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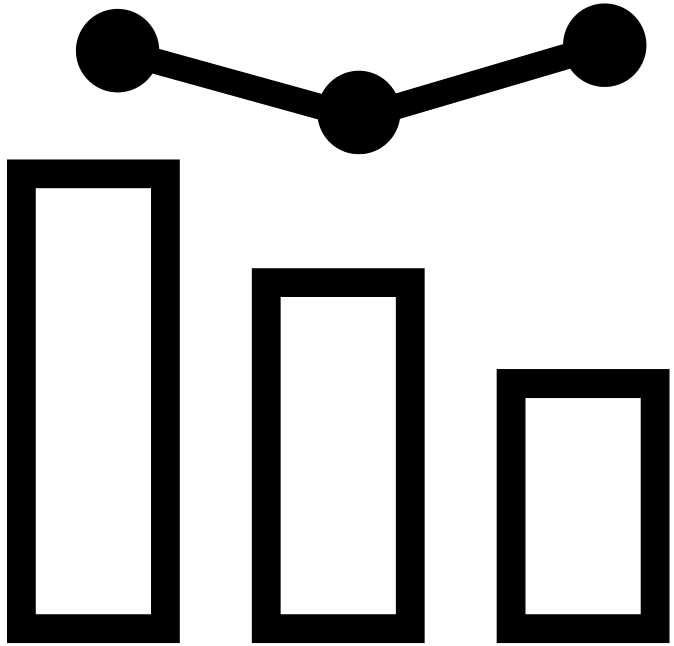


Inflation Update

May 2023

Inflation: a brief update

Inflation in the eurozone seems to have passed its peak. In this update, we dive a little deeper into this with our inflation dashboard. Our dashboard indicates that the recent cooling of inflation has been driven mainly by declining commodity prices and tighter monetary policy. However, there is still upward pressure from the labour market. This suggests that core inflation, which is relatively sensitive to wage growth, may well remain high for longer than financial markets estimate.

Eurozone inflation dashboard

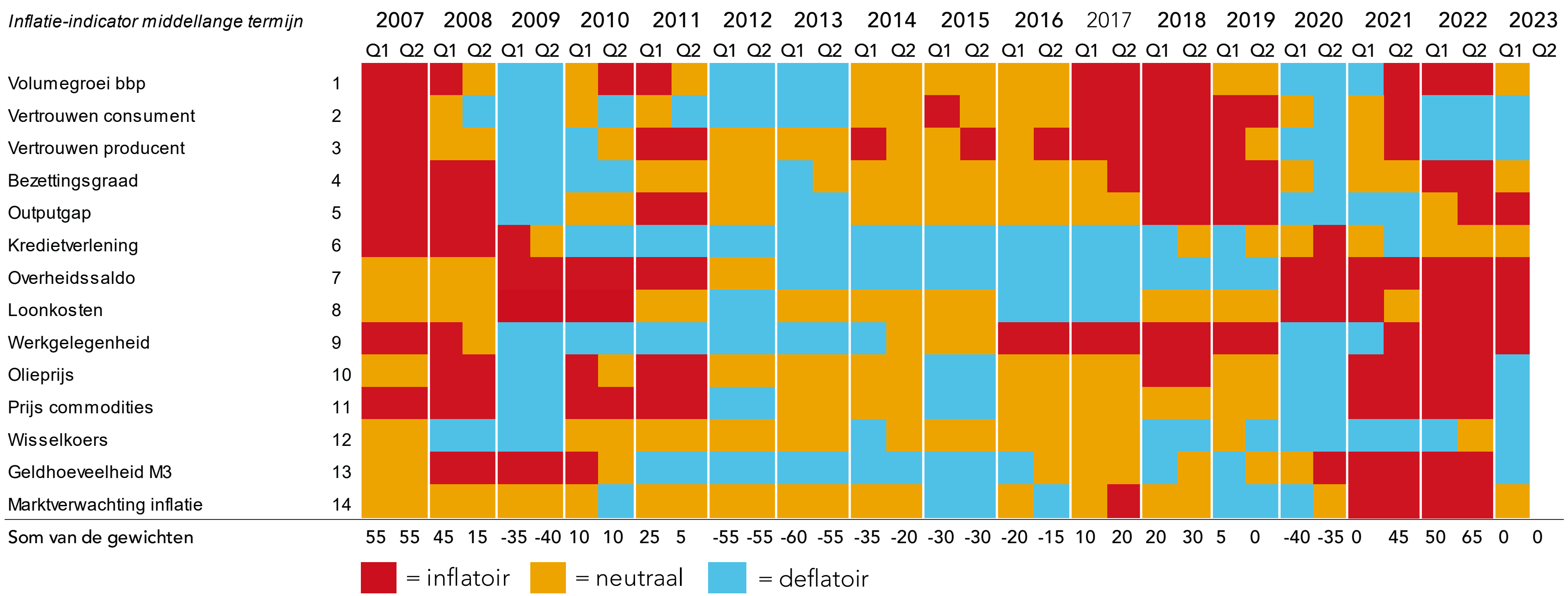
To have a timely picture of the macro-economic drivers of inflation in the eurozone, we maintain an inflation dashboard (Table 1). Roughly speaking, the components of this dashboard can be categorised under three headings: spending inflation (components 1-7), cost inflation (components 8-12) and monetary stimulus and market expectations (components 13 and 14).

