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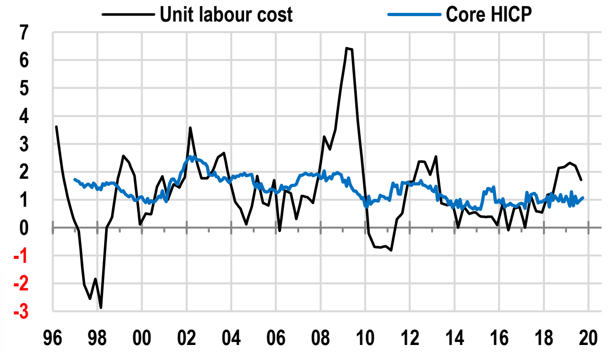
Eurozone: very low interest rates for how long?

■Danish monetary policy is closely linked to ECB policy so the recent statement of Denmark's central bank governor that he expects interest rates to remain around current negative levels in the next five to ten years is not without importance for the eurozone ■ Forward guidance by ECB implies that policy will only be adjusted when justified by economic conditions. The inability to be clearer in terms of time frame illustrates the complexities of inflation dynamics ■ Past wage increases will gradually filter through in a pick-up in inflation although low inflation, well-anchored inflation expectations and intense competition in certain sectors may very well moderate this transmission ■It thus seems clear that the current policy will remain in place for a considerable time. How long 'considerable' turns out to be will depend on the data. The eurozone clearly needs more growth.

For how long will ECB policy rates stay at their current level? Recent statements by Scandinavian central banks have, indirectly, shed some light on this. According to Reuters, "*Denmark's central bank governor Lars Rohde expects interest rates to remain around current negative levels in the next five to 10 years*."[i] Considering that Danish monetary policy is closely linked to ECB policy, it is tempting to consider this statement as an implicit projection for eurozone policy rates. His Swedish counterpart at the Riksbank, on the other hand, has flagged that, despite a slowing economy, the executive board will most probably raise the repo rate from -0.25% to 0% at its meeting on 19 December.

According to governor Stefan Ingves, negative rates have worked well "*but it is a completely different conversation what happens in an economy if you stick to negative rates for a long, long time period*."[ii] This suggests that the planned repo rate hike is inspired by concerns about possible unintended consequences of a prolonged negative rate, an issue which is most relevant for the eurozone as well. However, such a move should not be considered as the start of a tightening cycle.

EUROZONE: UNIT LABOUR COST VS CORE INFLATION, Y/Y%



Source: Eurostat, BNP Paribas

According to the governor, considering the very uncertain outlook for economic activity and inflation, it is "*difficult to say, at present, when it will be appropriate to raise the repo rate next time*."[iii] This difficulty also underpins the data-dependent forward guidance by the Federal Reserve (which implies that rates are on hold as long as there is no material reassessment of the growth and inflation outlook) as well as the ECB's state-dependent forward guidance (which requires a robust convergence of inflation to a level close to but below 2%).

This guidance implies that policy will be adjusted when justified by economic conditions but the reluctance, or should one say inability, of major central banks to be clearer in terms of time frame illustrates the complexities of inflation dynamics. These can be represented as a trickle-down process whereby 1) strong demand on a sustained basis 2) creates bottlenecks in the labour market, which 3) causes an increase in wages and, 4) despite increases in productivity, a pick-up in unit labour costs. Strong demand for goods and services may very well reduce the price elasticity of demand, thereby 5) enabling companies to raise their prices so as to shield their profit margins from higher wage costs. This sequential process takes time as the economy moves through the different phases. In the current cycle, eurozone wage growth eventually accelerated, even significantly in some countries, in conjunction with a decline in the unemployment rate and the emergence of labour market bottlenecks. The real issue is the transmission of higher wages into higher inflation, which has been until now very limited.

