Inflation – the last mile is the hardest

Dr. Jörg Krämer

Next week's inflation data for the eurozone will show that the rapid decline in inflation is continuing. But the last mile in the fight against inflation will be much more difficult. We use criteria from ECB Executive Board member Isabel Schnabel to show why inflation is unlikely to settle at the targeted 2% in the end.

Why the first miles are easy going

Inflation in the eurozone peaked at 10.6% in the fall of last year. Since then, it has fallen as rapidly as it had previously risen. In October, it stood at just 2.9%; next week, the EU statistics office is expected to publish a further fall to an estimated 2.7% for November. If inflation were to continue to fall at such a pace, the ECB would soon have reached its inflation target.

But the first few miles in the fight against inflation were easy because they were mainly caused by base effects: Since energy prices cannot continue to rise as quickly as they did after Russia's war of aggression on Ukraine began, the year-on-year rise in energy prices is falling. Almost three quarters of the decline in the inflation rate since the fall of 2022 is due to this base effect (title chart). The rest is due to the fact that the rise in prices for food and industrially manufactured goods, which had become massively more expensive due to material shortages, has subsided.

Even after the energy price shocks of the 1970s, inflation in many countries has fallen as rapidly as recently. However, according to a study by the International Monetary Fund, the inflation problem was still not solved in 42 of the 100 cases analyzed. Rather, inflation stabilized at rates that were at least 1 percentage point higher than before the respective inflation shocks, or even rose again. In 90% of these unresolved inflation episodes, inflation in the first three years after the shocks had fallen at a similar rate to the most recent one, giving rise to premature celebrations.

Schnabel's criteria for successfully combating inflation

The rapid fall in inflation due to mere base effects is simple and says little about whether inflation will ultimately settle at 2%. According to a speech by ECB Executive Board member Isabel Schnabel, two points are crucial for success in the final miles of the fight against inflation:

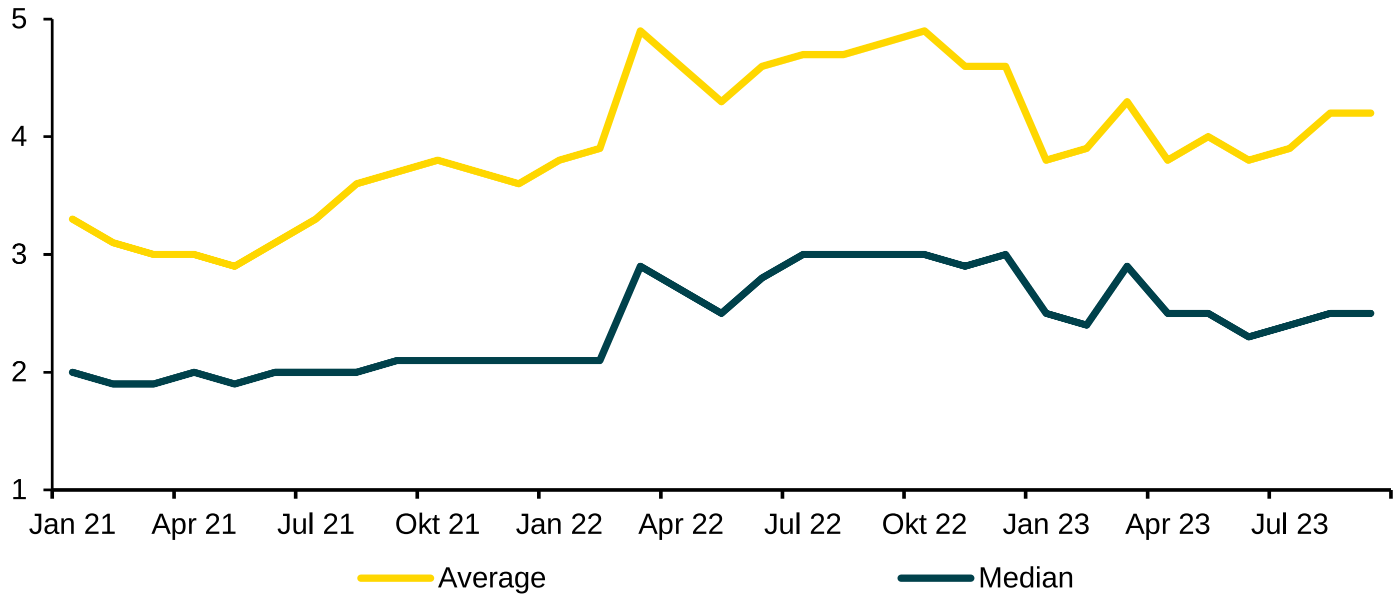
- First, the central bank must tighten monetary policy sufficiently after the inflation shock so that long-term inflation expectations of companies and consumers remain anchored at 2%.
- Secondly, the central bank should subsequently dampen the economy through higher interest rates to such an extent that trade unions have to accept slower wage increases and companies have to accept cuts in their profit margins.

