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Research Briefing | Eurozone

Low-flation risks to come back to the fore in late-2022

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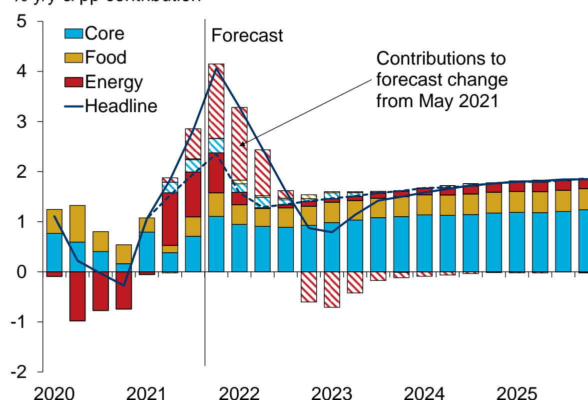
- **We see little evidence that the outlook for underlying inflation in the eurozone is much changed from a few months ago. In fact, there's a high probability that low-flation will make a comeback next year. Thus, speculation of European Central Bank (ECB) hikes in late-2022 seems way off the mark.**
- **True, we have materially raised our near-term inflation views in recent months as energy prices surged more than expected and supply bottlenecks worsened. But we still forecast inflation next year slowing rapidly, heading towards 1% in Q4 2022, averaging 2.0% in 2022 and only 1.2% in 2023.**
- **Delayed pass-through of the recent surge in gas and electricity prices will keep inflation above 2% in H1 2022. But our commodity forecasts foresee a swift fall in oil and gas prices, so energy will become a drag on inflation into 2023.**
- **Surging durable-goods prices could continue to prop up core inflation in the near term. But in contrast to the US, spending on durables is weak, so supply logjams are more to blame than demand. And easing commodities prices and bottlenecks should see prices return to their decade-long downtrend.**
- **Services inflation, which is a better gauge of demand and wage pressures, has picked up sharply. But that jump mostly reflects base effects, with evidence that some sectors are facing some temporary non-wage cost push rather than the more healthy and sticky demand-pull inflation that the ECB rightly focuses on.**
- **Lastly, we see no signs of an emerging wage-price spiral. We also don't expect the recovery to be strong enough to let firms fatten profit margins, so inflation will slow as import price pressures ease. In all, we maintain our view that underlying inflation will remain contained over the coming years, unless growth is stronger or commodity prices are higher than expected.**

Figure 1: Upward revisions to inflation outlook primarily reflect a surge in energy prices



We have made considerable upward revisions to our inflation forecasts since our last examination into the outlook for consumer prices. This was due to higher energy prices, though we still see price pressures remaining muted as services prices stay contained and goods prices are seen slowing.

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Inflation has spiked above 4%. What's next?

Inflation worries have grown considerably in the eurozone over recent months as price gains exceeded 4% y/y in October, the first time since the run-up to the global financial crisis. This has also fuelled speculation that the ECB would be dragged into a much earlier and sharper tightening of monetary policy than the central bank had signalled. However, despite inflation having surprised materially to the upside this year, we continue to expect a sharp slowdown in price pressures next year and forecast a subdued medium-term trend (**Figure 2**).

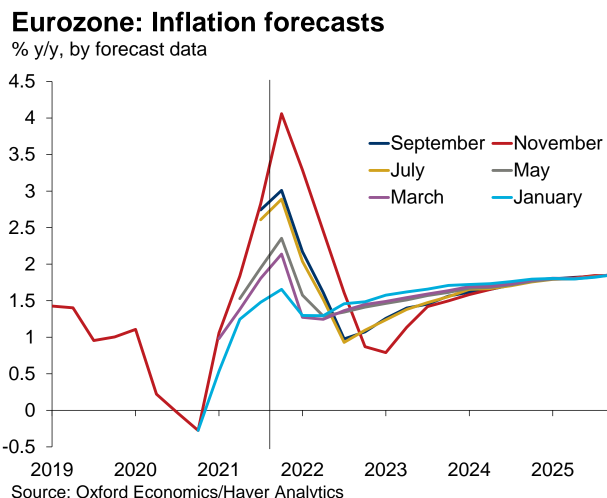
Prices could slow towards 1% by Q4 2022

Energy price dynamics are the main reason for our benign view on inflation. They have spiked massively this year as demand rebounded faster than supply, with the latter having been constrained. The surge in the price of energy has been the main reason for upward revisions to our forecasts from a few months ago. But we expect oil and gas prices to fall back sharply next year, averaging 7% and 16% below this year's levels. This should also cut electricity bills. In fact, the current jump in commodity prices means that we now think that consumer energy prices will become a significant drag on headline inflation late next year (**Figures 1** and **3**).

