

The NewsLine

April 4, 2018

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EMU

Stable price development

Despite the continuing improvement on the labor market and increased wage dynamics, we do not see any inflation risks arising in the eurozone from the domestic side. The ECB should be satisfied with "normalized" inflation rates and not be too hesitant in steering its monetary policy towards "normal". Otherwise, the good economic phase could prove to be too short to get away from the low interest rates.

According to today's flash estimate for March, eurozone inflation has risen to 1.4%. At the same time, core inflation (excluding energy and unprocessed food) increased slightly to 1.3% year-on-year. For the second quarter we forecast a base-effect-driven rise in the overall inflation rate to 1.5% (Q1: 1.3%). For this year we expect an average inflation of 1.5% – unchanged from 2017. In our opinion, core inflation will remain slightly below overall inflation.

So far, neither the prices of industrial goods (excluding energy) nor those for services have shown a significant upward trend. This means that there are currently no price-driving effects from either the world economy or the domestic economy. The labor market in the eurozone is not yet tight enough to exert significant homemade upward pressure on prices. According to data also released today, the EMU unemployment rate fell further to 8.5% in February. This is now a good percentage point above the low reached at the end of 2007/ beginning of 2008. In the course of the steady improvement on the labor market, wage growth has already picked up. Compensation per employee in the fourth quarter of 2017 was 1.8% higher year-on-year, compared with an average increase of only 1.2% in 2016. But even if wage growth accelerates towards 2.5% by the end of 2019, we believe this is compatible with core inflation of around 1.5%. Domestic inflation risks are therefore not in sight. We consider the topic of "reflation risks" to be more relevant on the other side of the Atlantic than on this side.

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In our view, price developments in the eurozone have normalized sufficiently after the crisis. Although the ECB inflation target of "below but close to 2%" has not yet been fully met, it will come within reach in the foreseeable future. Hence, the normalization of monetary policy should not be approached too hesitantly. After the end of QE, the gradual process of key interest rate hikes will take time anyway (not to mention an ECB's balance sheet reduction). We see the danger that the good phase of the EMU economic cycle could not last long enough to bring monetary policy back to more normal territory. In other words, either tightening steps by the ECB would come at the same time as a weakening of the economy or the low-interest rate environment would persist.

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