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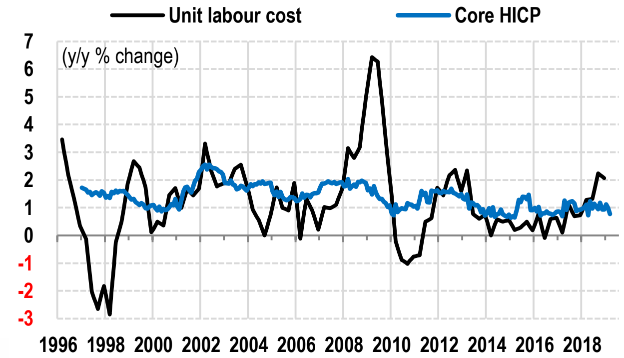
ECB: easing of inflation raises pressure

■The pass-through of wage growth to prices is stronger and faster when inflation is higher to start with ■The low inflation in the Eurozone has slowed down the transmission ■The considerable growth slowdown, on the back of adverse foreign demand and uncertainty shocks, impairs this process even more ■This raises pressure on the ECB to take action in order to dislodge core inflation, which remains stuck well below its objective

At a conference in Frankfurt last November, Mario Draghi explained in great detail how faster wage growth tends to lead to higher inflation[1]. As demand for goods and services rises and production increases, productivity picks up, giving a boost to corporate profitability. Eventually, wages increase, all the more so when companies recruit more staff and the competition for talent intensifies. Unit labour costs rise, putting pressure on profit margins. Sustained strong economic growth ends up providing companies with enough confidence to raise their prices in order to protect their margins.

These lags, which are perfectly normal, allow the central bank to maintain a very accommodative policy, even though growth is already robust. ECB research has shown that the pass-through from wage growth to inflation is faster and stronger in periods of higher inflation. This implies that when inflation has been low, like in the eurozone, the process will take more time[2]. It is of course essential that in the meantime growth remains on track: "*if firms start to become more uncertain about the growth and inflation outlook, the squeeze on margins could prove more persistent. This would affect the speed with which underlying inflation picks up and therefore the inflation path that we expect to see in the quarters ahead.*"[3]

EUROZONE: UNIT LABOUR COSTS AND CORE INFLATION



Source: Eurostat, BNP Paribas

Five months later, it turns out these words of the ECB President were very much prescient. Growth has slowed significantly for a host of reasons (slowdown of the global capex cycle, slower world trade growth, slower growth coming from China, country-specific factors in Germany, Italy and France, a prolonged period of pervasive uncertainty, etc.). As a consequence, labour market bottlenecks, whilst remaining tight, have eased. Moreover, growth of compensation per employee, which is still strong, has declined slightly, though it remains to be seen whether this is the beginning of a new trend. This provides a challenging environment to generate the necessary pass-through from wages to inflation so as to have the latter converging to the ECB's policy objective. This is confirmed by the latest inflation data with core HICP up 0.8% in March versus last year. There is something tragic in the observation that the combination of an imported growth slowdown and imported uncertainty shocks have shortened the phase of very strong growth in the eurozone and triggered a premature slowdown. This in turn has reduced the effectiveness of an expansionary monetary policy, leaving the ECB no choice but to start working on more of the same. The details on the new TLTRO are eagerly awaited.

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[1]ECB, Mario Draghi, *The outlook for the euro area economy*, speech at the Frankfurt European Banking Congress, Frankfurt am Main, 16 November 2018 [2]Elena Bobeica, Matteo Ciccarelli, Isabel Vansteenkiste, *The link between labor cost and price inflation in the euro area*, ECB Working Paper 2235, February 2019 [3]Mario Draghi, op. cit

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