow, but not collapse



Sources: Eurostat, BANTLEON; * Input: Energy and food prices, labour costs, price expectations

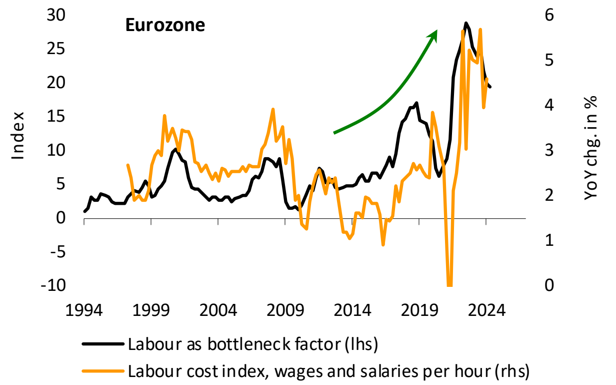
As a result, our inflation forecasts for the two main components of the core rate – 3.0% for services (weight 63%), 0.0% to 0.5% for industrial goods (weight 37%) – come to around 2.0%. This is in line with our top-down forecast for core inflation, which also sees the rate at around 2.0% at the start of 2025.

ECB with a Pyrrhic victory?

Overall, it can be said that the ECB should manage the last mile on the way to the 2% target – even if only just – in the course of the second half of the year and that the inflation rate will stabilise at this level in the first half of 2025. The precondition is, of course, that the oil price plays along. This gives the monetary authorities the flexibility to reduce the degree of restrictiveness of monetary policy. **If the neutral key interest rate in the Eurozone is estimated at 2.50% to 3.00%, this is likely to be the goal of the monetary authorities in the coming months.** Key interest rates will only have to be lowered below this level if the economy collapses, which we do not expect.

End well, all's well? *Jean-Claude Trichet* would say: »We have to be vigilant«. The environment for the ECB remains challenging. If growth in the Eurozone stabilises at 1.0% to 1.5% over the next few quarters, the bottlenecks in the labour market will persist. Companies have seen the labour shortage – and not a lack of demand – as the biggest problem in manufacturing for several years (see Figure 7). Demographic change is taking its toll here. **Accordingly, wage growth is unlikely to fall below 3.0%. At the same time, there is currently a lack of imagination to hope for a strong increase in labour productivity. In structural terms, service price inflation could therefore settle at 2.5% to 3.0% – almost 1.0%-points higher than before the pandemic (see Figure 6).**

Figure 7: Labour shortage causes wage pressure



Sources: Eurostat, EU Commission, BANTLEON; * Answer to question: »What main factors are limiting your production?«

In addition, it cannot be assumed that inflation for industrial goods will remain close to zero in the long term. Rather, in view of the investments in the green transformation and the associated explosion in demand for industrial metals, an overarching upward trend in commodity prices can be assumed. **Inflation for industrial goods should therefore at least return to the old levels (1.0%).**

Against this backdrop, it will be difficult for the ECB to push inflation below 2.0% in the long term. In normal economic times, the central bankers will then have no choice but to repeatedly raise key interest rates into restrictive territory – i.e. above 3.00%. As a result, the zero interest rate environment is a thing of the past for the time being. Yield levels on the bond markets will therefore remain at significantly higher levels in the remaining 2020s than in the 2010s.

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