

Eurozone: Reopening inflation will add to ECB's worries

Price categories affected by social distancing are already turning a corner. With a reopening of economies, higher prices in sectors hit by social distancing and lockdowns will add to this year's inflationary pressure in the eurozone



Social distancing inflation starts to turn

Inflation has been distorted in all sorts of ways due to the coronavirus crisis. Think of oil price swings, supply chain distortions, unavailable prices for goods and services due to lockdowns and also the impact from social distancing. Over the course of 2020, price categories that were affected by most social distancing measures, such as accommodation, package holidays and transport, saw prices fall on average. This pushed down headline inflation substantially. The contribution of these social distancing categories to headline inflation fell by 0.5% between December 2019 and October 2020, almost a third of the total drop for the same period.

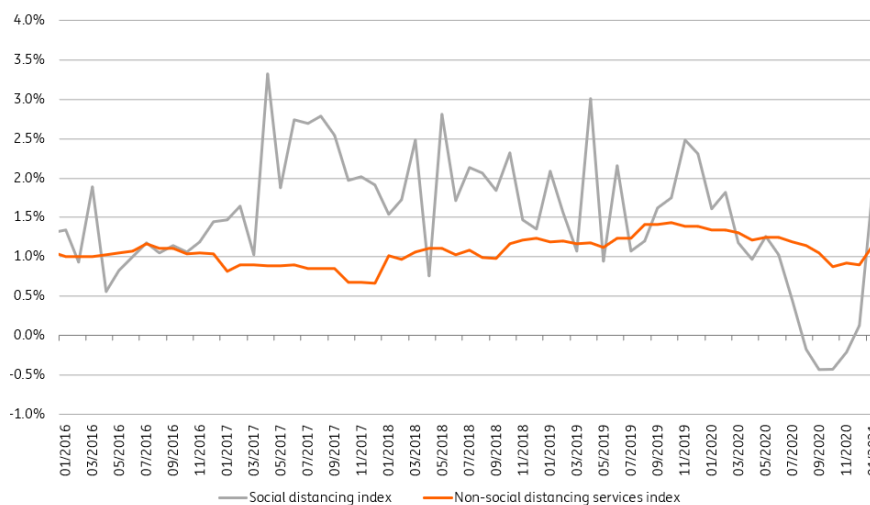
But after falling prices from August until November, inflation related to social distancing services has now turned a corner. Most recently, our index – which we explain in more detail in [this note](#) – increased from 0.1% in December to 1.9% in January. This was thanks to strong improvements in transport and package holiday inflation turning less negative. Transport prices saw a jump in

January, possibly on the back of losses made in 2020 and some pass-through of higher energy prices. Package holidays saw prices close to last year's levels, which could be related to improving demand as hopes for reopening increase, or simply the result of imputed price-setting by statisticians. Also, some of the negative base effects are fading already and more is to come once restrictions on the sectors involved are lifted. This adds to the temporary price pressures expected for 2021.

The jump would have been less pronounced if the weights for the index had not been changed though. The weights of the categories in the basket of goods and services that add up to headline inflation have changed substantially for 2021 on the back of consumption changes last year. Heavily affected by lockdowns, social distancing consumption has been much less than before, pushing down the weight in the total consumption basket. It also shifts the weights in our social distancing inflation index, making the weakest indicators less important. That adds significantly to the jump in January, although otherwise it would have still been substantial: from 0.1 in December to 0.7% in January under the old weightings.

This changing of the weights also leads to a somewhat smaller relevance for the total basket of social distancing consumption this year, down from 17.8% to 13% of the total basket. The January contribution of social distancing inflation was therefore already 0.1 percentage point less than it would have been last year. Somewhat artificial, but important to note moving forward.

Social distancing inflation has turned a corner



Source: ING Research

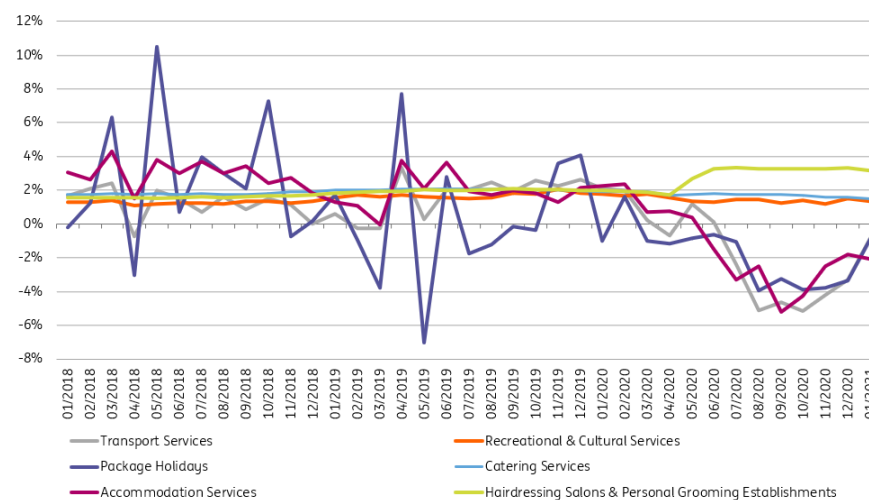
The biggest effect will be in the second half of this year

The current increase in our social distancing inflation measure comes with hardly any easing of social distancing. Consequently, there is more to come. The largest swings are to be expected in the price categories that saw the largest declines. Hotels, package holidays and transportation have all cut prices as demand has been impaired over the course of the pandemic. Once restrictions get lifted and fear of the virus retreats, it is reasonable to expect that prices will increase. A simple return to pre-coronavirus levels would push social distancing inflation above 2% in the second half of the year.

However, this is probably not where it will stop. Once economies reopen, at least some sectors are

likely to show both a supply-side and demand-side inflation shock; at least temporarily. This would be the “hairdresser effect” as hairdressers responded to the surge in demand after the first wave with price hikes causing elevated haircut inflation. Similar patterns can be expected in the hospitality sector. Price mark-ups will also help to offset new costs to adjust to different coronavirus requirements. Eventually, the duration of such reopening inflation will also depend on the level of competition. The higher the competition, the lower the risk that any reopening inflation will be longer-lasting. Admittedly, with the second wave still causing restrictions for the moment, selling price expectations for the coming three months remain very subdued for restaurants, transportation providers and the accommodation sector. But this can change quickly.

Hairdressers have already increased prices after the first wave ended



The effect may be understated in headline inflation, but will warrant the ECB's interest

The reopening of economies, if and when it happens, will add to the ECB’s inflation worries this year. The simple return to pre-coronavirus price levels combined with the risk of some reopening price mark-ups will be another inflation driver, in addition to higher oil prices and the German VAT reversal. In fact, eurozone headline inflation could easily accelerate above the magic 2% level this year. As much as the ECB has been hoping for inflation to return to 2%, this is not the inflation the ECB has been looking for. Inflation coming mainly from supply-side shocks and one-off factors is rather more deflationary than inflationary. Unless there are any second-round effects on wages in the making, the ECB will turn a blind eye to these developments. This is not an easy task but any premature normalising of monetary policy would risk choking off the still fragile economic recovery.

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