EDITORIAL

EUROZONE: THE HEADACHE OF SLOW DISINFLATION

The preliminary inflation numbers for February had the effect of a cold shower due to the acceleration of core inflation. To assess the observed price developments since the start of last year, monthly inflation has been calculated for the more than 400 HICP components. The frequency distribution for average monthly inflation between October 2022 and January 2023 has hardly shifted compared to that for the first quarter of 2022 but the nature of inflation has shifted. Annual energy price inflation has dropped but food price inflation continues to accelerate. As the different shocks reverberate, inflation becomes sticky. Going forward, wage developments should also play a key role. The latest inflation data have caused a jump in the expected terminal rate, which implies a bigger headwind to activity. When inflation surprises to the upside, the likelihood that growth ends up surprising to the downside increases.

The preliminary inflation numbers for February had the effect of a cold shower. Admittedly, headline inflation eased to 8.5% from 8.6% in January but this was higher than the consensus expectation of 8.2%.

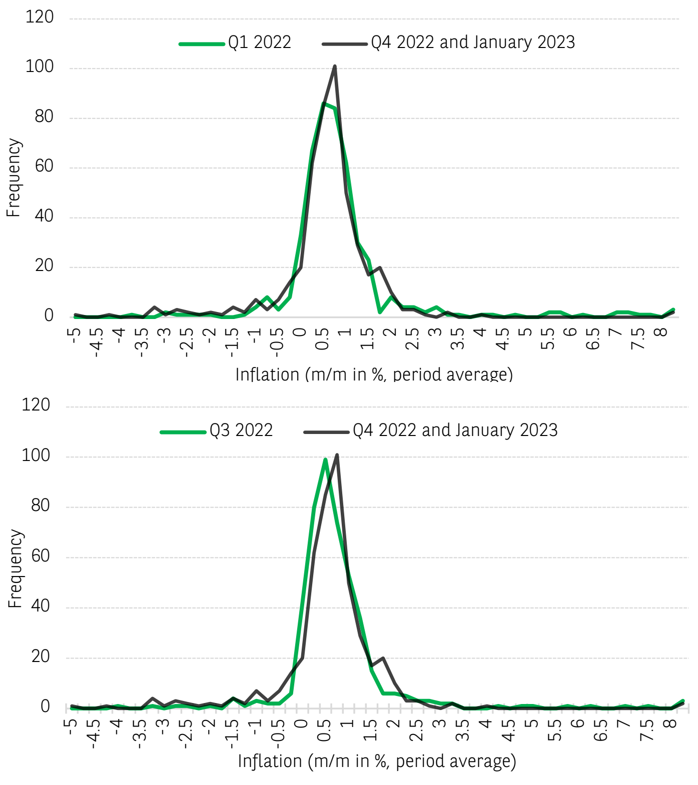
The real issue however was core inflation, which accelerated to 5.6% (5.3% in January). Is there a better way to illustrate the challenge of the ECB than the 0.8% print of monthly inflation excluding energy, food, alcohol and tobacco? Yet, certain survey data provide some elements of hope, although the overall picture remains very mixed.

The latest European Commission's survey shows that the downward trend of selling price expectations in manufacturing industry continued in February. In retail trade they edged down in February, thereby continuing a moderate downward trend that started in November. In construction, price expectations continued their decline. However, in services, selling price expectations have been fluctuating in a narrow range for several months, without any clear trend and consumers' price expectations for the next 12 months have stabilized in February after declining significantly since autumn last year. S&P Global's purchasing managers' indices for February showed a *"rate of increase in selling price expectations staying sharp and well above it's long-run average"* and in services, output price inflation was among the strongest on record[1].

To assess the observed price developments since the start of last year, monthly inflation has been calculated for the more than 400 HICP components[2]. The frequency distribution for average monthly inflation between October 2022 and January 2023 has hardly shifted compared to that for the first quarter of last year (chart 1)[3]. Compared to the third quarter, it has even shifted slightly to the right (chart 2).

