Eurozone: ECB suffers from social distancing too

The drop in services inflation in the Eurozone shows that social distancing product categories saw the largest drop. Our social distancing price index shows that policymaking at the ECB will hinge on assumptions about when a vaccine will be effective and whether demand for social distancing- related products returns before a vaccine is ready

Source: Shutterstock

Inflation back in negative territory: Deflation alert!

Getting inflation back on track in the eurozone has been an enormous challenge for the ECB in recent years. Sluggish growth, negative output gaps and above all structural factors like digitalisation and globalisation have complicated the ECB's life.

In the current crisis, inflation has dropped further, currently on the back of lower energy prices, the VAT reduction in Germany and weaker economic fundamentals. Looking at the latest ECB staff projections, it almost seems as if 1% has become the new 2%. While headline inflation is still expected to increase significantly from 0.3% in 2020 to 1.3% in 2022, measures of underlying inflation remain at around 1% for the next three years.

> *The inflation outlook has become more complicated, which is why we stick to the ECB chief economist Philip Lane's more general warning against complacency*

The inflation outlook has become more complicated. On the one hand, there is the macro picture with a base case of a gradual recovery after the initial V-shaped rebound which would return the eurozone economy to pre-crisis levels in 2022. A scenario which underpins the gradual increase in headline inflation. On the other hand, there are the structural factors like supply chain disruptions, an uneven recovery across sectors and countries and behavioural changes which could affect prices in many and often opposing ways. Consequently, it is simply too early to conclude that there is no deflation risk or that inflation is back on track. We stick to the ECB chief economist Philip Lane's more general warning against complacency.

But what is there to be complacent about? The drop in German VAT and lower energy prices will not be the reason for the ECB to act forcefully, these are one-off effects on prices. The same holds good for the drop in goods prices, which is related to a change in the discount sales period in countries like Belgium, France and Italy. The bigger concern is the decline in services inflation, which has come down from 1.9% in November to 0.7% in August. This decline is more directly related to the economic situation and therefore something for the ECB to more seriously consider.

It's all about social distancing categories of inflation

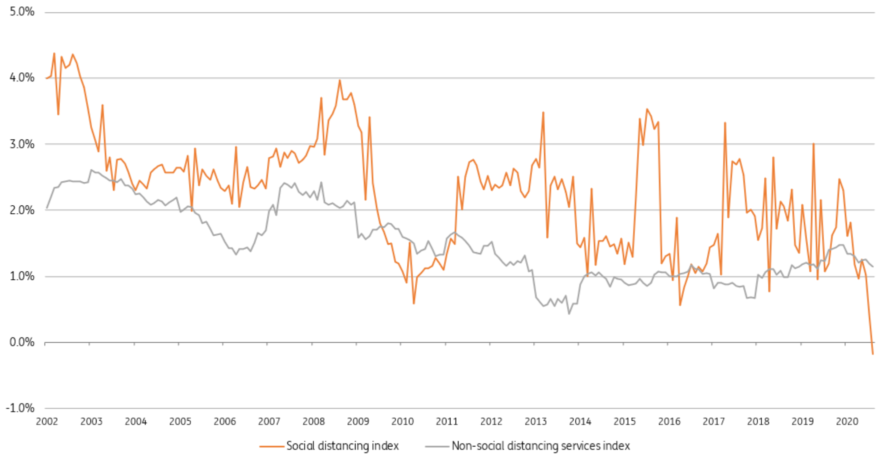
Funnily enough, a large part of the decline in services inflation is actually related to products in which sales are impaired by social distancing measures.

While one would expect social distancing rules to result in price markups due to supply limitations, it seems that concerns about the virus and practical problems related to social distancing are causing demand to fall so much that results in lower inflation for those categories.

To measure the social distancing impact on prices, we took several components from the HICP basket which in our view are most subject to social distancing and developed a social distancing price index.

Eurozone social distancing price service categories have fallen in the Covid era

Source: Eurostat, calculations ING Research



The list is probably non-exhaustive but includes enough social distancing impaired categories to capture the general impact of social distancing on prices.

It comprises just under 18% of the total inflation basket and about 40% of total services inflation, indicating that social distancing affects a non-negligible part of the inflation figure.

- Transport services
- Catering services
- Recreational and cultural services
- Accommodation services
- Package holidays
- Hairdressing salons and personal grooming

This social distancing price index dropped significantly since the start of the health crisis.

In August, the price index declined for the first time ever as can be seen in chart 1. Interestingly enough, outside of these Covid-19 affected categories, services inflation has remained relatively stable in the recent period. The index was at 1.1% in August, down from just 1.3% in February, which means that there is a direct link between the more relevant decline in inflation and social distancing and that inflation for other services has remained relatively stable despite the corona crisis.

