

Eurozone: The ECB and the return of inflation

As eurozone inflation is on the rise, staying on the sidelines has become less comfortable for the European Central Bank. Instead, expect a further shift towards (real) yield curve control



Source: Shutterstock

Eurozone inflation in January was just confirmed at 0.9% year-on-year, the highest level since February last year. Core inflation stood at 1.4% YoY. Higher energy prices, some supply-side disruptions and bottlenecks as well as higher prices for services are the drivers behind higher headline inflation in the eurozone. The divergence across eurozone countries is high, with headline inflation ranging from -2.4% YoY in Greece to 1.6% YoY in Germany and the Netherlands - a divergence which doesn't make the ECB's life any easier.

Inflation - the only way is up

Looking ahead, for eurozone inflation, the only way is up. In fact, there will be a series of one-off factors pushing up headline inflation. In the short run, it will mainly be higher energy prices driving this. But when economies reopen, price markups in sectors most hit by the lockdowns will also add to upward pressure on inflation. In addition, the full swing of the German VAT reversal will only

unfold in the second half of the year. Taking all these factors into account, headline inflation could eventually even touch the 2% level this year. Remember that in the December projections, the ECB had forecast headline inflation at 0.4% in the first quarter, accelerating to 1.5% in the fourth quarter - a highly unlikely outcome. Instead, it looks as if this year will be the first year in a long while in which the ECB's inflation projections will turn out to have been too pessimistic, rather than too optimistic.

However, interpreting this year's inflation data will not be an easy task. It is complicated, not only due to the series of one-off factors but also due to two technical measuring factors. The first is the fact that the pandemic has changed consumption patterns, which are relevant in determining the weightings in the inflation basket. These weights are updated once every year. For 2021, this means that changes in consumption patterns due to the pandemic will be applied, leading to a varying and messy comparison of pandemic-driven consumption patterns with lockdown situations but also later this year with returning normal consumption patterns. The other factor is that there are still goods or services which currently are simply not available due to the lockdowns. As a result, some 13% of the entire inflation measure is still imputed.

(Real) yield curve control with words

Quickly rising headline inflation rates, which are mainly driven by technical one-off factors, pose a new challenge for the ECB, as can be witnessed in bond markets. To understand the ECB's reaction function to higher inflation (expectations) and yields, it is important to look at the nature of these inflation developments. In fact, there are two types of inflation, the "cost-push" inflation, driven by temporary one-off factors, and the "demand-pull" inflation, with too much money chasing too few goods as a sign of an overheating economy. "Cost-push" inflation can actually be considered as being deflationary, reducing purchasing power. This is why the ECB will look through these kind of temporary and technical inflations spurts. It is the "demand-pull" inflation which the ECB will monitor closely. Particularly in the eurozone, there are no signs yet of such a demand-driven inflation pick-up. Admittedly, we will only know by the end of the year whether one-off drivers remain one-offs or have led to a more permanent increase in inflationary pressure.

For the time being, the ECB will focus on taming any inflationary expectations and speculation with words. However, the difficulty of this challenge is reflected in the fact that over the last few weeks the ECB has come up with a series of verbal interventions, warning against premature normalising of monetary policy, focusing on financing conditions, talking about real rates and finally emphasising nominal bond yields. All of this makes it harder to read the ECB's reaction function but at least it shows that the ECB has become aware of its newest challenges. In our view, the ECB could eventually move towards a kind of (real) yield curve control. Until then, one thing is clear, staying on the sidelines has become less comfortable for the central bank in recent days.

Author

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 www.ing.com.