We also think that core inflation will reverse part of its current climb next year. It's true that core inflation rose to 2.1% in October, the highest since 2002. However, that is primarily due to base effects stemming from the weakness of consumer prices in H2 2020, which was driven by Germany's temporary VAT cut as well as extremely subdued inflation in contact-intensive service sectors. Comparing prices with those from two years ago to exclude the base effects and looking at recent monthly changes to gauge momentum, the picture looks much more benign. In both cases, core inflation amounted to about 1.2% at an annualized rate in October. That is in line with the subdued pre-pandemic dynamics.

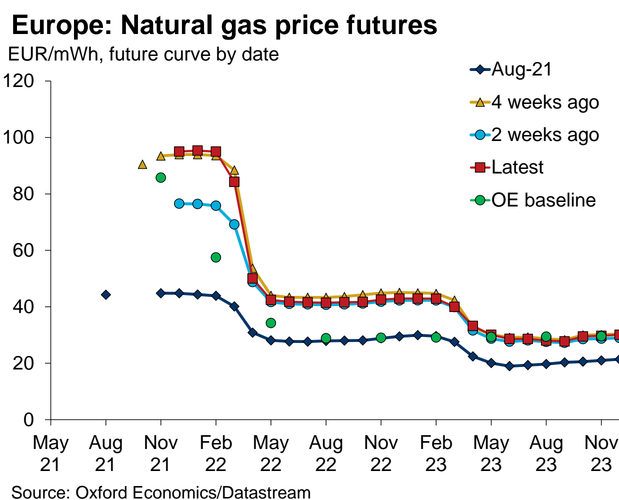
So we would describe the recent strength in core inflation as a swift return to pre-pandemic trends. As of now, that can hardly be described as a strengthening of underlying price pressures that should worry the ECB and force it into a swifter than signalled policy normalisation. What's more, while there are important differences across eurozone countries, most of them show similarly benign core price pressures, with only three countries recording core inflation rates above 2% over the past two years (**Figures 4** and **5**).

Figure 2: Like the consensus, we have made large upward revisions to our inflation forecasts



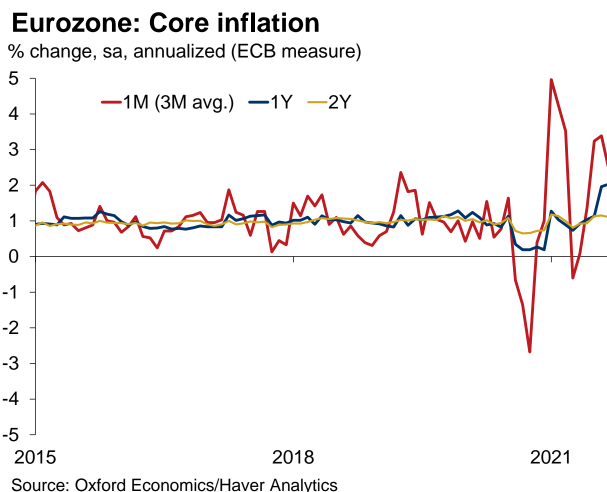
Source: Oxford Economics/Haver Analytics

Figure 3: Markets price a sharp drop in gas prices next year broadly in line with our forecast



Source: Oxford Economics/Datastream

Figure 4: The sharp rise in core inflation mostly reflects base effects and a fast return to trend



