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EUROZONE: THE UPTURN IN INFLATION COULD BE SHORT-LIVED

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Eurozone inflation rose markedly in Q1 2021 and seems to be extremely volatile. Core inflation, which is usually stable, has been moving in fits and starts.

The rebound in goods prices largely explains the broad increase in inflation. Prices of tradeable services have also picked up, notably in the sectors that were hit hardest by the pandemic, such as transport.

The recent acceleration in prices is being driven by temporary factors: changes in VAT rates, higher crude oil prices, and the revision of HICP weights. Inflation could continue to rise over the next few months.

These temporary effects should dissipate at the beginning of next year. Thereafter, there seems to be very little risk of an inflationary surge in the Eurozone.

INFLATION PICKED UP IN EARLY 2021

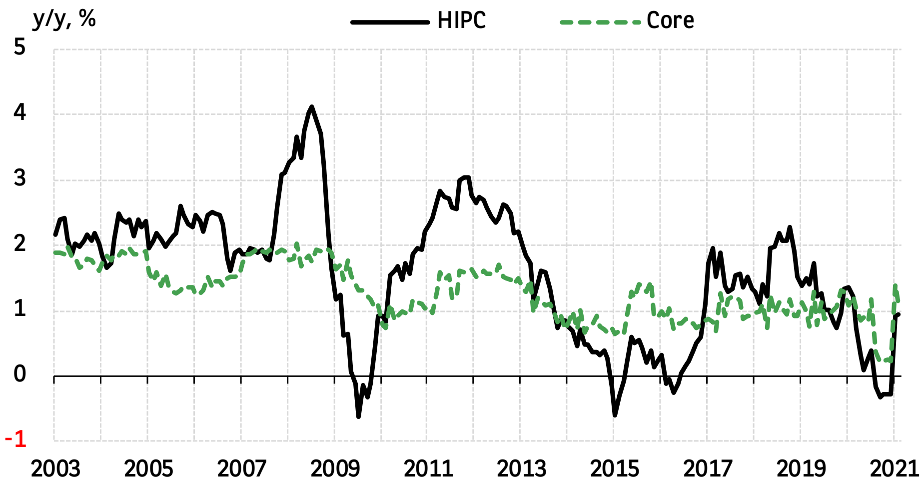

CHART 1

SOURCE: EUROSTAT

VOLATILE AND RISING INFLATION IN EARLY 2021

By nature, the Covid-19 crisis and the measures implemented to reduce its impact have fostered big variations in inflation. Indeed, Eurozone inflation has been extremely volatile since the beginning of 2020. In particular, core inflation – excluding energy, food, and alcohol & tobacco – seems to be highly volatile after several years of relative stability.

In the first three months of 2021, Eurozone inflation has risen sharply, averaging 1% year-on-year (y/y), up from -0.3% y/y in December 2020, and an average annual rate of +0.3% last year. Core inflation averaged +1.1% in Q1 2021, up from +0.2% in December 2020 and an average annual rate of +0.7% (see chart 1).

The rebound in Eurozone inflation in early 2021 can be attributed to higher prices for goods, and to a lesser extent, for services. The price of goods rose by 0.3% and 0.4% in January and February 2021, respectively, after declining at an average annual rate of 0.2% y/y in 2020 (see chart 2).

The textiles component explains a large part of this recent upward trend. In the services sector, which was particularly hard hit by the health restrictions implemented by all of the Eurozone member states, inflation also increased (+0.6% in January and February 2021, after averaging +0.4% in 2020). Prices are rising for virtually all services. In "transport-related services", a segment that was highly disrupted by the very low mobility of Europeans in 2020, prices rebounded in January 2021. Pricing dynamics were similar in leisure services, which includes tourist packages (see chart 3).

Looking at the breakdown by country, prices picked up in all of the Eurozone member states in early 2021 (see chart 4). Germany made the biggest contribution to the sharp rise in headline inflation in the Eurozone. At the end of 2020, the German economy put an end to the temporary reduction in the VAT rate, which made inflation particularly volatile (see the next section for more on this point).