Chart 3 uses the same data to trace the dynamics of individual components. In some cases, high monthly inflation in the first quarter of last year has been followed by low monthly inflation more recently -this has been the case for petrol, gas, electricity- but in other cases -many food items-, the opposite has happened. This illustrates the shifting nature of inflation.

EUROZONE INFLATION: FREQUENCY DISTRIBUTION (NUMBER OF EXPENDITURE CATEGORIES)



CHARTS 1-2 SOURCE: EUROSTAT, BNP PARIBAS CALCULATIONS

1 Source: S&P Global news release, 1 and 3 March 2023.
2 For more information of inflation developments, see our recently developed inflation tracker: Inflation tracker - March 2023 (bnpparibas.com).
3 The granular data for February are not yet available. Monthly inflation numbers avoid the possible bias from base effects in annual numbers but may be more volatile. To this end, averages over 3 or 4 months have been calculated.

> The latest increase in core inflation has caused a jump in the expected terminal rate, which implies a bigger headwind to activity. When inflation surprises to the upside, the likelihood that growth ends up surprising to the downside increases.

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EUROZONE INFLATION (M/M, %, PERIOD AVERAGE)

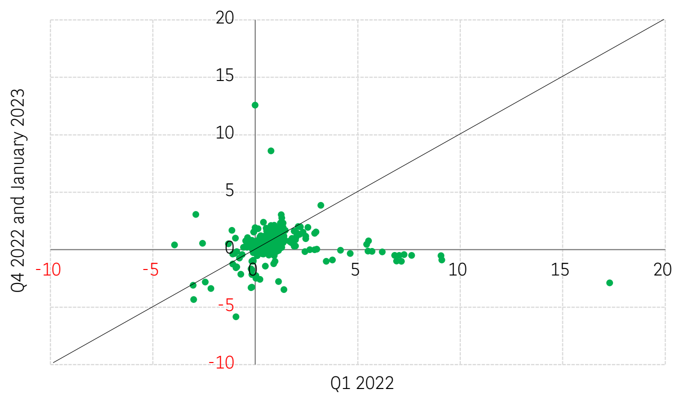

CHART 3 SOURCE: EUROSTAT, BNP PARIBAS

EUROZONE: INFLATION OF PRINCIPAL COMPONENTS (Y/Y, %)

