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Are inflationary risks gaining ground? Monetary and economic policymakers should be prepared

Berlin, 12th April 2018

Developments in the markets are giving the chief economists of the Savings Banks Finance Group no respite. In their analysis of price developments, they warn against underestimating the accelerating forces of price increases with a view to the many sub-markets, such as employment and housing. For this reason, they suggest the following two lines of action:

→ Monetary policymakers should decide to exit the QE measures before the end of the first half of 2018 and to prepare the markets for key interest-rate increases in 2019.

→ Economic policymakers must act prudently to promote public demand and its stimulation, always in line with available production capacity.

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Are inflationary risks gaining ground? Monetary and economic policymakers should be prepared

In view of the anticipated economic growth rate of slightly over 2 percent this year, the economic outlook for the euro area is once again favourable, in line with the expectations of most of the chief economists of the Savings Banks Finance Group. Inflation rates are expected to gradually approach the ECB's target. Hence, the central bank should envisage exiting its ultra-loose monetary policy.

In the past few years, the ECB has pursued an ultra-expansionary monetary policy to support both the economy and the stability of the financial system. The favourable economic data in all the Member States of the European Monetary Union suggest that this policy has been successful. This does not yet apply to the central bank's inflation target of "below, but close to, 2 percent". In February 2018, consumer prices in the euro area increased by only 1.1 percent. In 2017, the average year-on-year rise in consumer prices amounted to 1.5 percent. The last time the 2 percent mark was reached or even surpassed on a sustained basis was six years ago. At any rate, the risks of deflation – often debated in 2014/15 – have definitively been overcome.

While the 2 percent inflation target is important, a close eye should be kept on the risk of rising prices

The objective of price level stability must be quantified if the central bank wishes to gear its monetary policy towards price stability. Inflation rates – whether too high or too low – are associated with economic costs. The ECB's target of "below, but close to, 2 percent" is aimed at minimising these costs. However, this target cannot be based on stringent criteria. Digitalisation and globalisation may suggest lower targets, for instance. In addition, cases of "good" deflation have been more frequent in the past than cases of "bad" deflation.

On the other hand, it must be borne in mind that a lower inflation target would restrict the central bank's economic policy opportunities during periods of economic weakness. The lower the inflation rate, the less it can help to reduce real key interest rates when rates approach or reach zero.

Moreover, the central bank should respond by pursuing an unconventional monetary policy. Lower inflation rates therefore increase the likelihood of such a policy. Since the 2 percent target is an important indicator that provides guidance, monetary policy decisions should be taken at an early stage, instead of waiting until the target inflation has actually been reached. In the current high-growth environment, in which risks of deflation can virtually be ruled out, it would seem reasonable to phase out the bond purchase programme in September 2018.

Above-average increases have recently been observed in energy and food prices. The core rate, which excludes these components, has already been hovering around the 1 percent mark since mid-2013. An upward change in the trend has not yet been observed. The core rate is being slowed down

by industrial goods, excluding energy, where prices increased by only 0.6 percent in February, while prices of services increased more than twice as fast. Industrial goods are mainly traded internationally and, therefore, the price-lowering effects of globalisation play a major role in this segment. Industrial goods include clothing, footwear and household products, as well as cars and electronic appliances. Hedonic methods are used to measure the quality of the latter. Since electronic goods are characterised by considerable improvements in performance, prices adjusted for quality change have fallen significantly for some time. On the other hand, services – on average – are less exposed to globalisation, which tends to reduce competitive pressure. In addition, services include products of non-private providers, such as health services, and local public passenger transport, which is highly dependent on oil prices. For this reason, prices of such services can increase more rapidly, even in Member States where unemployment is still running high. Cost increases are therefore frequently passed on to consumers, also to relieve pressure on public budgets.