Question mark already over inflation expectations

The first point, inflation expectations, already raises questions. According to an ECB survey (median), consumer inflation expectations have risen to over 2% in each of the three years since 2022 (Chart 1). A similar survey by the Bundesbank shows an even more pronounced de-anchoring of inflation expectations for Germany. Market-based inflation expectations have also risen significantly, although these may also be influenced by changes in inflation risk premiums. All in all, however, the rise in inflation expectations shows that the ECB is facing headwinds over the last few miles.

Chart 1 - Stubbornly elevated inflation expectations

Consumers' expectations regarding inflation in three years' time according to the Consumer Expectations Survey (CES), in percent



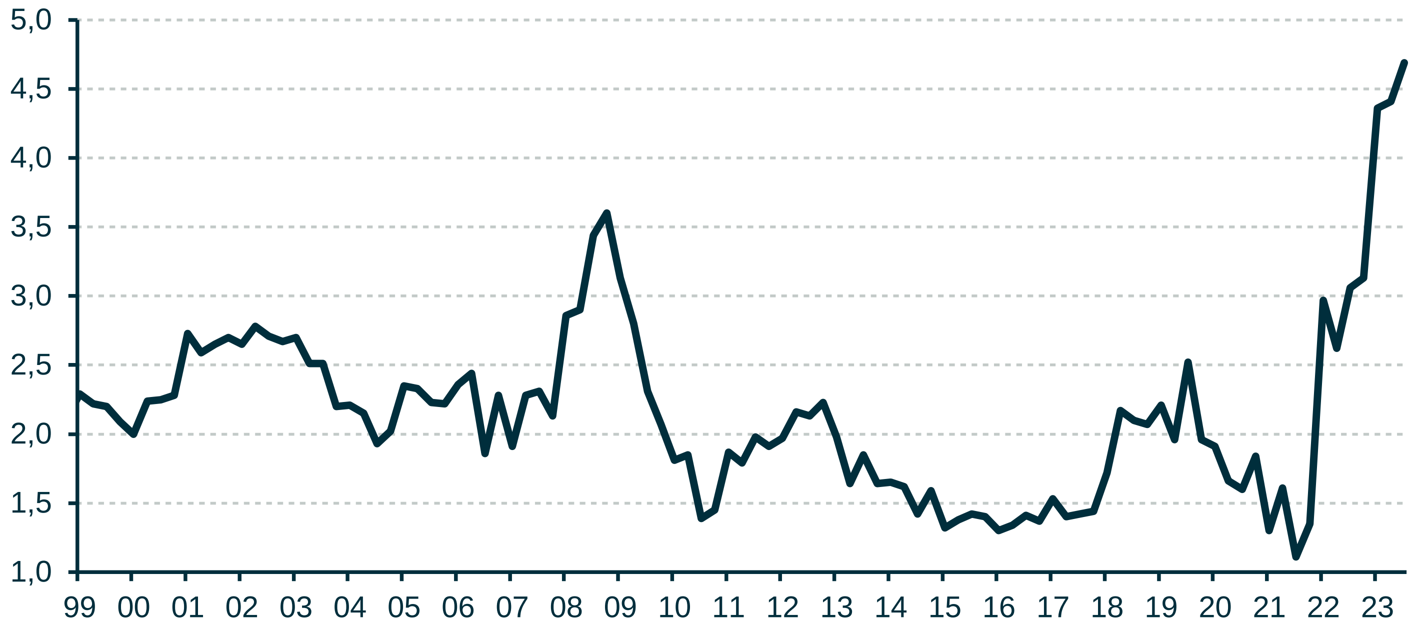
Source: ECB, Commerzbank Research

Starting position for wages and profits is difficult

There are also some question marks behind the ECB's efforts to slow down the economy in such a way that the inflation-driving influence of trade unions and companies is sufficiently contained. The rise in collectively agreed wages in the eurozone has recently accelerated to 4.7% (Chart 2). According to the ECB, the most recently concluded new collective wage agreements even provide for an increase of 6%. However, in order to be compatible with inflation of 2% in the medium term and given productivity growth of less than 1%, wages should only increase by just under 3%.

Chart 2 - Strongest wage increase in the history of the eurozone

ECB negotiated wage indicator, annual rate of change in %



Source: ECB, Commerzbank Research

But the trade unions will not simply lower their wage demands in line with the renewed fall in inflation. This is because consumer prices in the eurozone have risen by 18% since the end of 2020, while per capita wages have only increased by an estimated 13%. The resulting 5% slump in real wages is historically unprecedented, meaning that trade unions will continue to demand relatively high wage settlements for a long time to come and, to a large extent, enforce them. This in turn increases companies' labor costs, which are likely to raise their prices by more than 2% for a long time to come - if the economy allows it.