PRICES OF GOODS ARE REBOUNDING AFTER FALLING SHARPLY

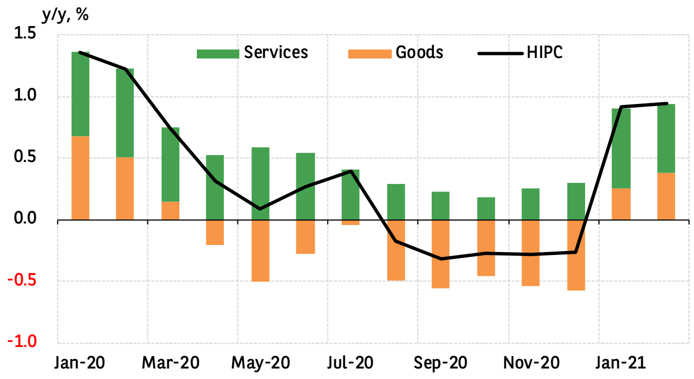

CHART 2 SOURCE: EUROSTAT

TEMPORARY FACTORS EXPLAIN THE VOLATILITY AND UPTURN IN INFLATION

Changes in indirect taxation

Indirect tax changes had an impact on price dynamics. A rise in the VAT rate drives up inflation, although the size of the increase depends on corporate behaviour. VAT increases can be carried over in full or in part to the end prices paid by consumers.

As we pointed out above, Germany made a big change in its VAT rate in H2 2020 that affected the country's inflation rate as well as that of the Eurozone. To counter the Covid-19 crisis, Germany temporarily lowered its VAT rate from 19% to 16% between July and December 2020. The reduction in the VAT rate lowered inflation in Germany, and via a knock-on effect in the Eurozone as well. The latter would have been much higher at a constant tax rate (see chart 5). Consequently, the January 2021 rebound in inflation would have been much smaller. At a constant VAT rate, German inflation would have been +1.4% y/y in December 2020 (0.3% for the Eurozone) and +1.8% in January 2021 (+1.0%), compared to observed inflation rates of -0.7% and +1.6% (-0.3% and +0.9%, respectively for the Eurozone).

VAT changes are not the only explanation for the sharp upturn in Eurozone inflation, although, all other things being equal, they explain nearly half of January's rebound.

Upturn in oil prices

Another major change compared to the year 2020 is the upturn in oil prices. Brent crude oil prices verged on USD 70 a barrel in mid-March, which is close to the pre-pandemic level of January 2020. Rising commodity prices will generate major base effects in the months ahead, and in full-year 2021. The energy component of the HICP has already rebounded to 4.3% year-on-year in March, after an uninterrupted decline since February 2020.

Yet the impact of higher oil prices was partially offset by the euro's appreciation against the dollar (see chart 6) and by the downward revision of oil's weighting in total HICP following such a peculiar year in 2020 (see below).

SERVICE PRICES ARE REGAINING STRENGTH
(INFLATION BY SECTOR, Y/Y, %)