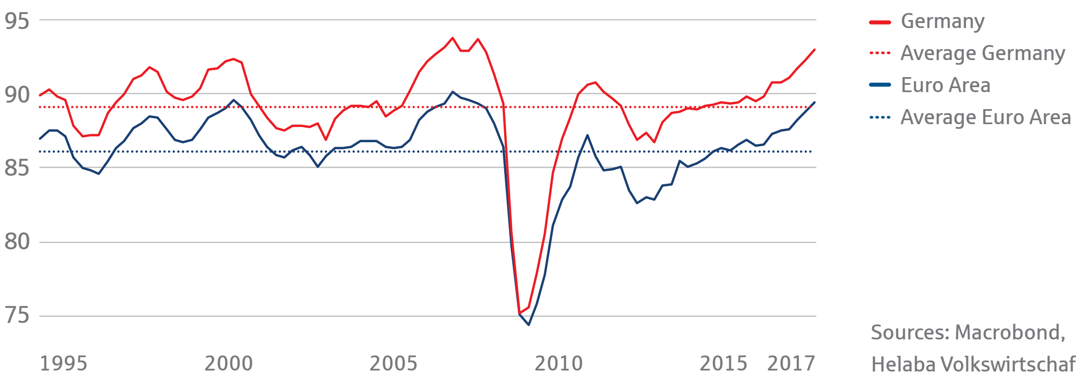
Regional inhomogeneity and financial markets pose challenge to ECB

The ECB's monetary policy is facing the challenge that there are significant inflation differentials across euro area countries. In 2017, as many as seven members of the Monetary Union reached a level of 2 percent or more. The peak inflation rate of 3.7 percent was registered in Estonia and Lithuania. However, in major economies like France and Italy, inflation was below the average rate of 1.5 percent, while inflation in Germany was above this level. In 2017, Spain achieved very high economic growth of over 3 percent for the third year in a row, which contributed to an increase in the inflation rate to 2 percent.

The monetary policy which seems appropriate for the average member of the currency area is probably already too expansionary for some Member States. Sustained price increases in a country above the average in the euro area will lead to a loss of competitiveness, at least in the medium term. In small economies like the Baltic countries, such increases could also be explained by growing demand for domestic products, while productivity remained constant. Attention should also be paid to differences in price increases, the risks that they may be passed on and, where appropriate, self-amplifying accelerating effects. Conflicting monetary policy objectives are all the more serious when considering not only traditional consumer prices, but also the valuation of assets, which the ECB has so far perceived as more of a macro-prudential issue than a monetary policy issue. The valuation of real properties, for instance, has increased significantly in recent years. Average prices of residential properties in the euro area are back above pre-crisis levels. If this development continues, it cannot be ruled out that a bubble may develop, at least in some countries. This applies in particular to Germany, for which the central bank's monetary policy is too expansionary.

Capacity utilisation: pre-crisis level has nearly been reached

Capacity utilisation in manufacturing sector, %



Sources: Macrobond,
Helaba Volkswirtschaft/Research

While consumer price indexes are representative despite digitalisation, they are still under scrutiny

Limited importance of digital products in the consumer price index

Capacity utilisation of German businesses has already been above average since 2017.[1] The output gap has probably also been closed in the entire euro area since autumn 2017 and is likely to grow to approx. 1 percent relative to the production potential.[2] This raises the question of why inflation has been somewhat slow in responding to this development. Is the "true" scale of inflation no longer captured by official statistics due to digitalisation or the fact that rental increases are underestimated? Does the relationship between inflation and the utilisation of production capacity (Phillips curve) no longer apply? Or can inflation simply be expected to increase with a certain time lag?

1 see ifo economic forecast 2017-2019: Deutsche Wirtschaft auf dem Weg in die Hochkonjunktur, in: ifo-Schnelldienst, 24/2017, p. 28-81, here: p. 39ff. and pp. 67ff.

