Economics

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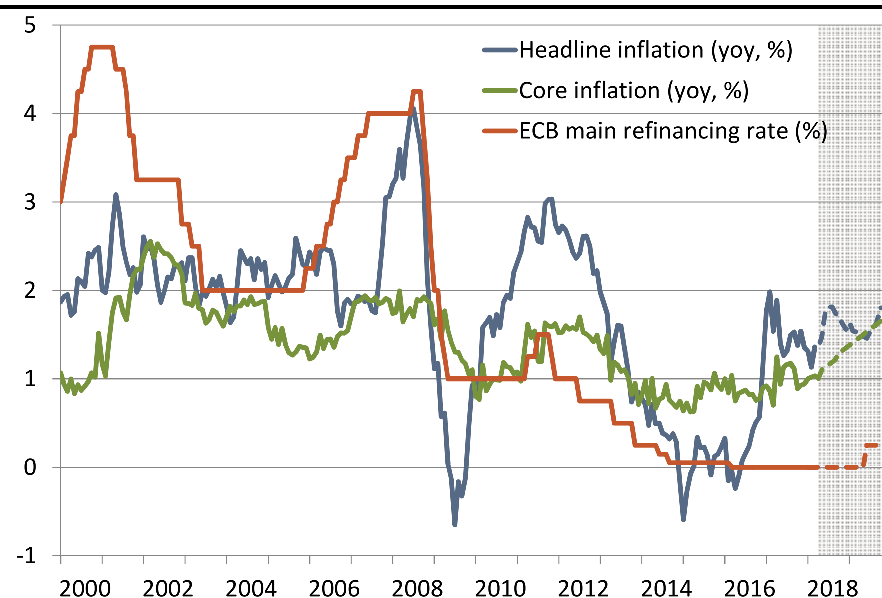
Inflation spike ahead: no need to worry

- When will inflation rear its ugly head again? Apart from the current trade tensions, a potential surge in inflation that could force central banks to tighten policies faster than we project poses the biggest risk to our positive outlook for economic growth and financial markets on both sides of the Atlantic.
- In the Eurozone, an oil-driven spike in headline inflation from 1.3% yoy in Q1 to 1.8% in Q3 2018 could possibly scare some observers. But beyond a temporary oil effect, the medium-term outlook remains benign. Underlying inflation looks set to firm only gradually, allowing the ECB to stick to its schedule of reducing its monetary stimulus cautiously, probably by ending asset purchases in December 2018 and hiking the refinancing rate for the fist time again in June 2019 by 25bp.
- On both sides of the Atlantic, market concerns that rising rates and bond yields could materially restrain economic growth seem overdone. In the absence of a major inflation problem, central banks can continue to act as a buffer. In the unlikely case that demand growth weakens significantly in response to higher yields, central banks could adjust their guidance, allowing yields to fall back.
- Despite significant gains in employment, Eurozone wage inflation is edging up only very slowly. The ability of companies to shift production abroad more easily than before and the rise of robots constrain wage gains even in labour markets with full employment.
- Recent reforms in France, Italy, Spain, Portugal and Greece have made the Eurozone labour market more flexible. In addition, Germany is attracting qualified immigrants mostly from other European countries that help to ease the labour shortages.
- We do not expect the rise in Eurozone unit labour costs to accelerate by more than 0.3ppt per year in 2018 and 2019. Core inflation could increase to 1.4% in late 2018 and 1.7% in late 2019 (see Chart 1 below). The risks to this call are tilted to the downside.

Chart 1: Eurozone inflation outlook



Yoy rates of headline and core inflation in the Eurozone versus ECB refi rate, Berenberg forecasts from April 2018 onwards. Source: Eurostat, ECB, Berenberg projections

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The oil factor

A temporary spike in headline inflation will not spook central banks

Consider the near-term inflation risk first. Measured in euros, the spot price for Brent crude has risen from a recent trough of €42 per barrel in mid-2017 to €60 now. As a rule of thumb, a €10 increase in the oil price tends to raise the price level in the Eurozone directly via higher energy costs by 0.33% within two months (see Chart 2 on page 3). After adding 0.1ppt to the headline inflation rate in March, energy prices may – at unchanged oil prices from now on – contribute 0.6ppt to headline inflation in July and August this year as Brent crude prices would then be up €18 yoy. This could take Eurozone inflation from 1.3% in March to a peak of up to 1.8% this summer. Thereafter, the rebound in oil prices that started last summer will drop out of the yoy comparison. Headline inflation can then fall back gradually again towards the core rate until the temporary oil effect vanishes completely from the yoy comparison by May 2019. As long as inflation expectations are well anchored, central banks tend to look through such temporary distortions, especially as oil price increases – like a tax on consumers – would also restrain real demand growth for a while.

