Economic Insight

Inflation risks? Moderate, and more in the US than the Eurozone

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Executive Summary

- Despite the currently synchronous economic expansion in the US and in the euro area, the inflation risks are still different. In the US, in view of low unemployment and a strongly pro-cyclical fiscal policy, there are certainly risks of economic overheating and thus also inflation risks. In the euro area, the inflation target of just under 2% is coming closer, but has not yet been met.

- As the labor market in the euro area is improving, moderate acceleration in labor costs can be expected. As a result, the EMU core inflation could rise to approximately 1.5% in the next one to two years. Strong domestically driven inflation, however, seems quite unlikely.

- In the US, wage growth in the recent past has proved less responsive to labor market conditions than in former decades . Nevertheless, the inverse link between unemployment rate and wage growth is not out of force . Overall, the core CPI inflation rate is expected to move towards 2 ¼ -2 ½ % in 2019.

- A stronger acceleration of inflation on both sides of the Atlantic could be triggered by a surge in oil prices. We have calculated the effects of an increase in the oil price per barrel (Brent) from currently around USD 65 to around USD 90. In this case, we estimate that consumer prices will rise by 1.8% in the euro area in 2018 (instead of 1.5%) and by 2.5% in 2019 (instead of 1.7%). In the US, rising energy prices would increase annual average inflation by 0.4 percentage points in both the current and the coming year.

- Barring a sudden spike in oil prices, the inflation outlook suggests a moderate and gradual rise of long-term bond yields. 1.5% in Germany and 3.5% in the US seem plausible forecasts for 10-year government bond yields at the end of 2019. In the case of abruptly rising energy prices, the US Federal Reserve should raise the key interest rate next year by an additional 50-75 basis points. The effect of these additional key interest rate steps on long-term interest rates is somewhat less, so that the yield curve would flatten sharply. The ECB would likely respond prudently to an oil price-related price surge and weigh the risks of inflation-increasing second-round effects against the inflation dampening effects of lower aggregate demand.

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EULER HERMES

Inflation risks? Moderate, and more in the US than the Eurozone

The economic expansion in the USA and in the euro area has gained momentum in 2017 and continued unabated until recently. We expect economic growth in 2018 to be 2.9% in the US and 2.3% in the Eurozone.

Key economic indicators
- Percentage change over previous year -

	2017	2018f	2019f
EMU			
- Real GDP	2.5	2.3	2.0
- Consumer prices	1.5	1.5	1.7
US			
- Real GDP	2.3	2.9	2.4
- Consumer prices	2.1	2.3	2.4

f = forecast.

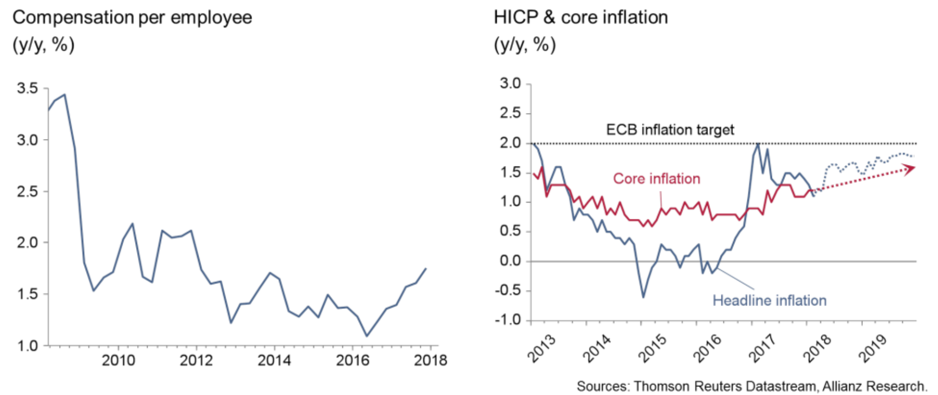
Sources: Thomson Reuters Datastream, Allianz Research.

Despite the synchronous economic development, the economic situation in the two regions is still quite different. In the US, the unemployment rate of 4.1% is below the level at which the Fed expects inflation to accelerate. In the euro area with an unemployment rate of 8.6%, the labor market does not pose major inflationary risks. From the ECB's point of view, a somewhat stronger rise in costs and prices would even be desirable to sustainably reach the inflation target of just under 2%. Correspondingly, monetary policy is different. While the ECB is maintaining unconventional measures and zero interest rates, the Fed has made good progress towards normalizing its policies. However, the situation is now becoming more complicated because US fiscal policy, with tangible tax cuts and additional spending plans, has moved on to a very expansionary course that clearly contradicts cyclically adequate policies. Is there an overheating, is inflation on the doorstep? The financial markets in particular have been asking this question and are reacting strongly to any sign of inflation .

In the following, we want to illustrate the expected development of inflation rates in our baseline scenario, but also the circumstances that could lead inflation to deviate markedly upwards .