2 see ifo economic forecast, loc. sit. p. 37

It is often argued that increasing digitalisation reduces the significance of statistics so that the true scale of inflation is considerably underestimated. This is unlikely, simply because digitalised products have so far played a rather limited role in the basket of goods. Even in a broad definition, such goods only amount to approx. 10 percent of the current basket in German consumer price statistics.[3] In the harmonised price index for the entire euro area, this is not likely to be any different. Nevertheless, additional conceptual tests of the system boundary of digitalisation remain on the agenda. It is true that changes in trading and business structures such as the emergence of online trading are already covered in statistics today. Prices of online platform services are also taken into consideration. This also applies to new digital goods such as e-books and music streaming, which have been included in the basket of goods. Nevertheless, the collection of statistical data such as the frequent price fluctuations of digital products and services still poses a challenge.[4] Nevertheless, the collection of statistical data such as the frequent price fluctuations of digital products and services still poses a challenge.

Rents increase more rapidly

Consumer price statistics might also be distorted by under-coverage of the increase in rents. Rentals net of utilities have a weighting of as much as 21 percent in the current German price index. In the harmonised price index, however, net rentals account for less than half as much (10.4 percent) because, unlike the consumer price index, the harmonised price index does not include owner-occupied residential property. Hence, the harmonised price index for specific countries or for the euro area as a whole is much less susceptible to potential distortion caused by rents. In 2017, rents increased by 1.6 percent in Germany, following 1.2 percent in the previous year. In February 2018, a level of 1.6 percent was reached, including not only urban but also rural regions, where adjustments are slower and more moderate. The key factor is that new homes, for which rental increases are presumably significant, only account for a very minor share of the total housing stock. On the other hand, there is often very little movement in rents for existing properties.

Germany's Federal Statistical Office has introduced a new sample rental survey to collect more representative data on the actual development. The survey involved is a stratified sample survey in which specific housing segments, which have so far been underrepresented (e.g. rental offers by small private landlords in rural areas), are more adequately taken into account. At the same time, the survey improves the comparability and quality of the data collected. Uniform criteria are now applied, for instance, to quality adjustments in case of modernisations. Newly built homes are systematically included. While the updated rental survey has already been introduced, it will not be fully implemented before the readjustment in 2019 to 2015 as the base year. Even so, significant changes in rental adjustments should not be expected.

3 see Dieter Schäfer, Matthias Bieg: Methodeninformation – Auswirkungen der Digitalisierung auf die Preisstatistik, Statistisches Bundesamt Wiesbaden 2016, p. 1-18, here p. 11

4 see Dieter Schäfer…, loc. cit., pp. 2ff.

5 see Bernhard Goldhammer: Die neue Mietpreisstichprobe in der Verbraucherpreisstatistik, Statistisches Bundesamt, Wirtschaft und Statistik 5/2016, pp. 86-101

Unit labour costs have only increased moderately

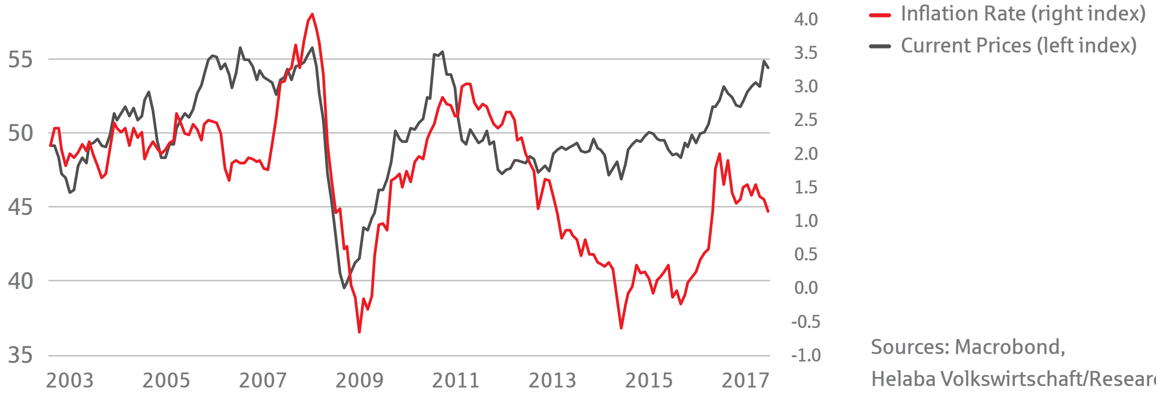
If one assumes that official statistics continue to be robust, the question arises as to why consumer prices have so far been so slow to respond. One of the likely reasons is that, since 2014, i.e. after overcoming the European sovereign debt crisis, unit labour costs have increased by only 0.7 percent on an annual average. Between 2000 and 2007, before the big economic and financial crisis, unit labour costs had increased by 1.6 percent annually, i.e. more than twice as fast. A key factor in recent years has been high unemployment in many Member States, in particular in southern Europe, where this has led to extremely low wage increases. It has also been due to the fact that under-utilisation in the labour market was higher than assumed. This can be concluded from the increase in part-time employment. As the labour market steadily improves, this is likely to change more and more, so that the number of full-time jobs will increase again. As ECB President Draghi stated at the ECB Watchers Conference in mid-March 2018, employment is now back at its pre-crisis level. This is all the more true since generally higher wage increases have been accompanied by only moderate productivity gains, which have recently remained below the 1 percent mark in the euro area.