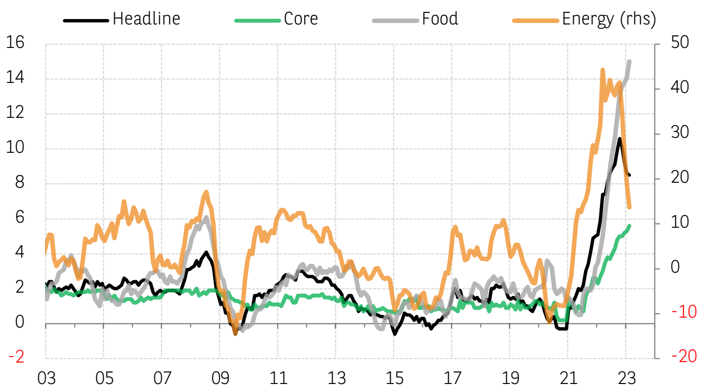

CHART 4 SOURCE: EUROSTAT, MACROBOND, BNP PARIBAS

CONTRIBUTION TO EUROZONE INFLATION

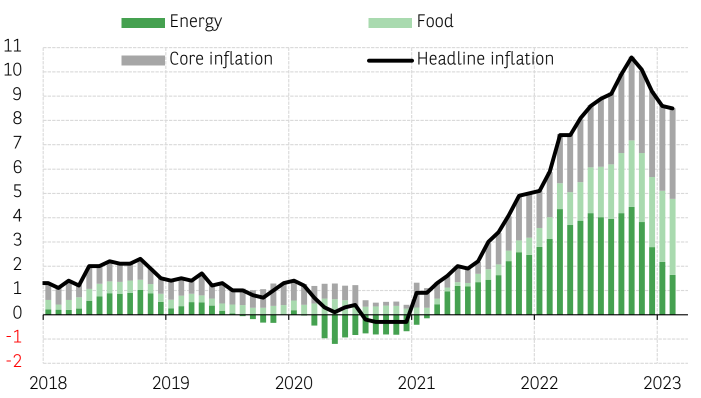

CHART 5 SOURCE: EUROSTAT, MACROBOND, BNP PARIBAS

EUROZONE: WAGE GROWTH AND INFLATION (Y/Y, %)

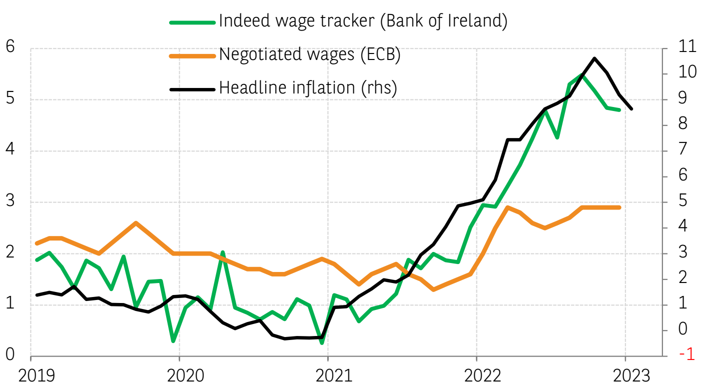

CHART 6 SOURCE: EUROSTAT, ECB, BANK OF IRELAND, BNP PARIBAS

Annual energy price inflation has dropped but food price inflation continues to accelerate (chart 4), causing a change in the contribution to overall inflation (chart 5). As the different shocks reverberate, inflation becomes sticky. This explains why in chart 3, in most cases, inflation that was elevated in Q1 2022 was still high more recently. Going forward, wage developments should also play a key role. The big increase in the Central Bank of Ireland's wage tracker, which is based on job postings[4], illustrates the tensions in the labour market (chart 6).

The correlation with headline inflation is also striking. For the near term, a key question is whether the recent slowdown in wage growth is a one-off or the start of a new trend. Given the ongoing labour market bottlenecks and the hiring plans of companies, one would expect that the decline would be slow at best. Wage negotiations should also contribute to inflation, although for the time being the increase of the ECB's negotiated wage index has stabilized[5].

To conclude, some survey data, though not all, provide some hope that inflation will come down but the hard data point to a high degree of inertia. A pick-up in wage growth is expected to contribute to this phenomenon. Core inflation hasn't even started to decline. Unsurprisingly, in reaction to the latest data, rate hike expectations have jumped and markets now expect a terminal ECB deposit rate of 4.0%. This should lead to a bigger headwind for demand and activity later this year. When inflation surprises to the upside, the likelihood that growth ends up surprising to the downside increases.

William De Vijlder

4 This tracker is based posted wages in millions of job ads on Indeed and covers France, Germany, Ireland, Italy, the Netherlands, Spain and the UK. Source: Central Bank of Ireland.
5 In a recent interview, Isabel Schnabel of the ECB has emphasized the role of wage developments: *"If we look at our wage trackers, we are seeing that wage growth has picked up substantially. It is expected to be around 4 to 5% in the years to come, which is too high to be consistent with our 2% inflation target even when taking productivity growth into account. Also, given a longer duration of wage contracts compared to the US and a more centralised bargaining process, one could expect wage growth in the euro area to be more persistent."* Source: Interview with Bloomberg, Interview with Isabel Schnabel, Member of the Executive Board of the ECB, conducted by Jana Randow and Alexander Weber on 15 February 2023, ECB, 17 February 2023.