Euro Area Research

ECB inflation gap persists in 2019

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Important disclosures and certifications are contained from page 20 of this report.
Summary: euro area inflation outlook remains subdued despite higher oil price

- We have marginally raised our inflation forecast for 2018 due to higher energy-price inflation, but inflation pressures will still decelerate and energy-price inflation will continue to be a drag from late 2018 and 2019, according to our projection.

- Without continued steep rises in oil prices or second-round effects materialising, we do not expect that recent higher oil prices will have a lasting impact on the euro area inflation outlook and therefore will also not speed up the ECB’s exit from extraordinary monetary policy measures.

- Several ECB members have recently floated the possibility of de-coupling the forward guidance on QE from the requirement of a sustained rise in inflation, which could open up the possibility of the ECB ending the QE programme in 2018, even without a clear pick-up in inflation.

- Supported by the continued strong economic momentum, we expect core inflation to stay above 1.0% in 2018 and 2019 which should be an important argument for the ECB in its decision to end the QE programme in 2018.

- We project that core inflation will not accelerate before 2019, as the outlook for wage growth remains subdued.

- We expect that despite a pick-up in core inflation in 2019, inflation will continue to undershoot the ECB’s target as even higher energy-price inflation is required to lift HICP inflation back to the 2% target.
We have raised our inflation forecast for 2018 due to higher energy-price inflation, but inflation pressures will still decelerate.
Markets remain sceptical of inflation picking up as the ECB projects

ECB’s 2019 inflation outlook still too optimistic in our view

Markets are even more pessimistic on euro area inflation outlook in 2019

Source: Eurostat, ECB, Macrobond Financial, Danske Bank
Recent higher oil prices will not change the ECB’s medium-term inflation and monetary policy outlook
Higher oil prices need to affect inflation expectations and wage agreements to have a lasting impact on inflation.

First-round effects

Higher oil prices usually pass through to higher energy prices fairly quickly (within three to five weeks) as a result of the impact on production costs.

Second-round effects

For higher oil prices to have a lasting effect on inflation, they need to impact inflation expectations and the wage formation process as well. However, we do not see strong evidence for that at the moment.

Source: ECB, Danske Bank
Oil prices have increased sharply since mid-2017.

Assuming unchanged oil prices for rest of 2017, ECB likely to revise up oil price forecast.

Oil prices are closely linked to gasoline prices and feed through to higher energy prices.

Source: ECB, Macrobond Financial, Danske Bank
What if oil prices rise to USD80/bl in 2018?

If oil prices continue to rise in 2018 at same pace... 

...it could lead to positive inflation surprises in 2018

Assumptions:
- Brent oil rises to USD80/bl end-2018 and unchanged thereafter.
- EUR/USD at 1.21 in 2018 and 1.26 in 2019

Source: Eurostat, Macrobond Financial, Danske Bank
Without significant further oil-price increases, energy-price inflation will still decelerate in 2018 and 2019.
Oil price rise alone will not speed up ECB policy exit

Without continued steep rises in oil prices or second-round effects materialising, we do not expect that the stronger near-term outlook for energy prices alone will speed-up the ECB’s exit from extraordinary monetary policy measures. Large oil price changes have often coincided with ECB policy changes [see below]. However, we do not think that recent higher energy prices will lead to big revisions in the ECB’s new December inflation projections, also because the ECB’s 2019 energy-price inflation forecast is already hopeful, in our view.

Instead we think it is more interesting that several ECB members have recently floated the possibility of de-coupling the forward guidance on QE from the requirement of a sustained rise in inflation, and rather link it to the overall monetary policy stance, i.e. the combination of new asset purchases, the existing stock of QE assets plus reinvestments and the forward guidance in policy rates. If that view gains prominence in the Governing Council in the coming months, it could open up the possibility for the ECB to end the QE programme in 2018, even without a clear pick-up in inflation.
Subdued core inflation despite economy growing above potential – wage growth still the missing link
The ECB is increasingly shifting focus towards a more holistic view of the euro area economy and inflation, with a strong belief that the closing output gap in light of ongoing expansion and continued employment gains will eventually push underlying inflation pressures higher. In line with this thinking, the so-called ‘super core’ inflation measure has increasingly featured in recent speeches of ECB members. Super core consists of a sub-index of all HICP items that have been closely correlated with the output gap in the past and could hence provide important signals about turning points in inflation.

The ECB does not publish the series, but using the ECB’s methodology we have tried to replicate it. Our series consists of 31 HICP items (mainly in the services component) that exhibit a strong link to the EC’s output gap estimate. Both our and the ECB’s super core inflation measure have indicated an upward trend since 2017, supporting the ECB’s argumentation of a pick-up in underlying inflation pressures due to strong economic momentum. However, the two series have diverged somewhat lately (possibly due to methodology changes), leaving us to expect a more moderate response in core inflation to the closing output gap than the ECB, especially in 2018.
Core inflation will rise less in 2018 than the ECB expects

Core inflation to accelerate first in 2019

Service-price inflation to stay below average

The linchpin to higher core inflation still remains higher euro area wage growth, which we do not expect to materialize before 2019, as labour market slack is still high (see slide 18) and German negotiated wages also do not show any convincing signs of increase (see slide 19), also due to low inflation expectations affecting negotiated wages adversely (see slides 18).