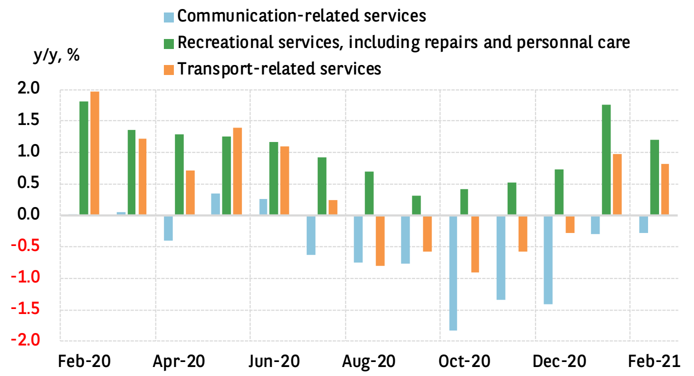

CHART 3 SOURCE: EUROSTAT

Revision of HICP weights

Another explanation for the upturn in inflation in the first part of the year is the significant revision of HICP weights, which was especially large in 2021. Each year, Eurostat re-estimates HICP weights based on the average consumer basket of Eurozone households in the previous year. The year 2020 was marked by major changes in consumer behaviour due to the health crisis and the closing of numerous businesses. As a result, the revisions were significant. The weight of consumer goods, mainly food products, was revised sharply upwards, to the detriment of services (see table). At the Eurozone level, the weight of goods rose to 58.2%, from 55.1% in 2020. This is the biggest annual revision ever reported. Revisions were made in all countries, but the biggest was in Italy (+4.5 percentage points). According to the European Central Bank (ECB), the change in HICP weights contributed 0.3 percentage points to the increase in inflation in January 2021 (compared to a situation of constant weights)[1].

1 ECB, 2021 *HICP weights and their implications for the measurement of inflation*, ECB Economic Bulletin, February 2021

Another methodological obstacle was data collection, since numerous businesses were closed. This was particularly true during the first lockdown in spring 2020, when pricing information on several products was either unavailable or alternative methods had to be used (such as online prices or telephone queries). This may have resulted in some imprecisions on the real change in consumer prices[2].

In 2022, HICP weights are likely to be revised again, introducing another source of volatility.

WHAT TRENDS CAN BE EXPECTED IN THE MONTHS AHEAD?

Inflation will continue to rise in the months ahead

There is every chance that inflation will continue to rise in the short term, lifted by the combined impact of base effects from energy prices (see above), the potentially strong rebound in European economic growth (we expect Eurozone GDP growth to reach 4.2% this year, after a contraction of 6.8% in 2020) and the probable continuation of disruptions in global supply chains. On this last point, supply and demand imbalances are also likely to maintain upward pressure on consumer prices. Prices of numerous industrial components and raw materials (semiconductors, aluminium, wood, copper) as well as basic foodstuffs (corn, livestock) are holding at historically high levels.

The purchasing managers index (PMI), and notably the output prices component, shows an increase in production costs for companies, which could eventually be carried over to consumer prices in the Eurozone (see chart 7).

LOOKING BEYOND SHORT-TERM VOLATILITY, INFLATION IS LIKELY TO FALL AGAIN

Medium-term inflation prospects still look very mild

The ECB's latest macroeconomic projections[3] underscore the volatile nature of Eurozone inflation. According to the Frankfurt-based institution, headline inflation in the Eurozone should continue to rise over the course of the year, to 2% in Q4 2021, lifted by the temporary factors outlined above. This would bring average annual inflation to 1.5% in 2021, after +0.3% in 2020. This inflationary upturn is likely to ease thereafter, with inflation slipping to 1.2% in 2022 before rising only slightly to 1.4% in 2023. If core inflation rises at all, it would come to only 1.3% in 2023. The ECB points out that, in the background, unit labour costs are expected to decline in 2021 and again in 2022, as labour productivity rebounds. In 2023, they are likely to rise timidly again, albeit without creating any major inflationary tensions. The inflation profile is similar in our latest macroeconomic forecast published in March 2021: inflation will rise sharply through Q4 2021 before easing in early 2022. All in all, inflation is expected to remain well below the ECB's target throughout our forecast horizon (with average annual inflation of 1.4% in 2022).