INFLATION OUTLOOK EURO AREA

Consumer price inflation in the eurozone has been very subdued up to now. The core rate (excluding energy and unprocessed food) fluctuates around a good 1%. In our view, this is largely due to the still weak upward trend in labor costs. For example, compensation per employee in the fourth quarter of 2017 was only 1.8% higher than in the previous year. Given productivity growth of 0.5-1%, labor costs per unit of output in the euro area are currently rising by only about 1%. The current core rate of inflation is thus fully in line with the development of domestic costs.



With the improvement in the labor market, however, a certain acceleration in labor costs can be expected. According to our estimates[1], the so-called Phillips curve, the inverse relationship between unemployment and wage increases, still exists, but is not very pronounced. A decrease in the unemployment rate of 1 percentage point is estimated to result in a 0.3 percentage point higher wage increase. We assume that the unemployment rate in the euro area will continue to decline in 2018 and 2019. As a result, a slightly stronger rise in costs could increase the EMU core inflation rate to approximately 1.5% in the next one to two years. However, for domestic economic reasons, a truly inflationary trend in the euro area is currently quite unlikely, because the labor market is not yet tight in a euro-wide perspective and the improved economic outlook has triggered higher investment in productive capacity.

In this moderate inflationary environment, only a gradual rise in interest rates is to be expected. Nonetheless, with the presumed end of QE by the ECB, the dampening effect of yields on the bond market will be lower than at present. In addition, key interest rates are expected to rise slightly in 2019. The yield on ten-year German government bonds should therefore rise towards 1.5% in the course of 2019.

Effects of an oil price surge

A strong acceleration of price increases in the euro area could, however, be triggered by a surge in oil prices. In the following, we calculate the effects of an increase in oil prices per barrel (Brent) from the current level of around USD 65 to around USD 90, if it were to occur around the middle of this year and would last for the forecast horizon . Such a development is certainly possible, but in view of the high price elasticity of the oil supply, not very probable.

According to our model estimates, the consumer price level in the eurozone would then increase by 0.8 percent compared with our baseline scenario.. The annual average inflation rate would rise by 0.3 percentage points in 2018, and by 0.5 percentage points in 2019. In addition, higher inflation expectations would feed into the wage formation process and via second round effects reinforce price level increases – we calculate this at 0.3 percentage points in 2019. Consumer prices would then be likely to rise by 1.8% in the euro area in 2018 (instead of 1.5%) and by 2.5% in 2019 (instead of 1.7%). The purchasing power of incomes would be significantly reduced, and therefore, over time, the economic

[1] Economic Insight, „Euro area: Inflation target will be achieved if unemployment continues to fall“, 21. November 2017.

expansion in the eurozone would be dampened. GDP growth rates would likely fall below 2%. Looking ahead to the year 2020, this would again curb the higher inflation rates.

The ECB's monetary policy would probably react with prudence to an oil price-related price surge. It is likely to weigh the risks of inflation-increasing second-round effects against the prospective inflation-lowering effects of lower aggregate demand. The timetable for the exit from unconventional monetary policy would probably not change much, but the question of what consequences it would have for interest rate policies and interest rate expectations is more difficult. It is quite conceivable that the ECB would not put an end to the zero-interest rate policy at a significantly earlier date compared to the baseline scenario.

The impact of the assumed oil price increase on long-term interest rates in the euro area therefore might be quite pronounced due to inflation expectations. This would be reinforced, if US long-term interest rates were to rise appreciably. The yield curve in the eurozone could become steeper.

INFLATION OUTLOOK US

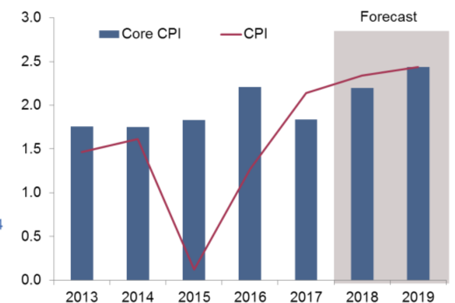
Despite continued economic expansion and a steady improvement in labor market conditions, labor cost pressure and US inflation have remained quite limited over the past five years. The average annual increase in the overall consumer price index amounted to only 1.3%. The 2% mark was reached only for a short period of time. On the whole, the strong fluctuations in energy prices shaped the inflation picture.

Core inflation was far more stable. The consumer price index excluding food and energy has risen by an average of just under 1.9% p. a. over the past five years. Different trends in the inflation of goods and of services were observed until 2016. Consistently declining (core) goods prices were offset by a steady increase in the price of services (excl. energy services). However, there was a setback last year. As a result of sector-specific developments, such as significant discounts on mobile phone charges in the spring, services price inflation was 0.5 percentage points lower than in 2016 at 2.7%. , The service component is of great importance, as it is causes about ¾ of the changes in the core consumer price index and is clearly subject to the influence of wage growth.

Core CPI inflation rate to pick up again

Wage Phillips Curve (2009 Q4 – 2017 Q4)

US consumer prices
Percentage change over previous year



Sources: Thomson Reuters Datastream, Allianz Research.

Wage growth[2] in the recent past has proved less responsive to labor market conditions than in past decades. Nevertheless, the inverse link between the unemployment rate and wage growth is not out of force. This is particularly evident when the short-term unemployment rate, i. e. the share of the labor force with an unemployment period of no more than 26 weeks, is used as a measure of labor market slack.

