EDITORIAL

THE CHALLENGE OF INFLATION: 5 THINGS TO LOOK OUT FOR

Inflation is no longer the No. 1 economic problem that it has been for the past three years, but it remains a major challenge. While it has not reached its 2% target yet, and the last pockets are slowly deflating, new inflationary pressures are mounting. At this stage, those pressures are limited but not negligible and new inflationary risks, linked to the economic and geopolitical context, are taking shape. The Fed's task is becoming more complicated by the risk of a US stagflation, and the ECB's one happens to be slightly trickier when balancing between downside and upside risks on growth.

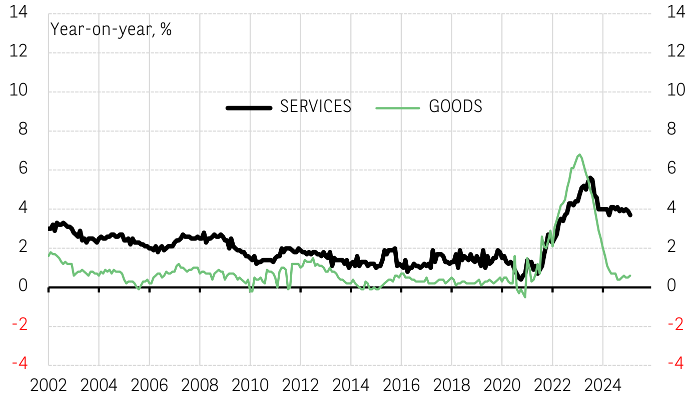
Still heading in the right direction overall. The latest data available for the United States (January) and the euro area (February, preliminary estimate) continue to point in the right direction overall. In the euro area, both headline and core inflation (for the first time since September 2024 for core inflation) fell slightly (-0.1 points to 2.4% and 2.6% y/y, respectively). The most encouraging point is the decline in services inflation, which can be expected to continue (after remaining stable at around 4% for just over a year). The process is likely to remain slow, as services inflation continues to be underpinned by the post-Covid shift in household consumption from goods to services, as well as by delayed adjustments to certain regulated prices[1]. However, the ongoing moderation in wage dynamics in the euro area is likely to fuel the disinflation process.

In the United States, January's inflation data were more mixed, but slightly positive on balance. CPI inflation rose by 0.1 points for both headline inflation (3% y/y) and core inflation (3.3%), but services inflation continued to decrease. What's more, inflation measured by the PCE deflator the Fed's preferred indicator fell slightly for headline inflation (-0.1 points to 2.5%) and more sharply for core inflation (-0.3 points to 2.6%). In addition, wage dynamics are also moderating in the United States but to a slightly lesser extent than in the euro area.

Inflationary pressures. It should also be noted that, on both sides of the Atlantic, the favourable trend in services inflation (downwards) is partly offset by the unfavourable one in goods inflation (upward in the United States, decline halted in the euro area), with much more pronounced trends in the United States (see charts 1 and 2). Although services have a bigger weight in the CPI, this less favourable trend on the goods inflation side is something to monitor. Besides, upstream inflationary pressures are once again developing, judging by the upturn in input and output price components of business confidence surveys. This upturn can also be seen in the services sector. While these pressures remain limited so far, they are likely to filter through price dynamics and have an upward impact on inflation figures over the next few months. In any case, a degree of volatility is to be expected given the forces at play. This volatility will be fuelled by the non-domestic components of inflation, while the domestic one should remain better oriented.

Inflation expectations: stable in the euro area, rising in the United States. As far as the euro area is concerned, the stability of inflation expectations at or close to the 2% target, both among households and professional forecasters, means that we should not be overly concerned about this rise in inflationary pressures. However, the story is different in the United States, where household inflation expectations, both 1 and 5 years ahead, have risen sharply in early 2025 (see chart 3).

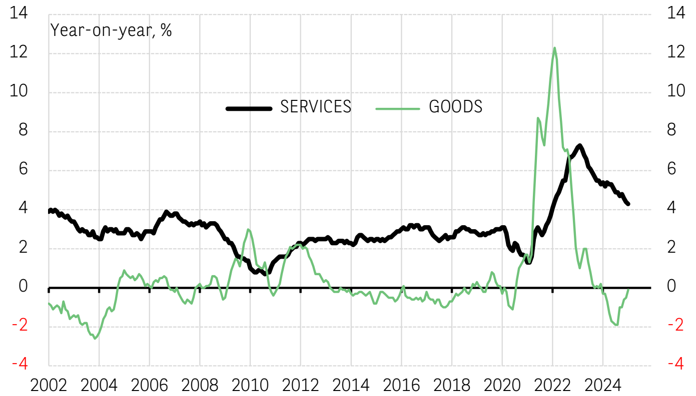
EURO AREA: CORE INFLATION DETAILS



SOURCE: EUROSTAT, MACROBOND, BNP PARIBAS

CHART 1

UNITED STATES: CORE INFLATION DETAILS



SOURCE: BLS, MACROBOND, BNP PARIBAS

CHART 2

1 For more details on the reasons for the stickiness of services inflation in the euro area, read, for example, the recent European Commission analysis, "The stickiness of services inflation in the euro area", Quarterly Report on the Euro Area Volume 23, No. 4 (2024), 20 February 2025.

