Eurozone: The great inflation reshuffle

The return of inflation could be one of the biggest surprises in 2021. For the first time since October 2018, headline inflation could actually hit 2% in the third quarter. However, don't be afraid: hyperinflation is not waiting around the corner

Inflation could become a surprise theme of 2021

With negative inflation rates, continuing lockdowns and a gradual economic recovery, the consensus expectation has long been for inflation to be muted this year. In its December staff projections, the European Central Bank forecast a gradual increase in eurozone headline inflation from 0.3% in 1Q to 1.5% in 4Q. While the ECB has developed an impressive track record in overestimating future inflation rates, we would argue that 2021 could be the first year in a long while that inflation will actually outperform the ECB's own expectations.

Headline inflation in the eurozone has been negative since August last year, stirring fears of yet another deflationary spiral and concern that the ECB will have a very hard time ever returning inflation to target. However, a closer look shows that falling inflation rates since January have mainly been the result of one-off factors like the temporary German VAT reduction, lower energy prices and the negative impact from social distancing and lockdowns on certain sectors and prices. All these factors together pushed headline inflation some two percentage points lower in the second half of 2020.

Inflation at constant taxes has been 0.6% higher since the German VAT cut

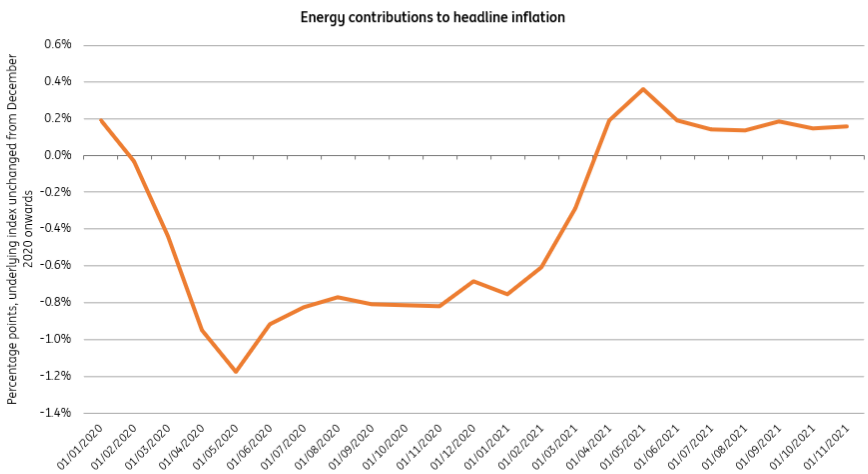
Source: Eurostat

More generally speaking, the lockdown measures across the eurozone complicate the proper measuring of inflation, as some services are simply not available. The pandemic has also (temporarily) changed lifestyle and spending patterns - changes that are not reflected in the composition of the price index. This makes the current estimate of inflation more uncertain and causes increased risk of higher (or lower) inflation than currently reported.

Drivers of deflation are set to become drivers of reflation

The drivers behind negative inflation rates in 2020 will fade in 2021: negative base effects from low energy prices, falling prices due to social distancing measures and, above all, the German VAT cut in July. The base effect for energy prices will turn positive in April and the positive base effect from higher energy prices could bring a positive contribution to eurozone inflation of some 0.4 percentage points by May, compared to -0.8 percentage points in November 2020.

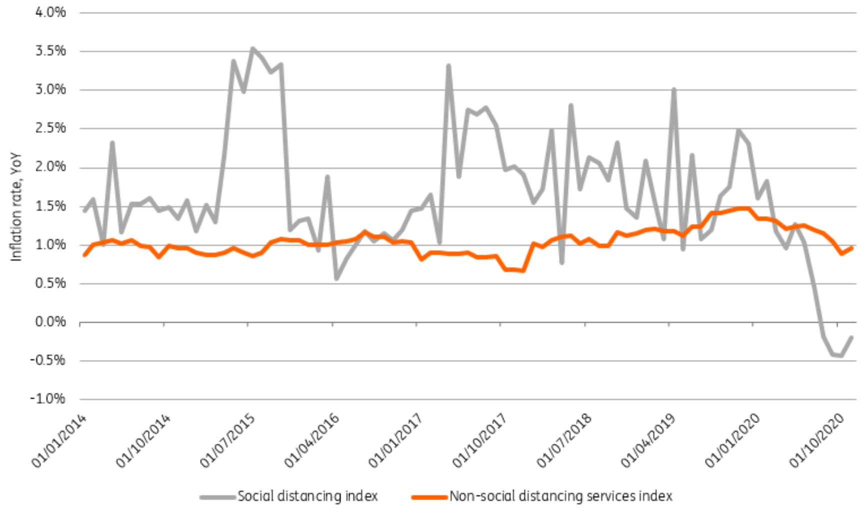
Energy inflation is set to reverse on strong base effects alone



Source: Eurostat, ING Research calculations

Assuming that governments will start to reopen their economies from the second quarter onwards, and that this reopening is permanent given the ongoing vaccination programme, a reversal of the social distancing deflation could push up headline inflation by another 0.5 percentage points. After the first wave lockdowns, price categories specifically impacted by social distancing (think package holidays and restaurants, in total accounting for some 20% of the inflation measure) nosedived, as fear of the virus dampened demand more than the restrictions did on supply. Once the economy reopens, expect this to reverse due to significant catch-up demand and businesses wanting to make up for lockdown losses.

Prices most affected by social distancing have seen a large decline, expected to reverse on reopening



Source: ING Research

For more on the social distancing index, please see our previous piece here: https://think.ing.com/articles/eurozone-ecb-suffers-from-social-distancing/.

Add to this the reversal of the German VAT reduction as well as the introduction of a CO_2 tax and German inflation is likely to come close to and probably even above 2% in the second half of the year, further adding to upside pressure on eurozone inflation. All in all, even without any significant change in underlying inflationary pressure, eurozone headline inflation could get close to 2%.

Fundamentals still point to low inflation in the medium term

With several strong headline inflation readings starting in 2Q, some financial market participants could get nervous, recalling old fears of accelerating inflation as a result of loose monetary and fiscal policies. Or at the very least, they could get worried about surprise tightening by the ECB. Together with the Biden bounce, and a possible reflation of the US economy, inflation fears could become a surprise topic of 2021.

However, before we get too carried away, remember these inflation fears may well disappear as quickly as they arrived. After a possible initial euphoria phase, combined with higher base effects, fundamentals will take over, and they look bleak. With the eurozone economy probably not reaching pre-crisis levels before 2023, output gaps will remain very high. Unemployment is expected to remain elevated compared to pre-crisis levels, at best, for 2021, which does not bode well for wage growth. Collective bargaining agreements over the course of 2020 were already much weaker than in 2019 and the number of bankruptcies is still set to go up as support unwinds. Also, the stronger euro puts a cap on inflationary pressures. That makes it hard to see how inflation is set to be structurally higher than before the coronavirus crisis began or how one-off factors could lead to unwarranted second round effects. In fact, we expect headline inflation to fall back to the 1% - 1.5% range in 2022, still clearly below the ECB's target.

Still, higher headline inflation numbers coupled with market speculation about future policy moves will put the ECB's communication skills to the test. In this regard, the latest comments from ECB board member Isabel Schnabel that it "would be the biggest economic policy mistake that could be made – tightening monetary and fiscal policy too soon" or from the Spanish Central Bank Governor Hernandez de Cos on possible yield curve control, have already given a taste of what's to come. Finally, don't forget that as long as quantitative easing is active, almost covering the entire supply of government bonds in the eurozone, demand and supply, rather than inflation expectations will determine the level of bond yields.

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