

Why the ECB has little to fear from inflation divergence in the eurozone

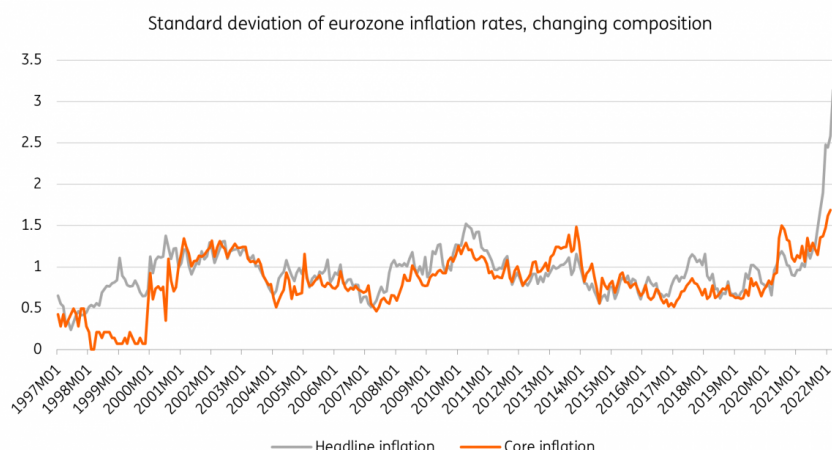
Inflation differences in the eurozone keep on mounting. But what was a problem for the European Central Bank in the past can almost be ignored right now. The ECB's 'one-size-fits-all' policy currently suits better than before



A few weeks ago, we wrote about how the divergence in inflation between countries in the eurozone is not a problem for the ECB. Since then, differences have become even more apparent now that we have seen another spike in inflation. In fact, March headline inflation ranged from 4.6% in Malta up to 15.6% in Lithuania. Measured in standard deviation, inflation divergence in the eurozone has never been higher than it is now.

In the past, inflation divergence was an additional problem for the ECB as it complicated its 'one-size-fits-all' policy. In fact, this problem occurred mainly in the first years of the monetary union when monetary policy was too loose for high inflation and catching-up economies, such as Spain and Ireland, eventually leading to asset bubbles. Since the financial crisis, monetary policy was often too loose for a country like Germany but partly still too tight for countries going through structural adjustments. Now, we have to consider whether much higher inflation divergence than in the past could once again complicate the ECB's life.

Divergence in inflation between countries has only increased



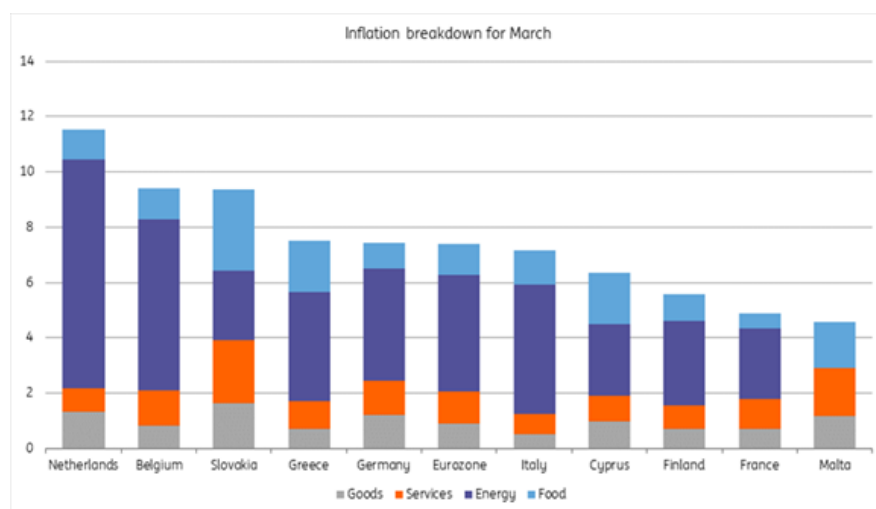
Source: Eurostat, ING Research calculations

Energy inflation still dominant in driving inflation differences

The recent jump in inflation has been predominantly seen in energy prices, coming on the back of the price shock seen in early March when the war in Ukraine started. Concerns about energy availability, especially for oil and gas, have resulted in another spike. Mind you, core inflation has also been rising due to supply chain problems, reopening effects and second-round consequences from the energy crisis, but to a much smaller degree. That makes energy the main driver of the divergence between countries at the moment.

The differences in energy inflation are mainly determined by the energy mix of countries – more fossil use makes consumer prices increase more quickly, the speed with which market price changes are translated into consumer prices and government interventions. While divergence of headline inflation surged like a rocket, divergence of core inflation remained relatively well behaved, though it is still slightly above previous peaks.