Arguments for less subdued inflation

Underlying inflation remains well behaved

Although economic growth in the Eurozone has surpassed its trend rate of 1.5% since the start of 2015, underlying inflation remains well behaved. At 1.0% yoy in Q1 2018, the core rate (ex energy, food, alcohol and tobacco), is still the same as in 2017, up only slightly on the annual averages of 0.9% in 2016 and 0.8% in 2015. Four arguments back the widespread assumption, shared by us and the ECB, that underlying inflation will edge up slightly faster in the next few years.

- First, some **pass-through from higher oil-prices** into prices for industrial goods will likely raise the price level in the Eurozone by 0.2-0.3ppt within the next 12 to 18 months.
- Second, the restraining impact on inflation from the rise of the **exchange rate** will gradually fade over the next 12 to 18 months unless the euro was to get much stronger in the future. Measured versus a group of 38 countries, the nominal effective exchange rate of the euro surpassed its 2017 average by 4.5% and its 2016 average by 6.7% in Q1 2018. At the moment, the exchange rate impact subtracts about 0.2ppt from Eurozone inflation.

Exchange rate impact will fade

- Third, a further **tightening of the labour market** will raise wage inflation by more than can be offset by concurrent gains in productivity growth, putting unit labour costs on an upwards trajectory. As we discuss below, this will likely remain a very gradual process in the Eurozone, though.
- Fourth, continuing **demand growth above trend** will boost the pricing power of companies. However, as we do not project a significant further acceleration of gains in real private consumption beyond the average increase of 1.8% in the last two years, this factor should not become much more pronounced than it is at the moment.

The wage puzzle

Tighter labour market is lifting wage inflation only very modestly

Taken at face value, the Eurozone labour market has tightened significantly in the last few years. While unemployment has fallen from a peak of 12.1% in mid-2013 to 8.5% in February 2018, employment growth has accelerated from 0.6% in 2014 to 1.6% last year. Nonetheless, wage inflation has advanced only modestly to 1.6% yoy gain in compensation per employee in 2017 after an average of 1.35% for the three years before.

The **German labour market** in particular, which accounts for 28% of total Eurozone employment, looks stretched. Amid widespread anecdotal evidence of labour shortages, officially registered job vacancies soared to a record 783k in Q1 2018. With a 2.6% rise in labour costs per employee in 2017, German wage inflation duly exceeds the 1.6% average for the Eurozone.

Near term, the German data may change noticeably. The major wage deals concluded so far this year in Germany (annualised gain of 3.3% for the highly cyclical metal-engineering sector and 3.1% for major parts of the public sector) point to an acceleration of overall German wages to around 3.1% in 2018. As the metal engineering deal is frontloaded with a

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4.3% increase in April 2018, quarterly statistics will probably indicate a sudden and potentially scary spike in Q2 2018. However, this acceleration will overstate the underlying trend. The key German deals concluded so far this year are for 27 months (metal engineering) or even 30 months (public sector). These deals will result in lower wage increases in 2019 and early 2020 than now. Put differently, after a near-term spike, German wage inflation may well ease again over the course of next year.

Why is German wage inflation not accelerating faster? In our notes on the inflation puzzle, we discussed the key long-term factors. The ability of companies to shift production abroad more easily than before and the rise of robots constrain wage gains even in labour markets with full employment. In addition, Germany is attracting qualified immigrants mostly from other European countries such as Poland, Romania and Bulgaria that help to ease the labour shortages. Over the last ten years, the number of citizens from the 13 recent EU accession countries living in Germany has risen by 1.7 million to 2.6 million with an increase of 0.3 million in 2017 alone, according to Destatis.

With a little help from productivity

Productivity can partly offset faster wage gains

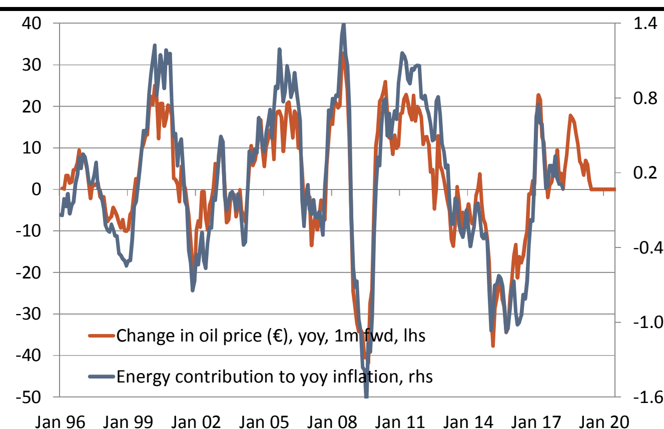
In the Eurozone, the faster rise in the compensation per employee (+1.6% yoy in 2017 after a 1.35% average in the three years before) has not yet translated into significant inflation pressure. Because productivity growth picked up to 0.85% in 2017 from 0.7% for the 2014-2016 average, unit labour costs growth rose from 0.6% to 0.7% over this period (see Chart 3). To the extent that resources become more strained in the coming years, firms will likely try to raise productivity gains even faster. Separately, recent reforms in France, Italy, Spain, Portugal and Greece have made the Eurozone labour market more flexible. As a result, rising demand for labour will likely show up more in employment gains and less in higher wages than usual. This also mitigates inflation risks.

