EDITORIAL

PENT-UP DEMAND TO TRIGGER INFLATION PICK-UP

The Covid-19 pandemic has caused a decline in inflation and, in most euro area countries, an increase in the inflation dispersion between sectors. It will take considerable time until activity has been restored sufficiently to generate labour market bottlenecks, which – in the absence of exogenous shocks- are a necessary condition to see a broad-based and lasting increase in inflation. This suggests that for the coming years, we should expect inflation to fluctuate around a slowly rising trend. In the course of 2021, the unleashing of pent-up demand – under the assumption that a vaccine is sufficiently widely deployed- could cause a temporary pick-up in inflation. In this respect, a decline in the price elasticity of demand will play a key role.

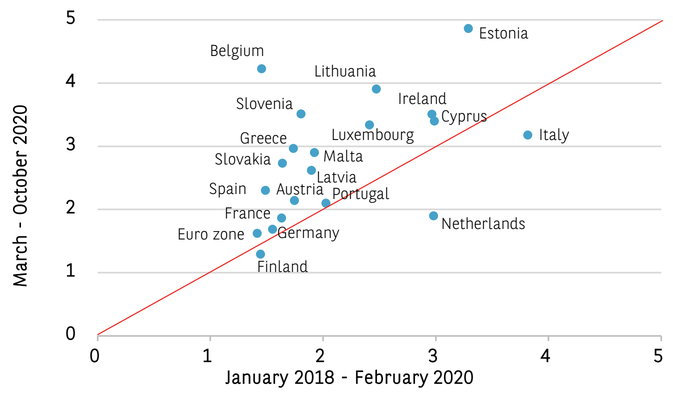
Inflation is mostly analysed from a macroeconomic perspective, such as how it relates to the stance of monetary policy, the existence of labour market bottlenecks, etc. However, it is largely the result of millions of decisions by households and businesses in terms of spending, production or commercial strategy. In general, the decisions of individual households will tend to be very correlated – think of swings in consumer confidence - and the same applies for companies. This warrants a macroeconomic approach to inflation. However, at times, heterogeneity is an important factor, leading to price developments that are very different across sectors. That is also the recent experience

The Covid-19 pandemic triggered a sharp slowdown in prices in the euro area. The inflation rate, measured by the annual change in the Harmonised Index of Consumer Prices (HICP), held in negative territory for the third consecutive month in October 2020 (-0.3% year-on-year). Granted, exogenous events like the temporary cut in Germany's VAT rate have played a role, but core inflation is also pointing to a very mild increase in prices. Core inflation held to a historical low of +0.2% in October, the same as in September. This feeble momentum can be seen in all four of the big euro-area economies.

The disinflationary shock triggered by the crisis is especially visible in certain sectors that were hit hardest by social distancing measures and other health restrictions. As chart 1 shows, in the majority of the euro-area countries, inflation differentials between sectors have tended to increase this year compared to the two previous years. In transport services, for example, prices have fallen sharply since the summer months, especially in Italy (-7.9% y/y in October) and France (-6%). At the same time, under drastic lockdown measures to restrict movement, the prices of services pertaining to "tourism and hotel packages" also fell sharply, notably in Spain (down about 8% over the past four months), whose economy is highly dependent on tourism

In general, for most of the country-sector pairings, inflation is weaker this year than in the period 2018-2019 (chart 2). A second wave of the pandemic is currently sweeping the member states, although it lacks the intensity of the first wave, which should maintain downward pressure on inflation in the euro area. As a result, inflation is likely to stray further from the ECB's inflation target, which is why the Governing Council is expected to ease monetary policy again at its next meeting on 10 December. The highly accommodative stance will need to be maintained for several years. It will take considerable time until activity has been restored sufficiently to generate labour market bottlenecks, which –in the absence of exogenous shocks- are a necessary condition to see a broad-based and lasting increase in inflation. We should also keep in mind the experience of 2017 and 2018, when, as we were approaching the peak of the business cycle, the transmission of faster wage growth into inflation was limited. This suggests that for the coming years, we should expect inflation to fluctuate around a slowly rising trend. In the course of 2021, the pick-up in inflation could –temporarily- be a bit quicker. The mechanical rebound that will follow the current lockdown in several European countries will occur against a background of increasing talk about the deployment of a vaccine. This should support confidence because of a decline in uncertainty. Those companies that have maintained a

SECTOR DISPERSION OF ANNUAL INFLATION*



*The chart shows the standard deviation across sectors of monthly observations of annual inflation.

SOURCE: EUROSTAT, BNP PARIBAS

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satisfactory profitability may be inclined to step up their investments, which in turn would raise households' confidence in the labour market outlook. In some sectors, the ensuing pick-up in demand could meet supply bottlenecks, following the lockdown measures. Once a vaccine is administered, pent-up demand could be unleashed –supported by the forced savings accumulated during lockdown- as people will be eager, depending on their financial situation, to travel again, go to restaurants and shops, etc.

This is where the microeconomic approach of inflation is relevant. In such an environment, the price elasticity of demand may very well decline. People could be eager to spend, even though it costs a bit more, because they associate it with going back to normal. It brings relief. Businesses could seize the opportunity to restore somewhat their financial situation by slightly increasing their margins. As a consequence, we could see above trend inflation for a while. Clearly, the extent depends on the weight of the sectors that would see these reactions. It should also be a temporary phenomenon: unleashing pent-up demand is temporary by nature.

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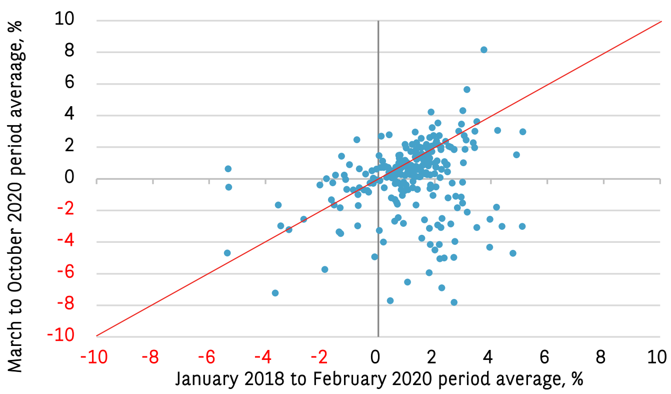
AVERAGE ANNUAL INFLATION PER COUNTRY-SECTOR PAIR (MONTHLY DATA)*



* Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, Spain.

Sectors: All items, Core inflation, Clothing & footwear, Housing, water, electricity, gas & other fuels, Furnishings, household equip. & routine, Health, Transport, Communications, Recreation & culture, Restaurants & hotels, Miscellaneous.

SOURCE: EUROSTAT, BNP PARIBAS