Table 1 shows that in the first quarter of this year, the inflationary pressures that the eurozone witnessed in 2022 are easing. Consumer and producer confidence is declining, commodity prices have fallen and the money supply is decreasing due to tighter monetary policy in the eurozone.

Inflationary pressures are currently coming mainly from the labour market. For instance, unemployment is still low and wage growth in the eurozone does not seem to have ended. This is in line with the fact that inflation is currently driven more by services than goods. In addition, there are still incentive policies from the government[1].

In summary, our dashboard indicates that the recent combination of declining headline inflation and stubbornly high core inflation will persist for the time being. Financial markets currently seem to be pricing in the fact that the ECB will stop raising its policy rates fairly soon and even start cutting them again by the end of this year. The latter in particular does not seem very likely to us, unless unforeseen circumstances were to arise.

Table 1: Our inflation dashboard indicates that price pressures are easing, but not in the labour market



Bronnen: Bloomberg, a.s.r. berekeningen

[1] The total expected stimulus from eurozone governments between 2020 and 2024 will be over 12% of GDP, according to the ECB, which is ultimately larger than the government stimulus in the US.

Comments: For each indicator, a historical data series for the eurozone has been determined with quarterly data over mostly ~25 years. Over that period, the average, maximum and minimum were determined. For each indicator, we determined an 'appropriate' deviation from the average. If the sequence is above (below) that 'appropriate' deviation, the component receives 1 point (-1 point), otherwise 0 point. The overall scores at the bottom of the table are a weighted average of the different components, with us using our own estimate for what the weight for each component should be.

Low interest on savings and 'greedflation'

The 2022 inflation surge can be at least partly explained by savings surpluses created during the COVID-19 pandemic of 2020-2021, partly thanks to generous COVID-19 support by governments and partly because the economy was in lockdown during the pandemic and consumers were having to spend less (and companies invested less) than under normal circumstances[2]. As these savings surpluses are being unwound, demand for goods and services tends to exceed supply, resulting in rising inflationary pressures.

The COVID-19-related savings surpluses not only partly explain the increased inflationary pressures, but also help explain why interest on savings lags relatively behind the development of interest rates on, for instance, mortgages and other loans. When savings are high or excessively high, banks are less likely to raise interest rates on savings. With savings surpluses from the COVID-19 pandemic clearly declining (Figure 1), our expectation is, however, that the ratio of interest rates on savings on the one hand and loans on the other will also gradually return to normal.

The scaling back of savings surpluses contributes not only to upward price pressures but also to companies' profits and profit margins. Higher demand for goods and services enables firms to increase prices for their products and services, and in many cases to increase them more than their cost prices, in other words to achieve higher profit margins (Figure 2). These higher profit margins, in turn, indirectly drive up prices.