A little Italian base effect will raise the core rate slightly in October

We do not expect the rise in Eurozone unit labour costs to accelerate by more than 0.3ppt per year in 2018 and 2019. With the help of a little base effect worth 0.05ppt this October (as the abolition of university tuition fees for poorer students in Italy last autumn drops out of the yoy comparison), core inflation could increase to 1.4% in late 2018 and 1.7% in late 2019 (see Chart 1 on page 1. The risks to this call are tilted to the downside.

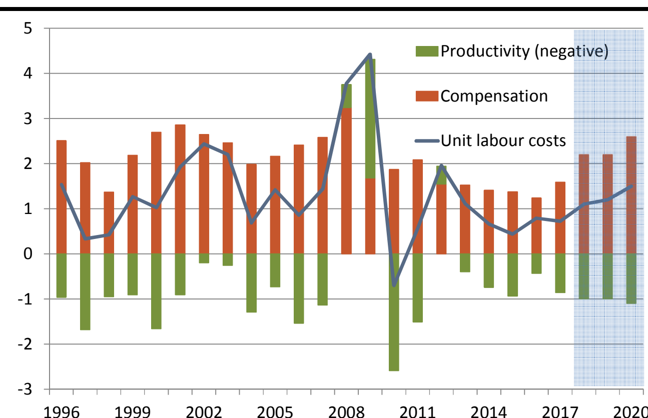
Whether or not headline inflation surpasses the core rate significantly will depend largely on oil prices. If rising US supply of oil and gas pushes the oil price back towards $60 per barrel later this year, headline inflation would temporarily undershoot the core rate in the spring and summer of 2019 before rising back to the core rate later that year.

Chart 2: The oil impact on Eurozone headline inflation



Spot price for one barrel of Brent crude, yoy change in euros, adjusted for overall change in HICP (base year 2015), left-hand scale; contribution of energy inflation to yoy rate of Eurozone headline inflation in ppt, right-hand scale; projection for 2018 and 2019 assume unchanged oil prices. Source: Eurostat, Haver, Berenberg projections.

Chart 3: Wage inflation, productivityy and unit labour cost growth



Compensation per employee, labour productivity and unit labour costs in the Eurozone, yoy changes in %; productivity gains dampen the impact of wage rises on unit labour costs. Sources: Eurostat, ECB, Berenberg projections

ECB or Fed: who will be the villain?

No need to be afraid of the ECB

Against this backdrop, we see no need at all to be afraid of the ECB. For the next two or three years, the European Central Bank will not face an inflation problem that could force it to tighten policy to such an extent that growth falls back to or even below the 1.5% trend. If a central bank eventually kills the Eurozone upswing, it will most likely be the US Fed rather than the ECB. Because the Eurozone's post-Lehman recovery had been interrupted for almost two years by the euro crisis, the cyclical recovery is less mature in the Eurozone than in the US. In addition, the US is granting itself an ill-timed fiscal stimulus while the Eurozone (fiscal deficit of just 0.9% of GDP in 2017) remains a paragon of prudence.

US inflation risks are more pronounced – but not virulent yet

In the US, inflation risks are thus more pronounced than in the Eurozone. Even in the US, these risks are not very virulent yet. Helped by a likely surge in business investment on the back of some deregulation and the corporate tax reform, faster productivity gains will offset some of the increase in wage inflation. We expect US CPI inflation to hover around 2.6% in the next two years as wage gains firm while economic growth moderates slightly in 2019 after the 2018 fiscal stimulus has run its course.

We look for the Fed to lean against the fiscal stimulus with three further rate hikes this year and three more such moves in 2019. At some point in the future, the US Fed may have to engineer a significant slowdown or even a recession to combat inflation risks. But that the Fed would have to - and want to - do so before the November 2020 US election seems unlikely. For the time being, the risk that inflation would force the Fed or ECB to end the upswing prematurely looks well contained.

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