Germany is trailblazer in the development of costs

Unit labour costs in Germany have increased by approx. 1 percentage point since 2014 on an annual average, i.e. more rapidly than in the common currency area. The economy's higher capacity utilisation and the tight labour market are the factors which have led to a much higher increase in wages. This is also demonstrated by the development of the core rate, which has usually been higher than the average of the entire euro area since 2013. This makes Germany the trailblazer, as it were, in the euro monetary union. If this positive economic development continues – and the chief economists of the Savings Banks Finance Group assume it will – unit labour costs can be expected to grow more rapidly over time and inflationary pressures can be expected to gradually increase in the euro area, as well.

In addition, the pricing power of companies will grow with increasing production capacity utilisation. It will then be easier to pass on the higher unit labour costs and, to some extent, energy price increases as well. This is exactly what already seems to have begun. The survey conducted among purchasing managers has shown that companies in the euro area are planning more substantial increases in their sales prices. The same trend has also been observed with regard to producer prices. This, in turn, is bound to affect consumer prices.

Companies to increase their sales prices, Euro area: Purchasing managers' indexes, composite in percent, year-on-year



Sources: Macrobond, Helaba Volkswirtschaft/Research

Cyclical developments are crucial for central bank

This cyclical trend should be crucial for the development of prices and monetary policy. While prices are also affected by structural factors such as demographics and digitalisation, the empirical evidence with regard to the effects of an ageing society on inflation is not clear.[6] On the other hand, the ongoing process of digitalisation is slowing down the increase in inflation. Price information for customers, for instance, is significantly improved by online trading. In production, the use of robotics and artificial intelligence, as well as the introduction of Industry 4.0, is leading to cost reductions and greater flexibility. However, empirical studies have reached the conclusion that the impact on consumer prices has so far been fairly modest.[7]

Globalisation has downward effect on prices

Globalisation also has downward effects on prices because it significantly exacerbates competitive pressure. However, these effects might be counteracted by protectionism, which is on the rise worldwide. A curtailment of free trade would lead to a higher price level and, in the final analysis, would have an adverse impact worldwide. However, trade structures are slow to change – if at all – so that the effects will be negligible in the short term. Nevertheless, economic institutions such as the EU Commission and national European governments should continue to advocate the highest possible standards of free trade.

Hence, what is referred to as the Phillips curve – which depicts an inverse empirical relationship between the capacity utilisation of an economy and the increase in wages or prices – would appear to remain valid. However, the slope of the curve has probably flattened.[8] In addition, it takes somewhat longer for wage increases to prompt price increases than in earlier economic cycles. This raises the question of whether previous empirical studies, which suggested that it usually takes one year for wage increases to be trans-

6 see ECB: Low inflation in the euro area: Causes and consequences, Occasional Papers Series, No. 181, January 2017, p. 1-86, here: p. 12.