Figure 1: Eurozone households saved a lot during the COVID-19 period

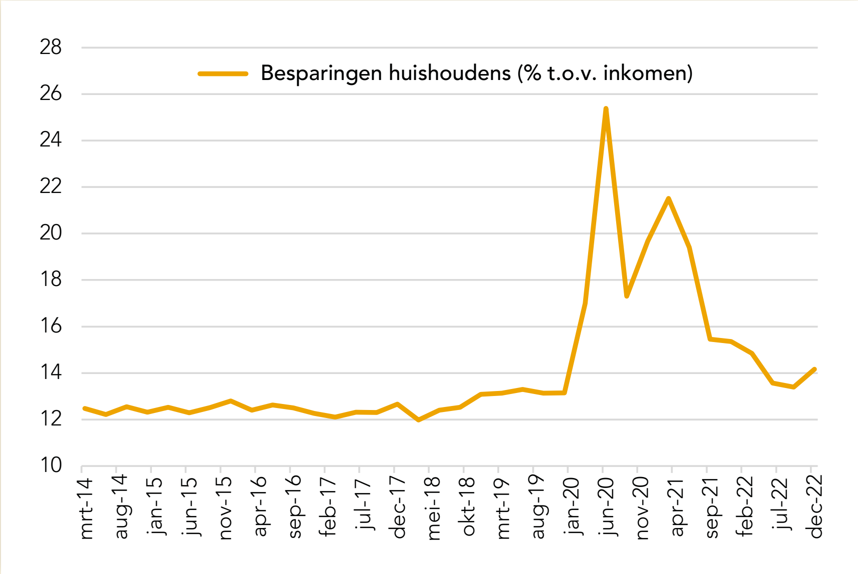
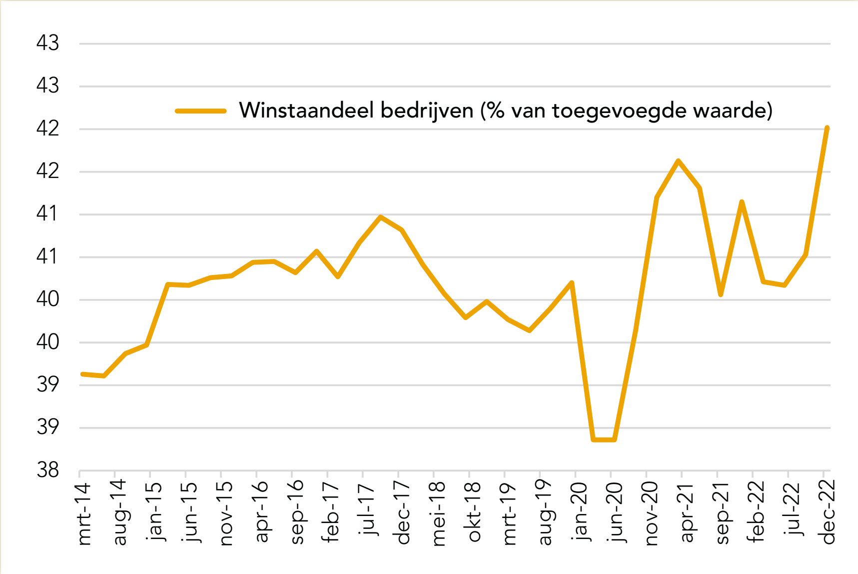


Figure 2: Eurozone companies' profit share increased



Sources: Eurostat

2 Eurozone consumers have saved around EUR 900 billion as of the COVID-19 period, according to Philip Lane of the ECB, representing almost 7% of the eurozone GDP.

Recent analyses (by, for instance, Rabobank and The Economist) show that part of the 2022 inflation wave was indeed driven by higher corporate profit margins. And it's true to say that in some cases, companies will have abused their market power to raise prices sharply (Rabobank's report cites the example of exorbitant prices for hotel stays after Hurricane Florence in the US). However, according to these analyses, there is no evidence that this type of price gouging is widespread. Moreover, it may be rational for companies to increase the prices of their services and goods in a high inflation environment in anticipation of higher input costs and higher wage costs in the future.

In any case, from a macroeconomic perspective, it is interesting that the part of inflation driven by profits is higher in the eurozone than in the US (according to an ECB analysis). The fact is that in the US, wage costs play a somewhat bigger role. This is understandable because the service sector is a larger part of the US economy (80%) than that of the eurozone (70%). And services are generally more sensitive to changes in wages than goods are.

The implication of this difference between the US and the eurozone is that if there is an economic downturn, inflation in the eurozone could fall slightly faster than in the US. After all, it is easier to have profits reduced than to bring down wages. But the issue is whether this effect is large enough to outweigh other effects, such as sensitivity to energy prices, the degree of monetary tightening, economic downturns, government stimulus and consumer savings surpluses.

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