2 For France, *How to compute a Consumer Price Index in the context of the Covid-19 crisis?* INSEE July 2020
3 *ECB Staff Projections for the euro area,* March 2021

MORE GOODS AND FEWER SERVICES IN HICP

Weight of each HICP component	Eurozone 2021	2020	Change
Total HICP	1000	1000	-
Food a non-alcoholic beverage	172.6	150.9	21.8
Alcoholic beverages & tobacco	45.0	39.9	5.2
Clothing & footwear	53.0	59.0	-6.0
Utilities	177.5	160.9	16.6
Furnishings	67.6	61.5	6.1
Communications	32.0	29.7	2.3
Transport	137.3	155.9	-18.6
Health	50.0	47.8	2.3
Education	10.4	10.0	0.4
Recreation & culture	79.6	87.9	-8.3
Restaurants & hotels	75.2	101.0	-25.8
Other G&S	99.8	95.6	4.1
Goods	581.7	551.3	30.4
Food (including alcohol & tobacco	217.6	190.7	26.9
Industrial goods	364.1	360.6	3.5
Non-energy industrial goods	269.1	262.1	7.0
Energy	95.0	98.5	-3.5
Services	418.3	448.7	-30.4

TABLE 1 SOURCE: EUROSTAT

GERMANY DRIVES UP HEADLINE INFLATION
(COUNTRY LEVEL INFLATION, Y/Y, %)

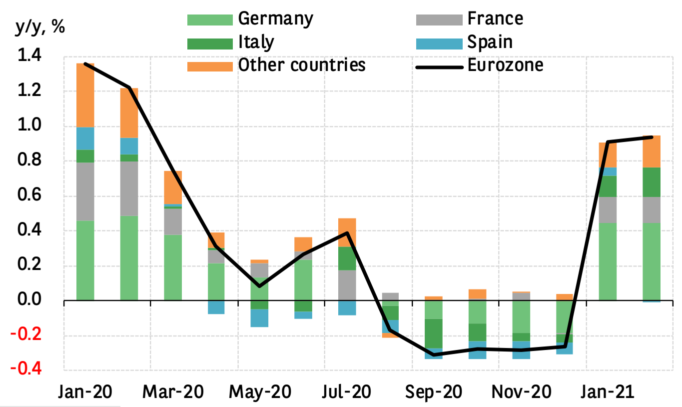

CHART 4 SOURCE: EUROSTAT

BIG VAT CHANGES MAKE INFLATION ESPECIALLY VOLATILE

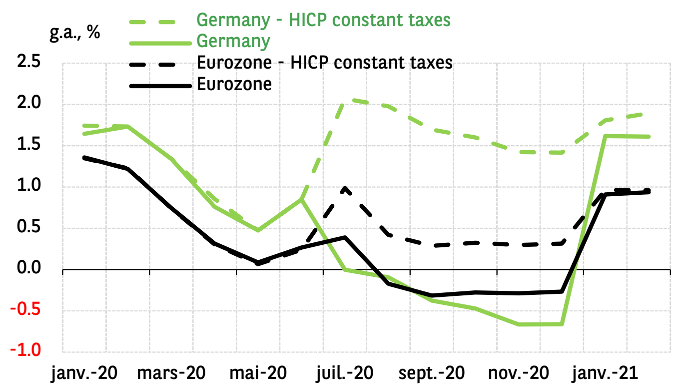

CHART 5 SOURCE: EUROSTAT

The Eurozone economy is still fragile

Inflation trends in the Eurozone will depend on the economic situation (Phillips effect). Using the output gap (the gap between effective and potential GDP) to indicate the cyclical positioning, the Eurozone economy still seems to be fragile. Moreover, ECB studies show a rather weak relationship between slack indicators and inflation[4] .

Although estimates of the output gap (OG) differ significantly between the European Commission and the IMF, both institutions are forecasting a negative output gap in the Eurozone at least through the end of 2022. This highlights the persistent shortfall of demand. The IMF is forecasting a negative output gap of -3 points of potential GDP in 2021 and -1 point in 2022. According to its longer-term projections, the Eurozone's output gap is not expected to close before 2024-2025 (see chart 8). Moreover, the unemployment rate in the Eurozone, which has increased relatively mildly since the outbreak of the pandemic, should continue to rise for a few more months. Lastly, inflation expectations are still far below 2% (the 5-year, 5-year forward swap rate is currently around 1.4%). As stated previously, although consumer prices are likely to continue accelerating in the Eurozone through H2 2021, they will probably begin to slow as of 2022.