7 see ECB: Low inflation…, p. 12 and box 3, pp. 71f.

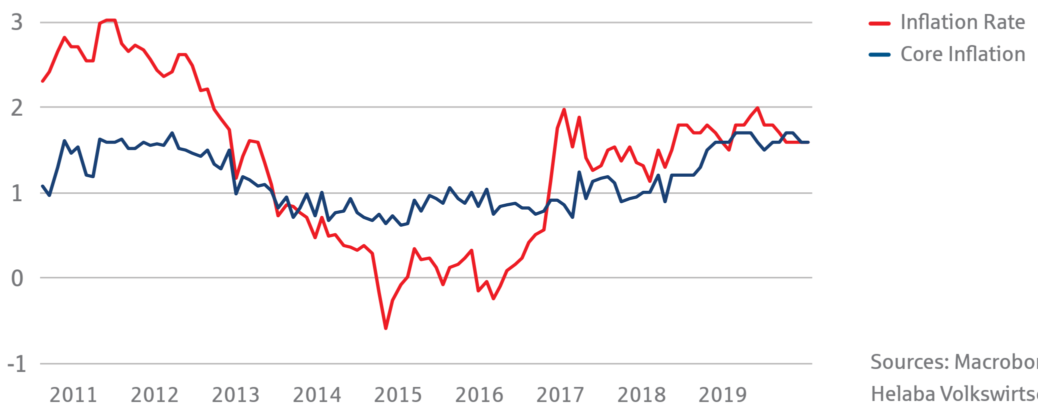
8 see ECB: Low inflation…, p. 9 sowie Helaba: Märkte und Trends 2018, Einkaufszentrum Nichts ist umsonst, p. 48f.

mitted, still apply today. Nevertheless, it is also conceivable, in the age of digitalisation, that price increases – once they are underway – may very well accelerate more quickly than in the past. It must therefore be assumed that the ECB's expansionary monetary policy is increasing growth and capacity utilisation in the euro area. With a certain time lag, this will also lead to higher wage increases and rising inflation.

Inflation is slowly approaching the ECB's target

The chief economists of the Savings Banks Finance Group assume that the economy in the euro area will continue to expand significantly in 2018, growing at just above 2 percent. In 2019, GDP growth in the common currency area is also likely to be above its potential. Due to the mechanisms described above, the current core rate of 1 percent might gradually increase to just below 2 percent by the end of 2019, although there is a high level of uncertainty and ultimately a differentiated assessment with regard to an onset of accelerating prices – even among the chief economists of the Savings Banks Finance Group.

Slow increase in core inflation rate in Euro area,
in percent year-on-year



Sources: Macrobond,
Helaba Volkswirtschaft/Research

ECB should act now

he economic development in the euro area is well on track. In light of the current growth and inflation prospects and in view of the general financial market environment, the ECB should indicate in the first half of 2018 that it is considering exiting its ultra-loose monetary policy. In September, the ECB should then end its purchase programme before adopting the first interest-rate policy decisions in 2019 such as increasing the deposit rate and subsequently increasing the refinancing rate.

In view of the fact that inflation rates might once again rise more rapidly in Germany and in the euro area, economic policy will continue to face challenges. It must keep an eye, for instance, on the effects which collective pay rises agreed this year in Germany will have – on top of last year's wage increases – on public budgets in the European Union and in the euro area. In addition, caution is advisable if an increase in public consumption is expected to continue to increase demand, while public investments are stepped up at the same time. In the construction sector, prices are already rising more rapidly because of extreme capacity utilisation. Increasing the potential production capacity will therefore remain crucial.

For this reason, the German government should provide funding for education and research during the legislative period that has just begun so as to prepare the ground for the medium-term future.

This was presented in detail by the chief economists in their statement on "Investment and Innovation for Germany and Europe" published in January 2018

Disclaimer

The present position paper of the Chief Economists does not necessarily correspond to the attitude of the DekaBank or the attitude of the respective Landesbanken and Savings Banks or the DSGV.

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