EUROZONE: CONCERNS ABOUT INFLATION PERSISTENCE

How much and how quickly inflation will decline in the Eurozone is of key importance for the ECB, households, firms and financial markets. There is concern that disinflation might be slower than expected until now. The latest ECB survey of professional forecasters shows an increase in the number of participants expecting inflation to remain elevated. Inflation persistence can have different sources: a succession of shocks, staggered price adjustment by firms, price and wage increases that try to compensate for the past increase in costs and the loss of purchasing power, evolving inflation expectations. Going forward, the tightness of the labour market, the strength of wage developments and the momentum in service price inflation are key factors to monitor.

Last year's debate on inflation was centered around when the latter would peak. Following the significant and swift increases of central bank policy rates and the decline of headline inflation on the back of lower energy prices, this debate has now shifted to how much and how fast inflation will decline.

For the Eurozone, the ECB's March staff projections showed a drop in headline inflation below 3.0% by the end of 2023 and a stabilization at 2.9% in 2024. The ECB's inflation target of 2% would be reached in the third quarter of 2025. In its spring forecast, the European Commission projects a decline in headline inflation to 3.5% in the fourth quarter of this year and to 2.3% at the end of 2024 bringing the annual average for that year down to 2.8%. However, headline inflation this year and next will be heavily influenced by base effects in terms of energy and food prices, so it's important to look at what may happen to core inflation.

The ECB projections expect it to be higher in 2023 than last year (3.2% versus 2.7%) on the back of lagged indirect effects of high energy prices and the depreciation of the euro[1]. In 2024, core inflation would drop to 1.7%. The European Commission forecasts are significantly higher with average core inflation at 6.1% in 2023, followed by a gradual moderation to 3.2% in 2024. This huge difference reminds us of the uncertainty about the path of disinflation and raises concern that inflation might be more persistent than expected thus far.

The ECB's estimate of the overall persistent common component of inflation (PCCI)[2] has declined recently but excluding food and energy, the improvement is very small (chart 1). Other indicators of underlying inflation do not show a turnaround either[3], which recently led Philip Lane of the ECB to conclude that *"In overall terms, the range is not only elevated but also wide, indicating that there is a high level of uncertainty about underlying inflation."*[4]

EUROZONE: PERSISTENT COMMON COMPONENT OF INFLATION

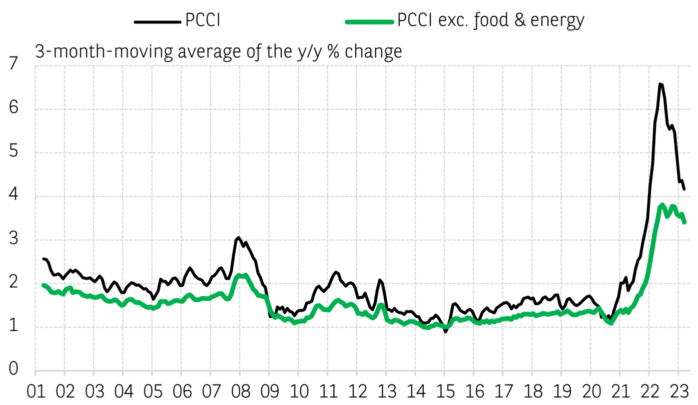

CHART 1 SOURCE: ECB, BNP PARIBAS

Moreover, the latest ECB survey of professional forecasters (Q2 2023) shows an increase in the number of participants expecting inflation to remain elevated. In the fourth quarter of 2022, 48% of survey participants projected inflation higher than 2.4% in 2024. In the latest survey, this number has increased to 60% of the forecasters. For 2025, 61.7% expect inflation of 2.4% or lower, down from 67.7% in the first quarter survey this year.

Inflation persistence can be defined as *"the tendency of inflation to converge slowly towards its long-run value following a shock which has led inflation away from its long-run value."*[5] It can have different sources. Firstly, a succession of shocks. This is what we have seen in recent years (the Covid-19 pandemic causing a disruption in demand

1 Source: ECB staff macroeconomic projections for the euro area, March 2023.
2 The PCCI is one of the measures of underlying inflation monitored by the ECB. Using quantitative methods, the inflation rate of each item in the price index is decomposed into a component that is common to all series and an idiosyncratic component that is specific to a given series. The PCCI is defined as a weighted average of the common components. Source: ECB, PCCI – a data-rich measure of underlying inflation in the euro area, Statistics Paper Series, n° 38, October 2020.
3 See BNP Paribas *Inflation tracker*, May 2023, page 9.
4 Source : Underlying inflation, Lecture by Philip R. Lane, Member of the Executive Board of the ECB, Trinity College Dublin, 6 March 2023.
5 Source : Filippo Altissimo, Michael Ehrmann, and Frank Smets, Inflation persistence and price-setting Behaviour in the euro area a summary of the IPN evidence, ECB Occasional paper n° 46, June 2006.