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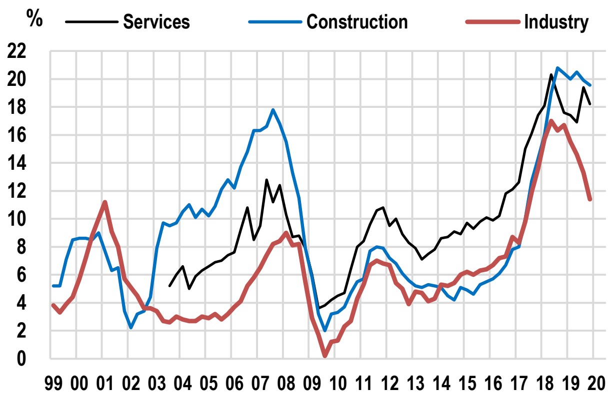
What does this mean for the outlook for monetary policy? In recent months, bottlenecks have eased considerably in manufacturing, although they still remain above previous cyclical peaks. In services and construction they have stabilised at a very high level. Profit margins (gross operating surplus as a percentage of value added) have been on a declining trend, which may increase the reluctance of companies to yield to demands for higher wages if they consider that the slowdown in sales weakens their pricing power. Should there be re-acceleration in growth, bottlenecks would resurface quite soon leading to faster wage growth, which should lead to a pick-up in inflation. The question is how much and how fast? In this respect, Bundesbank research shows that, in Germany, a 1% increase in wages results in a 0.3% increase in consumer price inflation. "*However, it takes considerably longer than one year for the cyclical adjustment of prices to a wage shock to be largely complete*."[iv] This could imply that part of the recent pick-up in wages still needs to show up in German inflation. A factor which may complicate matters is that, according to research by the ECB, a low inflation environment is associated with a more moderate pass-through.[v] Finally, empirical research by the IMF shows that the impact of faster wage growth on inflation builds up gradually, peaking after about 6 quarters. "*Overall, the passthrough ratio—defined as the ratio between the cumulative change in prices and the cumulative change in wages—is about a third*." Moreover, this transmission is more moderate when inflation is low, when inflation expectations are well-anchored and when competition (foreign as well as domestic) is intense. On the other hand, declining profit margins tend to cause a bigger transmission, but in a competitive environment, this puts companies between a rock and a hard place: increasing prices to protect profit margins may come to the detriment of sales volumes.

To conclude, the bottlenecks which remain high (though less than before in manufacturing, because of the crisis in this sector) has already led to somewhat higher wage increases. These will gradually filter through in a pick-up in inflation, but such a process takes several quarters and, as shown by empirical research, a number of conditioning factors (low inflation, well-anchored inflation expectations, intense competition in certain sectors) may very well moderate this transmission. Given the firm conditions set by the ECB Governing Council before envisaging a change in policy, it thus seems clear that the current policy will remain in place for a considerable time. How long 'considerable' turns out to be will depend on the data. The eurozone clearly needs more growth.

William De Vijlder

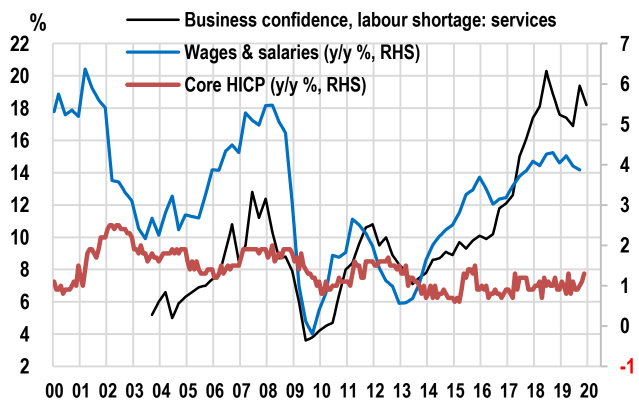
[i] Danish central bank governor sees negative rates in next 5-10 years – Borsen, Reuters, 25 November 2019
[ii] Swedish central bank to hike in Dec, end 5 years of negative rates, Reuters, 24 October 2019
[iii] Repo rate unchanged at −0.25 per cent, Press release, 24 October 2019,Sveriges Riksbank
[iv] The impact of wages on prices in Germany: evidence from selected empirical analyses, Deutsche Bundesbank, Monthly Report, September 2019
[v] The link between labor cost and price inflation in the euro area, ECB working paper 2235, February 2019

EUROZONE: BUSINESS CONFIDENCE, LABOUR SHORTAGE



Source: European Commission surveys, BNP Paribas

EUROZONE: LABOUR SHORTAGE AND WAGES



Source: European Commission surveys, BNP Paribas