Source: Oxford Economics/Haver Analytics

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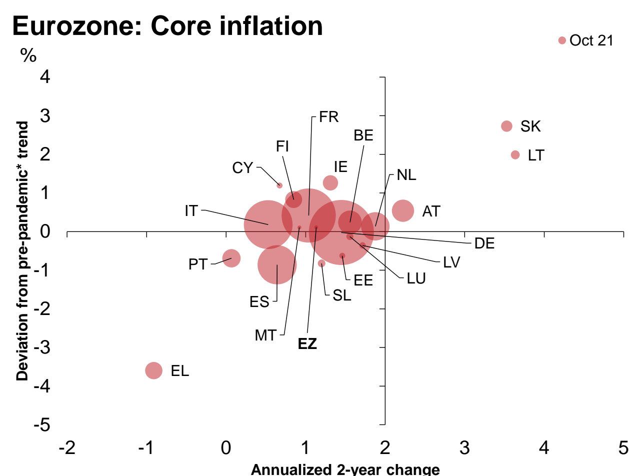
A detailed look into the core inflation data further bolsters that conclusion. Much of the increase in core inflation has been due to a surge in durable goods prices. But spending on durables has remained fairly weak in recent quarters after partially rebounding in H2 2020. And it was probably below its Q3 2019 level in the third quarter this year. Hence, we think that much of the 2.8% y/y rise in durable goods prices in October this year, which marked a historic high, can be blamed on supply bottlenecks rather than buoyant demand that needs to be reined in by tighter policy. Recent consumer confidence data shows that near-term spending plans have suffered, while next year's outlook remains robust (**Figures 6**, **7,** and **8**). Overall, there is a stark contrast to the US, where tight supply is accompanied by strong demand.

What's more, we expect global supply bottlenecks to lessen next year, which will weigh on import and producer prices. In addition, prices of key non-energy commodities (e.g., steel) as well as transport costs have come off their recent peaks as the restocking cycle and demand recovery begin to ease. At the same time, we think consumption patterns will normalise further as pandemic disruptions subside, so the current supply-demand imbalances should ease. Consumers beginning to deploy their excess savings could delay that, but we wouldn't be surprised if durable goods prices returned to their decade-long disinflationary trend sooner rather than later (**Figure 9**). If that should coincide with the above-mentioned drag from falling energy prices, the eurozone might be in for a new disinflation scare sometime next year rather than sustained inflation worries.

In comparison to surging goods prices, services inflation has seen a disappointing recovery this year. In October, it rose above 2% y/y for the first time since 2011, but that was in large part due to base effects as prices for contact-intensive services plunged by as much as 1% y/y last year and are now recovering. Surveys indicate that hospitality and tourism prices could pick up further in the coming months, but with prices up less than 1% (annualized) over the past two years, we see that as a welcome further recovery. The only gradual return of pricing power is hardly surprising given that tourism activity is still some 15%-25% below pre-pandemic levels (**Figures 10**, **11** and **12**).

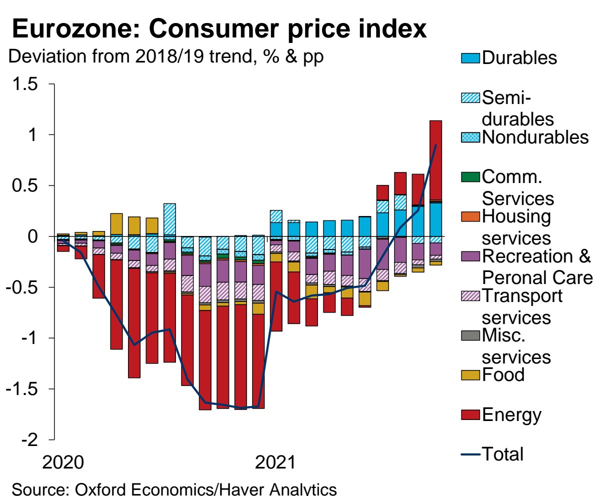
The lack of pricing power isn't confined to the tourism sector, though. We recently showed that the rebound is insufficient to allow firms to widen their margins materially. While GDP in the eurozone is 0.5% below its pre-pandemic peak, it is 1.4% above it in the US, where inflation is rampant. What's