Inflation breakdown for March shows energy is the dominant driver of total differences



Source: Eurostat, ING Research calculations

Inflation expectations remain moderately similar between countries

As energy prices are the main driver behind current inflation divergence, the ECB will not really be too concerned. In fact, the divergence of core inflation is much smaller, although it has now also surpassed the corona crisis peak. In any case, what matters most for the ECB and its future monetary policy path are inflation expectations and wage developments.

As for inflation expectations, the risk is that high current inflation becomes engrained in expectations moving forward, resulting in diverging paths between countries, making the ECB's job harder anyway. For the eurozone as a whole, inflation expectations from both consumers and professional forecasters have been soaring across eurozone countries since 2021. However, we cannot detect any growing divergence across countries.

When looking at consumer expectations for prices, we see that they have been rising sharply in most eurozone economies. We also note that price expectations are mainly correlated with current inflation rates, but the most important thing in determining divergence in inflation expectations is whether we see different developments across countries. This is not the case. All countries see marked run-ups in inflation expectations for the coming year – longer-term expectations are not available – and most countries are seeing all-time highs since the start of the series in 1985. So even if you have to take the data with a grain of salt, at least it is moving in tandem between countries.

Consumer inflation expectations are high across the eurozone

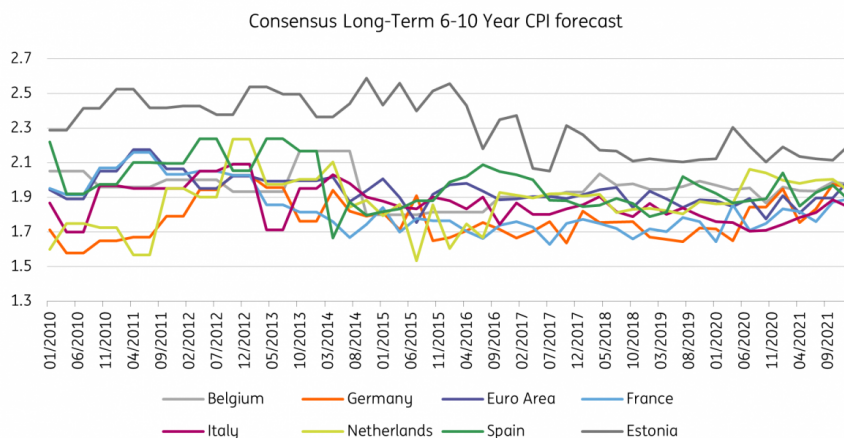


Source: European Commission DGECEFIN

Surveys among forecasters show that longer-term inflation expectations have been rising modestly in eurozone countries. The trend is similar between countries here, and expectations have been converging towards the 2% target for the larger countries. Smaller – mainly CEE – member states see higher inflation expectations for the medium-term as economic convergence also comes with faster-rising prices. Overall though, the convergence in inflation expectations means that we don't see expectations of faster current inflation resulting in rising medium-term inflation between countries. Once more, this means that the ECB's life is not made more difficult by diverging current inflation. Economic outlooks have been converging, and so are longer-term

inflation expectations.

Longer-term inflation forecasts for eurozone countries have been converging



Source: Consensus Economics

In terms of divergence, bond yields remain the ECBs Achilles' heel

The ECB's job has become increasingly tough in recent months, where an error on both the hawkish and dovish sides could prove costly for the economy. While divergence in inflation rates between countries only seems to add to this problem, we're actually seeing that key medium-term indicators for monetary policy continue to converge. That helps in making policy somewhat easier to set for the ECB and focuses the discussion on how monetary policy in the eurozone should react to looming stagflation, potentially distinguishing between normalisation and tightening (see also our ECB Preview for Thursday's meeting [here](#)).

There is, however, another more crucial weakness in terms of country differences that is complicating the ECB's life: bond yields. In the current environment of rapidly rising longer-term rates, the ECB will closely watch how quickly yields are rising and whether this remains sustainable for the more vulnerable eurozone economies. This is starting to become more of an issue as last week saw peripheral yields soar to the highest levels since the announcement of the EU recovery fund. Continued rapid increases in interest rates would result in a choked off recovery and could cause further financial stress. Don't forget that the ECB has always warned against so-called unwarranted tightening of financing conditions.

The recent increase in bond yields and the widening of spreads could worsen the ECB's stagflation problem as higher yields and worsening financing conditions have a relatively stronger impact on growth than inflation. Therefore, we were not at all surprised by recent market [rumours](#) that the ECB is working on a new programme to tackle the unwarranted widening of bond yield spreads. With such a programme, the devil is definitely in the detail as it would require assumptions on 'neutral' or fundamentally justified bond yield spreads across countries and would also potentially create new legal headaches. Still, we have always expected the ECB to eventually come up with an anti-fragmentation asset purchase programme to accompany its path of policy normalisation. In any case, inflation divergence in the eurozone is currently one of the most negligible problems the

ECB is facing.

Authors

Bert Colijn

Chief Economist, Netherlands

bert.colijn@ing.com

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. (“ING”) solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.