On the corporate side, 1-year inflation expectations have also risen, but those for 3 and 5 years have not moved (yet) and remain anchored at 3% inflation[2].

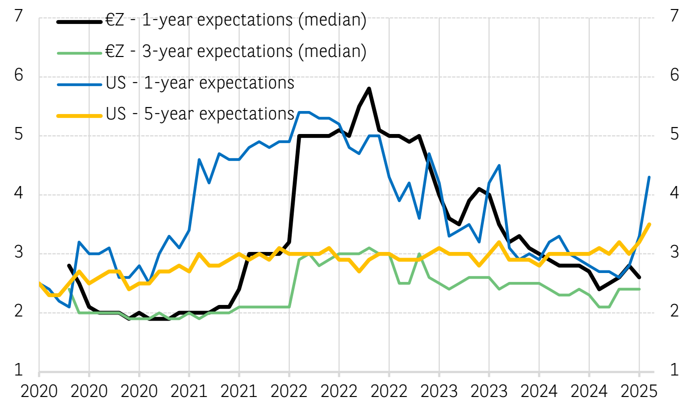
Inflationary risk 2.0. This rise in inflation expectations in the United States is fuelled by the announced hikes in US tariffs. As a result of this tougher tariff policy, a resurgence of inflation in the United States remains a risk (not a reality yet), but it has been clearly identified since the election of Donald Trump[3]. This risk has only grown in intensity since his inauguration and is likely to materialise more quickly than we had previously anticipated. To what extent can this extra-inflation in the US be exported elsewhere in the world? This depends partly on the scale of the retaliatory measures that will be taken. It also depends on the ability and willingness of companies to absorb the shock in their margins (a point that also applies to companies in the United States). There is considerable uncertainty surrounding these two transmission channels. An appreciation in the exchange rate can also help to offset the inflationary impact (and conversely, a depreciation may lead to a little more inflation). Finally, depending on the dynamics of domestic demand, the environment will be more or less inflationary. For both these transmission channels, the situation has recently changed somewhat on both sides of the Atlantic.

In the US, some concerns are beginning to emerge about the economic outlook. This is reflected in the latest Fed Beige Book[4]. While the term "recession" does not appear in it, the terms "customs duties", "inflation", "uncertainty" and "immigration" are mentioned a significant and increasing number of times. In some respects, the situation in the euro area mirrors the one in the US, with timid and sparse signs of improvement –going from an atonic starting point to a likely more solid growth. (despite the adverse effects coming from the United States). What makes us say that is the German turnaround on fiscal policy, the planned increase of military spending and the new plan to boost European competitiveness. The fall in the US stock markets over the last few days and the continuing upward trend in European indices illustrate well this change in outlook, as is the appreciation of the euro against the US dollar, which has quite clearly moved away from the parity towards which it seemed inexorably to be sliding.

These changes in the growth outlook (slightly less favourable in the US, slightly more favourable here) are broadly in line with our expectations. They have yet to be confirmed, of course. At this stage, they point to an inflationary risk that remains relatively high in the United States, but possibly falling slightly, and limited in the euro area, but possibly rising slightly.

The growth-inflation trade-off is becoming more complicated for the Fed and trickier for the ECB. While Scott Bessent, the US Secretary of the Treasury, highlights the temporary nature of the tariffs hikes impact on inflation and suggests that the Fed should not pay particular attention to that and continue to ease its monetary policy, we are of the view that it would be difficult for the Fed to look through the inflationary leap given the risk that inflation expectations become unanchored.

HOUSEHOLD INFLATION EXPECTATIONS



SOURCE: ECB, UNIVERSITY OF MICHIGAN, MACROBOND, BNP PARIBAS

CHART 3

For the time being, a prolonged monetary *status quo* looks to be the right approach to a stagflationary shock. But if the inflation-growth trade-off becomes more complicated, which is likely, with the risk of recession rising at the same time as inflation rises due to tariffs, this could lead the Fed to break away from its wait-and-see attitude and resume cutting rates.

The task is less complicated for the ECB, but the inflation-growth trade-off is becoming slightly trickier and reopens the range of possible decisions. More precisely, the likelihood of a further rate cut in April has diminished somewhat as the downside risks on short-term growth have decreased (thanks to the positive signal from the German and Commission budget announcements). However, a new cut (doubled by another in June) is still our central scenario at this stage, in view of the downside risks arising from Trump's tariff policy. Nor is there any counter-indication on the inflation front, given that the disinflation process is still well underway. And even if monetary policy is deemed to be "significantly less restrictive", according to Christine Lagarde, it has not yet reached its destination (neutrality), suggesting a bias towards further rate cuts. The current rise in long-term interest rates is also an argument in favour of limiting the tightening of financing conditions.

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2 Firms' Inflation Expectations Have Picked Up - Liberty Street Economics, 5 March 2025.
3 We have incorporated this into our central scenario, published in December 2024. At the time, we were forecasting 2.9% annual average inflation in the United States in 2025 and 3.9% in 2026. After an update on 7 March 2025, these forecasts are currently 3.2% and 3.3%. They are likely to change again as part of the review of our overall scenario that is currently underway.
4 The Fed - Monetary Policy: Beige Book (Branch), 5 March 2025.