

## How long can core inflation linger in the eurozone?

The disinflationary trend in the eurozone has started and should gain more momentum after the summer. It will take a while but core inflation should follow suit as well



Slowly but surely, the inflation outlook for the eurozone is improving. Base effects as well as fading supply chain frictions and lower energy prices have and will continue to push down headline inflation in the coming months – a drop that the European Central Bank deserves very little credit for orchestrating. With headline inflation gradually normalising, the big question is how strong the inflation inertia will be. As long as core inflation remains stubbornly high, the ECB will continue hiking interest rates. How long could this be?

### **Inflation is moving in the right direction, but will core inflation remain stubborn?**

Headline inflation has come down sharply, which is widely expected to continue over the months ahead. The decline in natural gas prices has been remarkable over recent months and while it would be naïve to expect the energy crisis to be over, this will result in falling consumer prices for energy. The passthrough of market prices to the consumer is slower on the way down so far, which means that there will be more to come in terms of the downward impact on inflation.

The same holds true for food. Food inflation has been the largest contributor to headline inflation

from December onwards, but recent developments have been encouraging. Food commodity prices have moderated substantially since last year already, but consumer prices are now also starting to see slow. In April and May, month-on-month developments in food inflation improved significantly, causing the rate to trend down.

## Historical relationships and post-pandemic shifts

Headline inflation – at least in the absence of any new energy price shocks – looks set to slow down further, but the main question now is how sticky core inflation will remain. There are several ways to explore the prospects for core inflation.

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*We know that history hardly ever repeats, but it at least rhymes – and if this is the case, core inflation should soon reach its peak*

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Let's start with the historical relationships between headline and core inflation after supply shocks. Data for core inflation in the 1970s and 1980s are not available for many countries, but the examples below for the US and Italy show that an energy shock did not lead to a prolonged period of elevated core inflation after headline inflation had already trended down. In fact, the peaks in headline inflation in the 1970s and 1980s saw peaks in core inflation only a few months after in the US and coincident peaks in Italy. We know that history hardly ever repeats, but it at least rhymes – and if this is the case, core inflation should soon reach its peak.

History is one thing, the present another. Digging into the details of current core inflation in the eurozone shows a significant divergence between goods and services, regarding both economic activity and selling price expectations. Judging from the latest sentiment indicators, demand for goods has been weakening for quite some time already. At the same time, easing supply chain frictions and lower energy and transport costs have taken away price pressures, leading to a dramatic decline in the number of businesses in the manufacturing sector that intend to raise prices over the coming months.

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*Services inflation remains the largest problem for core inflation and the ECB*

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The services sector is still thriving, however, and enjoying the post-pandemic shift from goods to services. Services most affected by lockdowns are currently experiencing much faster price growth than other services or goods. While the upcoming summer holiday period could still fuel service price inflation, we did see a decline last month. The drop was largely due to cheaper public transportation tickets in Germany, however, so it seems too early to call a significant improvement in services inflation just yet. Finally, services inflation traditionally shows a much stronger correlation with wage growth than goods inflation. With wage growth trending up and probably coming in at around 5% year-on-year in the eurozone, services inflation remains the largest problem for core inflation and the ECB.

Still, a key question remains over how long the divergence between goods and services inflation can last. Historically, we don't see much evidence of an extended difference between the two. Goods inflation typically leads services inflation by approximately six months, which means that the peak in the former from February suggests that the latter is unlikely to remain elevated for the rest of the year. If we are right and the post-pandemic shift ends after the summer holiday period, we could see services inflation starting to come down before the end of the year.

## Core inflation set to trend down from here on out

While services inflation continues to see some upside risk for the months ahead, core inflation overall looks set to trend down on the back of slowing goods prices. Even services inflation could already be trending down, but perhaps not as fast as policymakers would like it to. When looking at selling price expectations for sectors that sell most to consumers, we see that there has been a steady downturn in the number of businesses intending to raise prices. This generally correlates fairly well with core inflation developments seven months later, which would point to a significant slowdown in the core rate.

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*Experts and central bankers will be hesitant to make an outright call for a sharp drop in inflation*

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At the current juncture, experts and central bankers will be hesitant to make an outright call for a sharp drop in inflation. The latest track record of inflation forecasting is simply not on their (or our) side. Nevertheless, as much as it was once obvious that the era of low inflation had to end at some point, it's now clear that the short period of surging inflation will also cease sooner or later. Historical evidence and the latest developments in both goods and services give enough comfort to expect both headline and core inflation to decline.

We currently expect core inflation to drop below 4% at the end of the year and for it to fall to 2.5% by mid-2024. The risks to that outlook seem to be fairly balanced, with more stubborn core inflation on the back of faster wage growth and a faster drop on the back of weak goods inflation both decent possibilities.

## Could the ECB fall behind the curve again?

For the ECB, this isn't to say that tightening is over. In fact, the central bank can't – and won't – take a chance on this kind of core inflation forecast. Why? Because they've simply been wrong too often in previous years. To put it into ECB language: inflation forecasts are currently surrounded by an unprecedented amount of uncertainty. This is one of the reasons why the central bank has put more emphasis on current inflation developments and less emphasis on its own inflation forecasts for one or two years ahead.

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*The European Central Bank will not change its tightening stance until core inflation shows clear signs of a turning point*

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While such a strategy supports the ECB's credibility, by definition it runs the risk of falling behind the curve. Given the time lags with which monetary policy operates and affects the economy, central banks should be forward-looking, not now-looking. This is the theory. In practice, however, the central bank will not change its tightening stance until core inflation shows clear signs of a turning point.

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