Figure 5: Trend in underlying prices remains subdued across countries



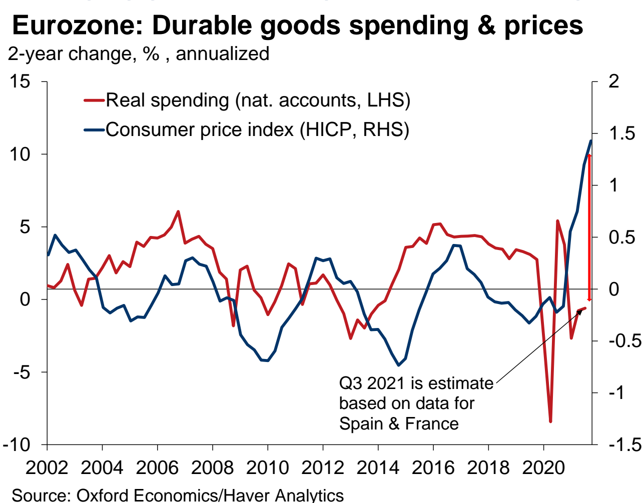
Source: Oxford Economics/Haver Analytics (*SA data & 2018/19 trend)

Figure 6: Durable goods and energy prices have driven prices above pre-pandemic trends



Source: Oxford Economics/Haver Analytics

Figure 7: Supply bottlenecks are likely to blame for surging goods prices given weak spending



Source: Oxford Economics/Haver Analytics

more, surveys show that the most recent strengthening in price expectations in the services sector happened against the backdrop of moderating demand expectations. We see this as tentative evidence that some sectors are facing cost-push inflation (e.g., repair of computers and household goods), with global supply bottlenecks yet again playing some role. However, since we expect bottlenecks to ease and demand growth is moderating, these price pressures are unlikely to have legs (**Figures 13** and **14**).

The usual pushback against our benign take on the inflation outlook is that the current period of very high price growth, even if temporary, could fuel excessive wage demands. But for now, we see no signs of that. Negotiated wages were up by a meagre 1.4% y/y recently, with no signal of a sustained pickup. So while we expect wages to climb as labour markets tighten further (see our recent take on Spain here), the bigger risk at this stage is that paychecks fail to rise by enough to bolster real wages, given the modest rise in underlying inflation we expect (**Figure 15**). We will publish in-depth research on the wage outlook and labour shortages soon, which are consistent with our views on inflation.

Overall, we forecast that inflation will slow to 2.0% in 2022 after averaging 2.4% this year. That is a tad above the consensus, but our view that inflation will slow to only 1.2% in 2023, as energy prices fall and core inflation stays muted, puts us towards the lower end among forecasters (**Figure 16**).

The outlook is unusually uncertain

There is admittedly a high degree of uncertainty around the inflation outlook, as upside and downside risks on both the demand and the supply side add complexity. We think the biggest risk is that energy prices don't fall as fast as we assume. For instance, if oil prices moved in line with current futures pricing, inflation could amount to 2.5% and 1.6% in 2022 and 2023, respectively. What's more, goods inflation could accelerate further in the near term, if Christmas shopping, sustained supply bottlenecks, and renewed virus restrictions coincide. We only see limited inflation risks from the monetary side, though. We recently showed that excess money growth in the eurozone has been limited compared to advanced economies. Over the medium term, stronger-than-expected demand growth could push up firms' pricing power. All this materially complicates the ECB's key policy decision due in December. But we think that the executive board's approach is the right one: Proceed cautiously in the face of ample uncertainty and after years of inflation undershooting.

Figure 8: High prices and tight supply seem to dampen consumers' near-term spending plans

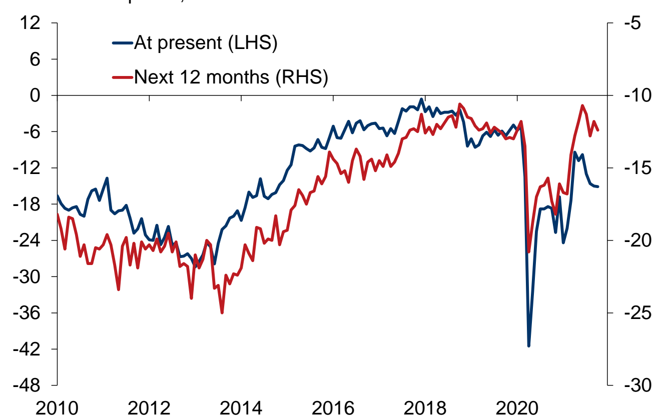


Figure 9: Current durbale-goods price dynamics are remarkable but unlikely to be sustainable