The prospect of inflation in the United States are somewhat different. According to IMF projections, the dynamics are much more encouraging in the US, thanks to a record-high stimulus package of USD 1.9 trillion and a more effective vaccination campaign. As a result, the output gap is expected to close by the end of 2021. Prior to the Covid-19 pandemic, the cyclical situation in the US was also different than the one in the Eurozone. At year-end 2019, the United States had reached a historically-low unemployment rate of 3.6% of the active population and was near full employment. Moreover, by March 2021, the unemployment rate in the United States had already fallen back to 6%. Consequently, the risks of inflationary pressures seem to be higher in the US.

Guillaume Derrien and Louis Boisset

OIL PRICES RETURN TO PRE-PANDEMIC LEVELS

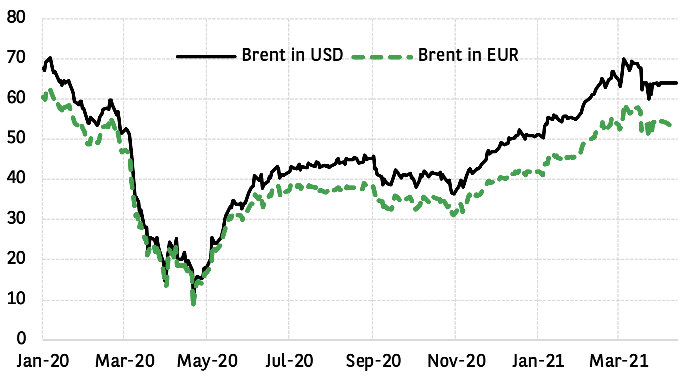

CHART 6 SOURCE: REFINITIV

PMIS INDICATE HIGHER PRICES IN THE MONTHS AHEAD

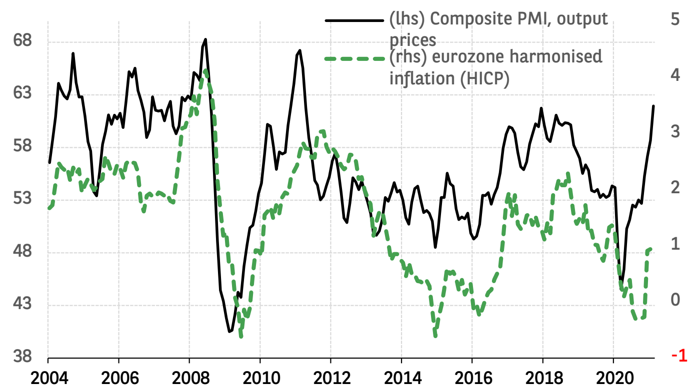

CHART 7 SOURCE: MARKIT, EUROSTAT

THE OUTPUT GAP CLOSES SLOWLY IN THE EUROZONE

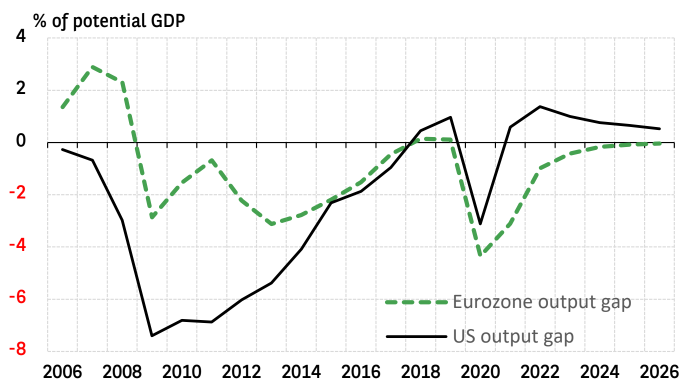

CHART 8 SOURCE: IMF

4 Philip Lane, *The Phillips curve at the ECB*, speech at the 50th anniversary conference of the money, macro & finance research group of the London School of Economics, 4 September 2019.

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