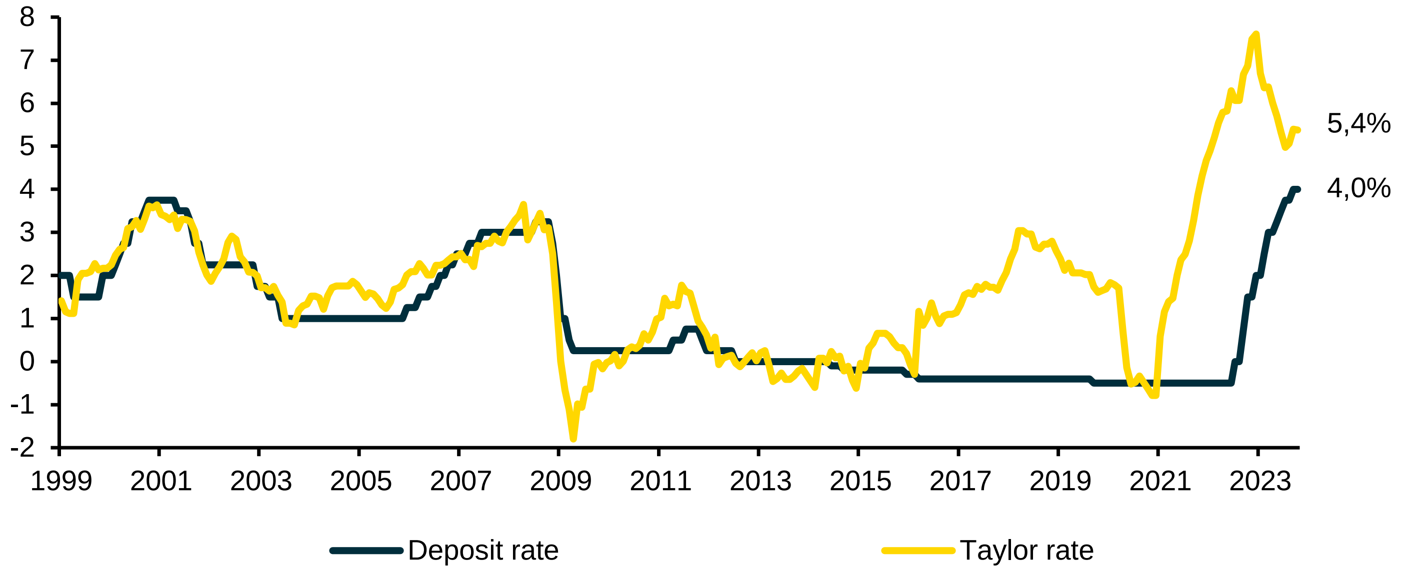
Is the ECB key interest rate really high enough?

To put an end to this wage-price ping-pong, the central bank should cool the economy with high interest rates until trade unions can no longer push through excessively high wage increases and companies can no longer push through excessively high profit margins.

But there is reason to doubt whether the ECB's monetary policy is already sufficiently restrictive. This is shown by our Taylor rule, which, starting from a neutral interest rate of an estimated 3%, applies mark-ups if the inflation forecast is above 2% or the forecast capacity utilization of the eurozone economy is higher than the long-term average. According to this rule, a deposit rate of 5% would be appropriate, whereas the rate is actually only 4% (Chart 3). Our Taylor rule therefore signals that monetary policy is not yet sufficiently restrictive. In this respect, it is questionable whether the ECB is cooling the economy enough to limit the contribution of wages and profits to inflation to 2%.

Chart 3 - Taylor rule suggests more than 5% key interest rate

ECB deposit rate and Taylor interest rate based on forecasts for growth and inflation in the euro area, in per cent



Source: ECB, Consensus Economics, Commerzbank Research

Inflation is likely to level off at 3% and not 2%

Inflation is likely to fall again in November – to an estimated 2.7%. Apart from the usual fluctuations, the decline should therefore be largely over. By contrast, core inflation (excluding energy, food and beverages) will probably continue to fall from its most recent level of 4.2% until the spring, as the rise in prices for goods (excluding energy) will continue to slow, primarily due to the easing of material shortages. However, due to the excessive rise in wages, core inflation is likely to stabilize at 3% rather than 2%, which is unlikely to change much in the following years.

Consequences for financial markets

Our forecast means that the fight against inflation will fail in the final miles. But investors are unlikely to share this opinion any time soon. This is because we expect a mild recession for both the eurozone (winter half-year) and the US (summer half-year 2024). This should fuel hopes that inflation will ultimately settle at the targeted 2%. This applies in particular to the US, whose central bank has acted more decisively than the ECB. We therefore expect the Fed to cut interest rates by a total of 100 basis points in the second half of 2024. This is the main reason why we see US bond yields falling in 2024 (year-end forecast for 10-year US government bonds: 3.6%). We also see a certain decline in yields for German government bonds, especially as the ECB is likely to cut its deposit rate by

25 basis points at the end of 2024. However, if the recession in the US is finally over and inflation rates remain at 3% rather than 2%, investors are likely to be disappointed at some point and bond yields will rise again. This could happen in 2025.

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In accordance with ESMA MAR requirements this report was completed 24/11/2023 07:36 CET and disseminated 24/11/2023 07:36 CET.

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