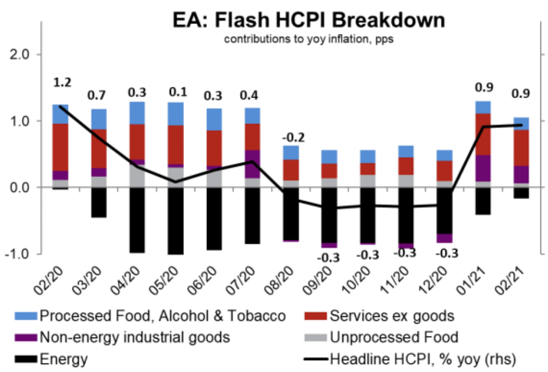
GIAM Macro & Market Research - Market Commentary

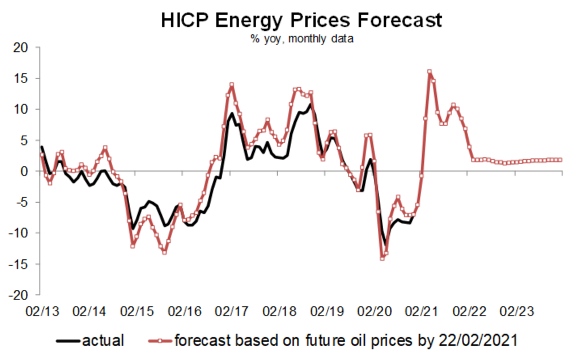
March 2, 2021

Euro area February inflation unchanged ahead of the April/May peak

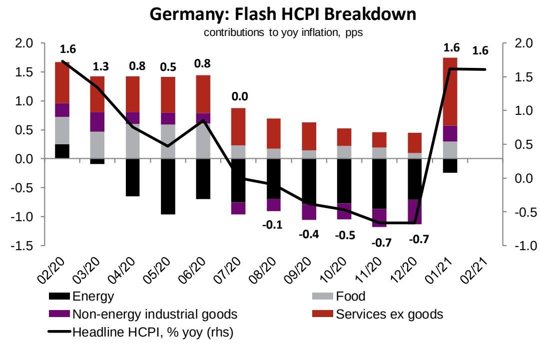
- **The flash estimate for February euro area inflation of 0.9% yoy is unchanged with respect to January. We see headline inflation trending up further even exceeding the 2% threshold in April/May before abating again, mostly due to temporary higher energy price inflation.**
- **Among EMU economies German inflation (February: 1.6% yoy) will stay above average. Special factors like the end of the temporary VAT cut, the introduction of a carbon tax and changes in the HICP basket weights could temporarily lift it above 3% yoy, leading to bouts of volatility.**
- **That said, underlying inflation will stay muted in the presence of a still sizeable negative output gap. We expect annual inflation to average 1.5% in 2021 but to moderate to 1.2% in 2022.**
- **At its forthcoming meeting on March 11 the Governing Council will make clear that it looks through the short-term spike and keeps its focus on still far too low underlying inflation implying that the current highly accommodative policy stance will be maintained.**

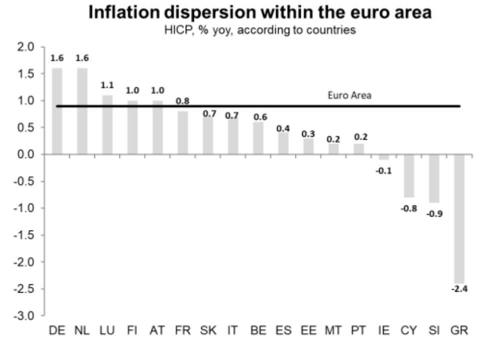
February inflation unchanged but energy prices to become again inflationary in March: Today's euro area flash inflation estimate for February of 0.9% yoy was unchanged from January and slightly below expectations. Lower inflation in services and non-energy industry goods was broadly offset by a less disinflationary energy price component (to -1.7% yoy, from -4,2% yoy before). But because of base effects and the latest increase in oil prices, energy price inflation will become positive again from March onwards. As we have explained in greater detail in a recent Focal Point, we expect it to peak in April/ May with readings of around 15% thereby contributing about 1 ½ pp to year-on-year inflation in that period. Euro area headline inflation will advance above the 2% threshold before abating again later in 2021.