We expect the wage growth measured by the Employment Cost Index (ECI) in the private sector (wages and salaries) to increase in the current year within the range of 3%-3 ½ % in light of the likely further tightening of the labor market, where the short-term unemployment rate could fall below 3% and the overall unemployment rate is expected to fall below 4%. Last year, growth in the ECI had averaged 2.5% and reached 2.75% in the course of 2017. This means that the inflation rate for services could again reach values around 3%. In addition, the year-long decline in core goods prices could gradually come to an end. Overall, core CPI inflation could move towards 2 ¼ - 2 ½ % over the forecast horizon.

The forecasting uncertainty is considerable. On the one hand, price increases could be lower due to technological changes. For example, rising purchases via the Internet and easier price comparisons have a dampening effect on companies' scope for setting prices.

On the other hand, despite the apparent flatness of the Phillips curve, one should be aware that the possibility of nonlinearities at very low unemployment rates constitutes an upside risk to future wage/price inflation.

Base Scenario US yields

Yields on ten-year US government bonds have risen by around 50 basis points since the end of 2017. Higher inflation expectations, the Fed's likely interest rate hikes and the expected increase in government borrowing contributed to this. However, long-term interest rates are still slightly below the 3% mark. Should consumer price inflation in the US accelerate towards 2.5% from the current 2% in the course of 2018 and 2019, as we expect, market-based inflation expectations of currently 2.1% (10-Year Breakeven Inflation Rate) should also move up to this level. In addition, the Fed's tightening of interest rates (three interest-rate hikes by the Fed this year and two steps next year) should lead to upward pressure on long-term interest rates. All in all, we therefore believe it is probable that the moderate rise in yields (under fluctuations) will continue in the USA and that the yield on ten-year US government bonds in 2019 will be around 3.5% rather than the current level of just under 3%.

Effects of an oil price surge

The momentum of price increase would be heightened in the event of significantly rising oil prices. While in our baseline scenario we assumed an oil price level in the range of USD 60-65/barrel for the coming quarters, we consider the alternative scenario for the oil price (90 USD/barrel) also for the US. Rising energy prices would increase annual average inflation by 0.4 percentage points in both the current and the coming year.

[2] As a measure of hourly wage development, we use the Employment Cost Index (ECI) designed by the Bureau of Labor Statistics. The ECI eliminates the influence of shifts in employment between occupations and economic activities on the observed labor costs.

Although this would dampen US economic growth, it should remain robust in view of the strong fiscal stimulus. In this situation, the Fed is likely to be cautious and to tighten monetary policy more than in the baseline scenario as the risk increases that inflation expectations will no longer remain anchored at around 2%. Empirical studies suggest that longer-term inflationary expectations play a significant role in wage/price determination in the US and have gained importance[3]. In view of the stability-oriented monetary policy of the Fed, the risk of second round effects presently appears low. Nevertheless, against the background of the historically low unemployment rate[4] – which is expected to decline this year to its lowest level since the end of the 1960s – it is conceivable that employees will be able to extract wage concessions that compensate for the loss of purchasing power. It should also be borne in mind that the US administration, with its misguided trade policy approach, is promoting the return of an inflationary mentality.

Assuming moderate second-round effects, the US Federal Reserve would probably raise the key interest rate by an additional 50-75 basis points next year. In accordance with the Taylor rule, a reaction coefficient of 1.5 is assumed for deviations of inflation from the target inflation rate. With key interest rates of more than 3%, monetary policy would move into a more restrictive direction. The effect of these additional key interest rate increases on long-term interest rates is likely to be subdued , so that the yield curve flattens out. According to numerous econometric studies, the slope of the yield curve can be regarded as a leading indicator of future economic activity. For example, the Federal Reserve Bank of New York[5] regularly publishes the probability of a recession based on the yield differential between ten-year government bonds and three-month treasury bills. In this model, if the yield differential were narrowed to 50 basis points, the probability of a recession over a twelve-month horizon would be estimated at 20%. And a probability of 30% would not be exceeded unless the yield curve is inverted. (For comparison figures for February 2018 – yield differential: + 1.26 percentage points, estimated recession probability Feb. 2019: 9.14%). These results are compatible with historical experience that sudden oil price hikes dampen growth with a time lag.

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[3] See e.g. Ball L. and S. Mazumder, „Understanding recent US inflation“. https://voxeu.org/article/understanding-recent-us-inflation

[4] In a recent speech, central bank governor Brainard highlighted the challenges for US monetary policy resulting from the current labor market situation: „We also seek to sustain full employment, and we will want to be attentive to imbalances that could jeopardize this goal. If the unemployment rate continues to decline on the current trajectory, it could fall to levels that have been rarely seen over the past five decades. Historically, such episodes have tended to see elevated risks of imbalances, whether in the form of high inflation in earlier decades or of financial imbalances in recent decades. – L. Brainard, “Navigating Monetary Policy as Headwinds Shift to Tailwinds”, Remarks at the Money Marketeers of New York University, March 6, 2018.

[5] See Federal Reserve Bank of New York under: https://www.newyorkfed.org/research/capital_markets/ycfaq.html

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