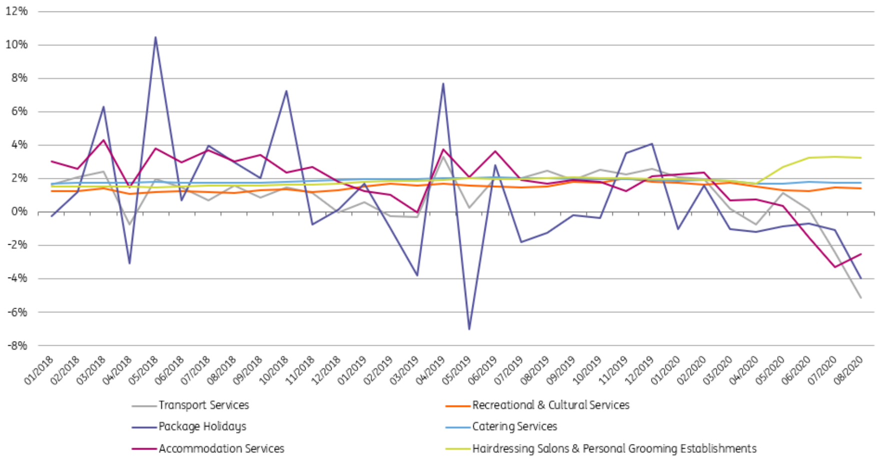
> *The supply constraints that social distancing brings indeed cause upward price pressure, but only if demand remains strong enough*

It has to be said that not all of the components of our index move similarly though. There is downward pressure on most, but hairdressing salons and personal grooming stands out. That is the only one showing a sharp increase in prices, clearly, the one category where demand has increased with easing lockdowns and where new costs to actually open up businesses again have been passed through to consumers.

This indicates that the supply constraints that social distancing brings indeed cause upward price pressure, but only if demand remains strong enough.

Not all social distance categories see declines, if demand is sufficient price pressures can return

Source: Eurostat, ING Research

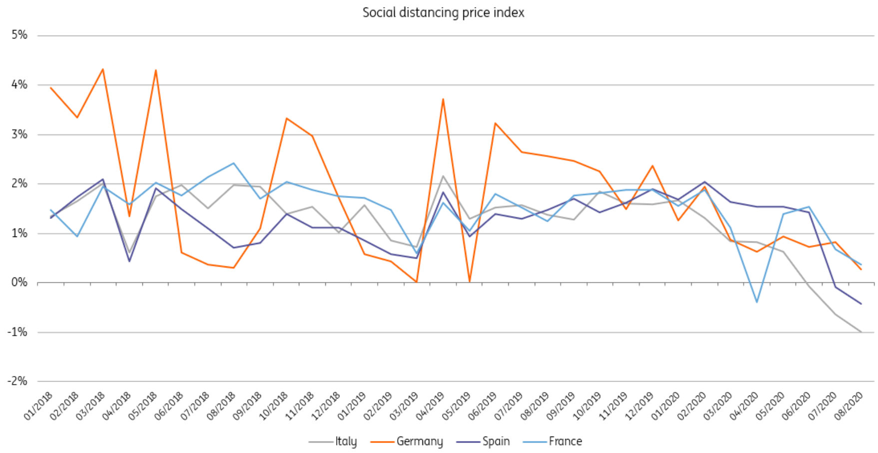


The largest declines come from transport services, package holidays and accommodation services, indicating that especially trips and holidays have seen prices fall considerably.

There are differences between countries though as larger tourist destinations experienced a bigger shortfall in demand over the summer months, causing differences in the decline in the social distancing price index between countries.

Looking at the four larger countries, we see Germany and France experienced a milder dip than Italy and Spain. Looking at accommodation prices specifically, we find a correlation between countries that usually receive more tourists over the summer and ones that usually receive less. A country like Germany now hosts many more domestic tourists than it usually does in summer when people travel elsewhere.

Popular holiday destinations see social distance inflation decline more significantly over the summer



Ultimately, the index shows that currently the direct virus fears, measures and limitations are putting more downward pressure on prices than the macroeconomic consequences of the virus are as the drop in inflation is not as widespread as it would be otherwise.

The ECB will have to take a position on vaccine availability

For the ECB, this decline brings a difficult decision with it.

Is this a fleeting issue that should be ignored like a drop in the oil price or a VAT decrease/hike? And what if social distancing measures are completely reduced next year if and when a vaccine has been rolled out successfully? Could there then be a price mark-up to make up for losses this year? And even if social distancing measures are not reduced, there is the risk that another year of staycations could also lead to demand-driven price increases in the Northern European economies. There is anecdotal evidence that many vacation destinations in Germany are already fully booked for the 2021 summer season, this would likely create a reverse effect in the Southern European economies.

> *While the kneejerk response to the decline in core inflation would be to stimulate the economy even more, the situation is more complicated than that*

So while the kneejerk response to the decline in core inflation would be to stimulate the economy even more, the situation is more complicated than that.

There are two multiple trillion euro questions for the ECB now. The first is whether demand can outstrip supply in a social distanced environment when virus risks are still significant and the second is when will a vaccine become available that will eliminate this problem altogether. Doves and hawks will have to include takes on these questions when deciding on a possible next round of stimulus later in the year.

One thing is clear: even the ECB is currently affected by social distancing.

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