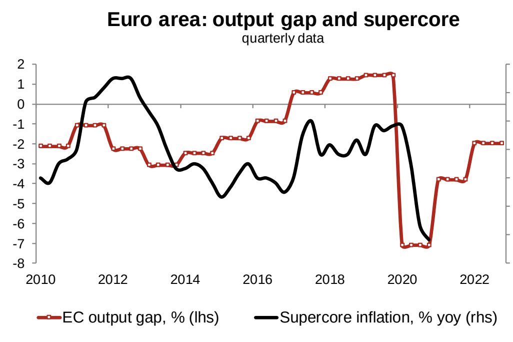


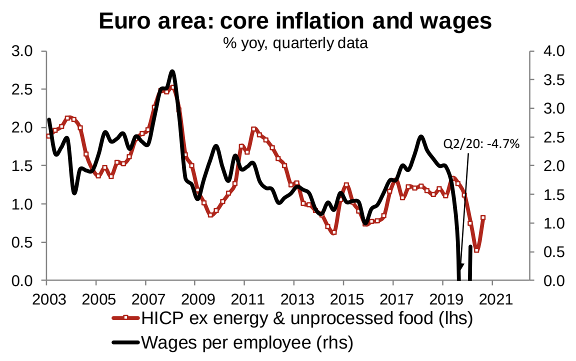
German inflation roller-coaster no reason to worry: Inflation in the euro area's largest economy will be particularly volatile and likely temporarily soar to levels not seen over the last decade. Apart from the expected positive contribution from energy prices, there are some effects specific to Germany at work. First, the temporary German VAT cut (from July to December 2020) adds to monthly inflation and will exert a strong upside effect on year-on-year inflation in the second half of the year. Second, the introduction of a carbon tax from Jan 21 onwards. Third, the share of energy prices in the HICP is higher in Germany (10.8%) than for the euro area average (9.5%). Fourth, the composition of the consumer basket has changed significantly. The 2021 weights take into account for pandemic-driven changes in consumption patterns. Package holidays, whose weight was reduced, play an important role and will contribute to significant inflation volatility over the course of the year as the Bundesbank explains in greater detail in its February monthly report. Moreover, it is also worth noting that in the CPI weights will be adjusted only every five years leading to huge deviations between the CPI and HCPI. We deem it likely that headline inflation surpasses the threshold of 3% temporarily, a territory last reached before the GFC in 2008. But we expect annual German inflation to average 1.7% in 2021, which is above the current consensus expectation of 1.5%. It is worth noting that inflation is quite heterogenous among the euro area economies. As of January there was a 3 pp difference between inflation in Germany (as well as the Netherlands) and in Greece.





Underlying inflation to stay low: That said, underlying inflation (of 1.2% yoy in February) is expected to stay muted, once volatility and special effects are stripped out. The key reason is that there is a lot of slack in the euro area economy that will be reduced but not fully eliminated over the course of this and also next year. A broad-based and lasting reflation trend needs to be backed by a strengthening labour market and rising wages. But the euro area labour market remains in a dismal situation. Unemployment is artificially held down by government support measures (e.g. furlough and short-time work schemes) without which it would be as high as 20% by some gauges. Wage growth even contracted in Q2/20 and its latest reading of 0.6% yoy is way below normal. Generally speaking, the output gap is unlikely to be closed soon. In our growth scenario we only expect a return to the pre-crisis activity level by the end of 2021. The IMF and the EC forecast the output gap to stay negative at -1.6% or even -2.0% respectively by 2022. This implies that a 'true', namely demand driven, reflation is still distant.





Annual inflation to moderate again in 2022: Energy prices and the special factors listed above will push annual inflation strongly up in 2021. We look for a reading of 1.5% yoy in 2021, above the current consensus expectation of 1.2%. However, in 2022 we forecast a moderation to 1.2%, in line with the consensus. In contrast to headline inflation, we foresee underlying inflation to average only 1.0% this year and to only slowly trend higher thereafter.

ECB to look through the temporary inflation spike: We see no outright policy implication from the forthcoming inflation spike for the ECB. At the next meeting on March 11, the staff macro projections will for sure show higher headline inflation rates for 2021 (December projection: 1.0%) and 2022 (December projection: 1.1%). A more hawkish stance is nevertheless unlikely. First, the projected inflation path will still be below the pre-pandemic one on which the ECB wants to re-embark. Second, the Governing Council will be very aware of the special factors driving this year's inflation increase and look through them as it looked through the deflationary period in the second half of 2020. Today's comments by ECB Vice-President de Guindos that the ECB was not very concerned about rising prices in the short term clearly support this view. We continue to see the ECB policy risks tilted to the dovish side and mainly related to an adverse evolution of the pandemic. In any case the ECB is set to maintain a highly accommodative policy stance.

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