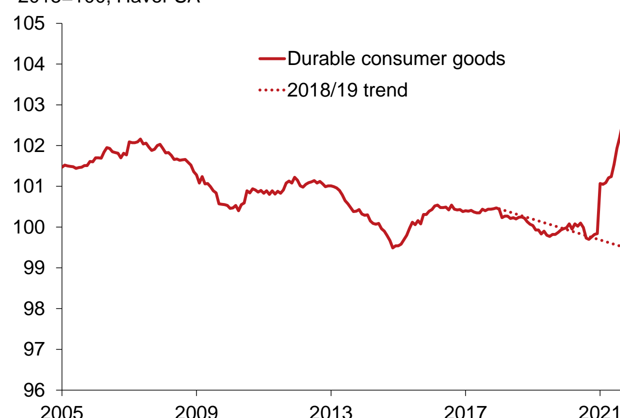


Figure 10: Services prices have undergone only an underwhelming rebound so far

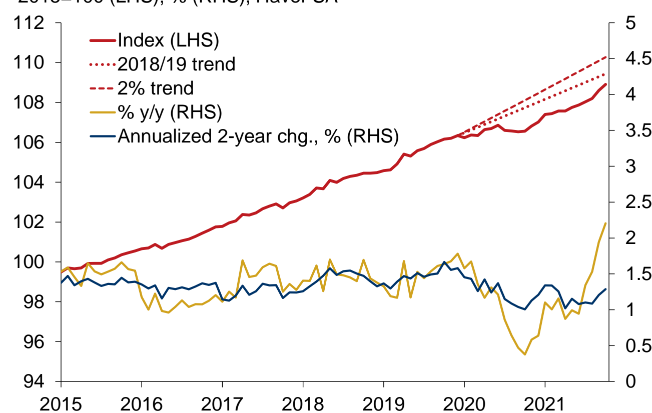


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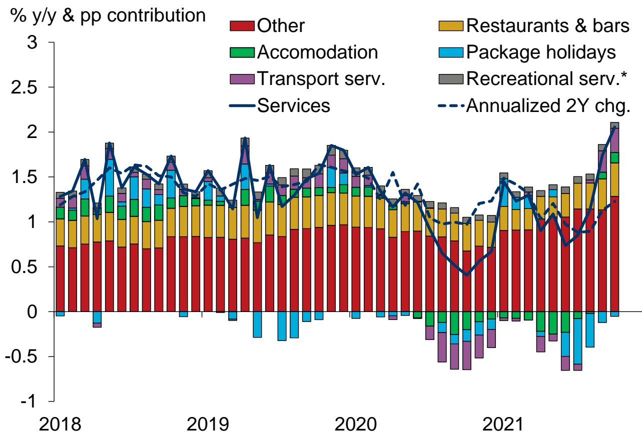
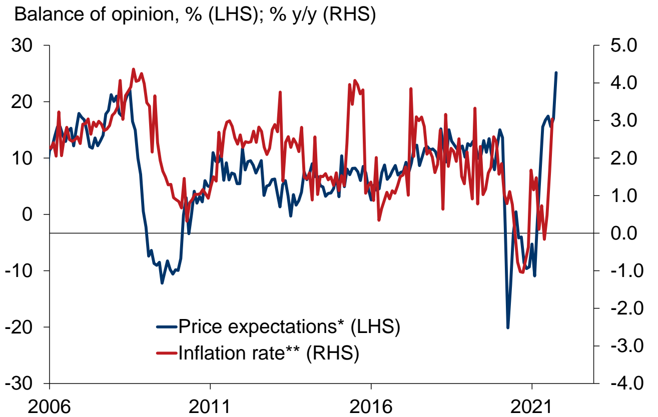
Figure 11: Rise in services inflation due to base effects and a recovery in hospitality/tourism



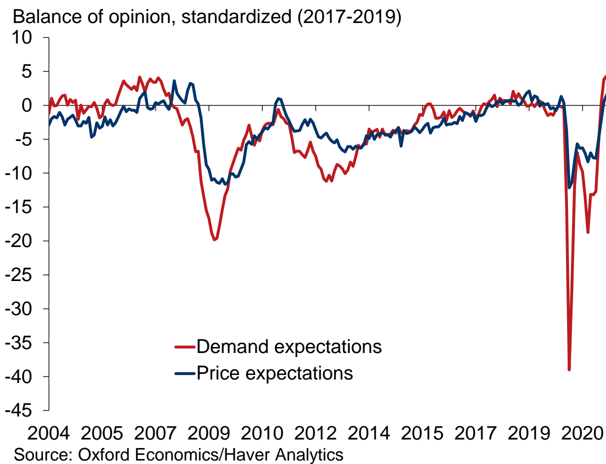
Source: Oxford Economics/Haver Analytics (* incl. cultural services)