Source: Eurostat, Macrobond Financial, Danske Bank
The closing output gap points to higher core inflation

Core inflation set to rise as output gap closes...

...but the relationship is not seen in all countries

Source: ECB, Eurostat, Macrobond Financial, Danske Bank

Source: European Commission, Eurostat, Macrobond Financial, Danske Bank
Economic momentum should raise underlying inflation pressures, but stronger euro creates a headwind

Closing output gap is supporting the largest component of service-price inflation...

...but stronger euro has started to feed through, lowering import prices and NEIG inflation in 2018
Higher oil prices indirectly affecting core inflation as well

Higher oil prices support core inflation indirectly by lifting producer prices and prices on transport services...

...but the effect will not be as strong as in 2017 and also comes with a time lag of up to 12 months.

Source: Eurostat, Macrobond Financial, Danske Bank
For service-price inflation to accelerate wage pressures need to rise

Wage growth expected to accelerate only in 2019 as unemployment falls below NAIRU

The European Commission has again lowered its NAIRU estimate from 8.8% to 8.4% in 2018.

Low service-price inflation as long as wages do not pick up significantly

The ECB’s wage growth forecast is still too optimistic in our view. In line with our wage growth projection, we expect service price inflation to accelerate only in 2019.

Source: EC, Eurostat, ECB, Macrobond Financial, Danske Bank
Wage growth to stay subdued as labour market slack remains high and low inflation expectations weigh on negotiated wages

Broader measures of unemployment still point to significant labour market slack...

...while low inflation expectations also adversely affect wage negotiations

Source: Eurostat, Macrobond Financial, Danske Bank
German negotiated wages: still no sustained upward trend in sight

Structural changes in the wage formation process (i.e. technological change, low productivity growth), may help explain the current wage restraint. Furthermore, flexible working time rather than higher pay is increasingly becoming the number one concern for German workers, see Reuters, German wage talks to include new focus: reduced working hours, 14 September 2017.

<table>
<thead>
<tr>
<th>Wage agreements, pay rises</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019 (late 2018)</th>
<th># of workers affected</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banking</td>
<td>1.50%</td>
<td>0%</td>
<td>1.1%</td>
<td>1.1%***</td>
<td>230,000</td>
</tr>
<tr>
<td>Doctors at municipal hospitals</td>
<td>2.30%</td>
<td>2.00%</td>
<td>0.7%</td>
<td>-</td>
<td>55,000</td>
</tr>
<tr>
<td>Construction (Western/Eastern Germany)</td>
<td>2.4% / 2.9%</td>
<td>2.2% / 2.4%</td>
<td>-</td>
<td>-</td>
<td>800,000</td>
</tr>
<tr>
<td>Metal industry</td>
<td>2.8%*</td>
<td>2.00%</td>
<td>[6%]**</td>
<td>-</td>
<td>2.3 mio.</td>
</tr>
<tr>
<td>Chemical</td>
<td>3.00%</td>
<td>2.30%</td>
<td>-</td>
<td>-</td>
<td>650,000</td>
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<tr>
<td>Printing industry</td>
<td>2.00%</td>
<td>1.80%</td>
<td>-</td>
<td>-</td>
<td>19,000</td>
</tr>
<tr>
<td>Federal and municipal public service</td>
<td>2.40%</td>
<td>2.35%</td>
<td>-</td>
<td>-</td>
<td>2 mio.</td>
</tr>
<tr>
<td>Cleaning sector</td>
<td>2.6% / 4.2%</td>
<td>2.0% / 3.8%</td>
<td>-</td>
<td>-</td>
<td>429,000</td>
</tr>
<tr>
<td>Textile and clothing (Western Germany)</td>
<td>-</td>
<td>2.7%*</td>
<td>-</td>
<td>1.70%</td>
<td>-</td>
</tr>
<tr>
<td>Public Service of the Länder (TV-L)</td>
<td>-</td>
<td>2.00%</td>
<td>-</td>
<td>2.35%</td>
<td>1.48%</td>
</tr>
<tr>
<td>Temporary employment (Western / Eastern Germany)</td>
<td>-</td>
<td>2.5% / 4.0%</td>
<td>-</td>
<td>2.8% / 4.0%</td>
<td>3% / 3.5%</td>
</tr>
<tr>
<td>Minimum wage</td>
<td>0%</td>
<td>4.00%</td>
<td>-</td>
<td>-</td>
<td>3-4 mio [Estimate]</td>
</tr>
</tbody>
</table>

* Including one-off payment of 320 euros
** Initial demand
*** From 1. Nov 2018

Source: Danske Bank
Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Aila Mihr (Analyst) and Christian Belling Sørensen (Assistant Analyst).

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