> The latest ECB survey of professional forecasters shows concern that inflation might be more persistent than expected thus far.

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and supply, the war in Ukraine, the jump in energy prices followed by a huge increase in food prices). The shocks may be transitory but when they operate in the same direction, they will cause inflation persistence[6]. Secondly, not all firms will be impacted simultaneously by the increase in prices. Some may have long-term supply contracts that, at least temporarily, shield them from the increase in prices. Moreover, not all firms will adjust their prices at the same time. Thirdly, the reaction of households and businesses to an inflationary shock may evolve over time, giving rise to intrinsic inflation persistence. Firms may increasingly set prices in reaction to past price increases to restore their profit margins. They may also raise their prices more often when input costs are rising quickly. Wage demands may rise to make up for the past loss in purchasing power due to higher inflation.

For a central bank, the danger is *"that these second-round effects become embedded in price and wage dynamics creating the threat of a self-sustaining momentum in headline inflation."*[7] A tight labour market and strong corporate pricing power will add to the persistence of inflation. Interestingly, the second-round effects may persist although the initial inflation shock may be over. This point has been made by Huw Pill of the Bank of England when explaining the consequences of a jump in energy prices.

The direct inflation effect will disappear over time due to a base effect but to the extent that households and businesses expect the increase in the price level to be permanent, they may continue to try to make up for the past loss in real income and profits even though energy inflation may have vanished. This may lead to a wage-price spiral. Finally, inflation expectations may also contribute to inflation persistence, either because there are doubts about the decisiveness of central banks in addressing elevated inflation - unanchoring of inflation expectations- or because households and firms have imperfect information about the nature of the shock -temporary or permanent- and how the economy will react to it.

With this overview in mind, what can be said about inflation persistence in the Eurozone? Several factors point towards disinflation. In manufacturing, the Purchasing Managers Indices show that the assessment of input prices has dropped to 44 in April implying that 56% of companies are reporting declining input prices. The assessment of output prices has improved as well but it remains above 50, more precisely at 51.6 in April. Supply bottlenecks have eased, as shown by the normalisation of the PMI delivery times and freight rates. Energy prices have declined. Tighter lending standards and policy rate increases should cool down demand, thereby contributing to a decline in inflation. Inflation expectations -both survey-based and market-based- remain well anchored. However, price pressures in services remain high, both in terms of input and output prices, and the European Commission expects price pressures in (processed) food and goods to fade only slowly. It also expects a strong acceleration in wage growth and a further increase in profit margins in 2023, before a squeeze in 2024.

On balance, the European Commission expects a gradual process of inflation moderation[8]. In assessing whether we are on the right track, we can find inspiration in the key indicators used by the Bank of England to assess the magnitude and evolution of inflation persistence: the tightness of the labour market, the strength of wage developments and the momentum in service price inflation[9].

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6 This is called extrinsic inflation persistence. Source: Inflation persistence and monetary policy – speech by Huw Pill, Bank of England, 4 April 2023.
7 Source : see footnote 5.
8 Source : European Commission, Spring forecast, May 2023.
9 Source : see footnote 5.

EUROZONE CUMULATIVE EXPECTED PROBABILITY DISTRIBUTION FOR INFLATION

Forecast range	2023			2024			2025	
	Forecast date*			Forecast date*			Forecast date*	
	Q2 2023	Q1 2023	Q4 2022	Q2 2023	Q1 2023	Q4 2022	Q2 2023	Q1 2023
< 0.0	0.0	0.3	0.7	3.4	3.6	1.4	1.9	1.9
0.0 to 0.4	0.0	0.4	0.9	4.4	5.6	3.3	5.5	5.6
0.5 to 0.9	0.0	0.5	1.3	7.0	9.1	7.7	12.7	12.3
1.0 to 1.4	0.1	0.6	1.7	12.1	13.9	16.0	20.8	23.0
1.5 to 1.9	0.2	0.7	2.5	21.4	23.8	33.2	36.4	45.0
2.0 to 2.4	0.5	1.0	5.2	40.4	42.3	51.9	61.7	67.7
2.5 to 2.9	1.2	2.1	8.5	62.8	61.1	68.8	78.2	81.3
3.0 to 3.4	3.4	4.7	12.6	78.6	74.4	80.7	86.9	89.2
3.5 to 3.9	6.5	10.5	18.2	88.6	82.9	87.9	92.5	93.7
4.0 to 4.4	12.9	18.7	28.7	93.5	88.9	92.8	95.4	96.1
4.5 to 4.9	28.5	33.2	45.0	95.9	93.5	95.9	97.0	97.5
≥ 5.0	100	100	100	100	100	100	100	100

TABLE 1 *Quarter in which the forecasts were made SOURCE: ECB