Figure 12: Hospitality and tourism prices could recover more lost ground in the coming months



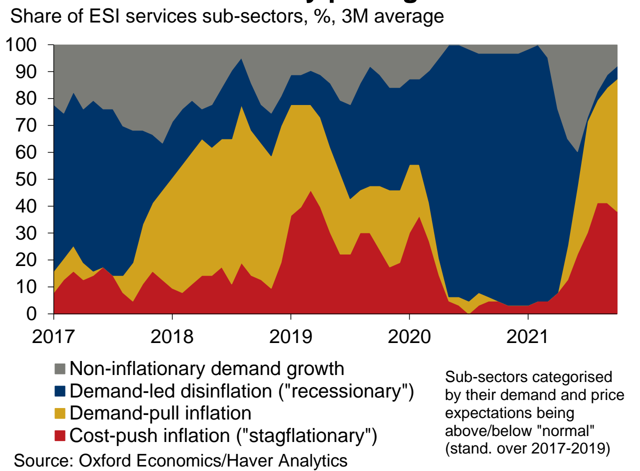
Source: Oxford Economics/Haver Analytics (*weighted avg. of accom., travel/ tour operators & rest./bars; **pack. hol., accom., transp. serv., rest./bars)

Figure 13: How long can price expectations stay high, when demand growth has peaked?



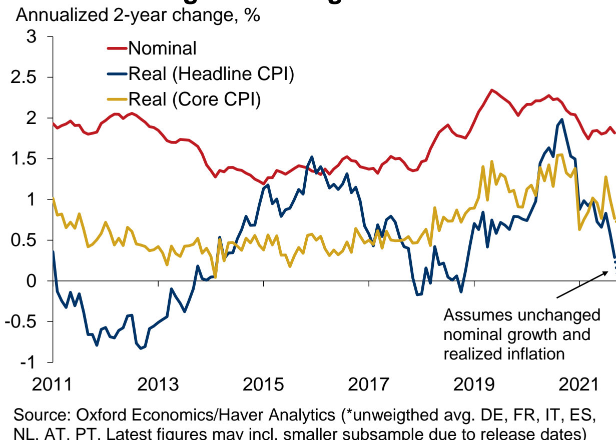
Source: Oxford Economics/Haver Analytics

Figure 14: Surveys shows signs that services inflation is in part due to cost-push pressures



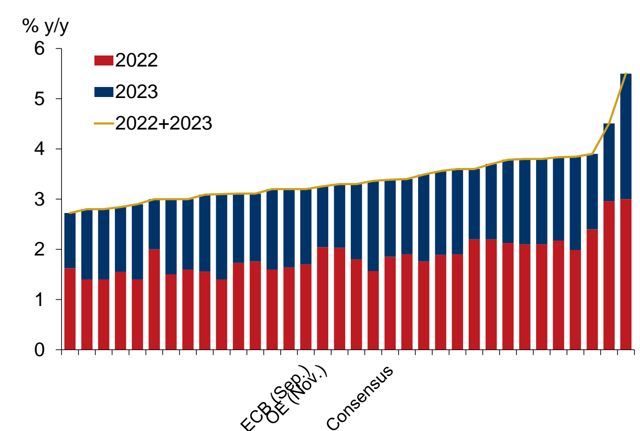
Source: Oxford Economics/Haver Analytics

Figure 15: A price-wage spiral looks unlikely as underlying wages have not yet begun to pick up



Source: Oxford Economics/Haver Analytics (*unweigthed avg. DE, FR, IT, ES, NL, AT, PT. Latest figures may incl. smaller subsample due to release dates)

Figure 16: Our 2022 inflation forecast is above consensus and ECB, but 2023 is well below



Source: Oxford Economics/Haver Analytics/Focus Economics (Nov. 2021)

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