Europe

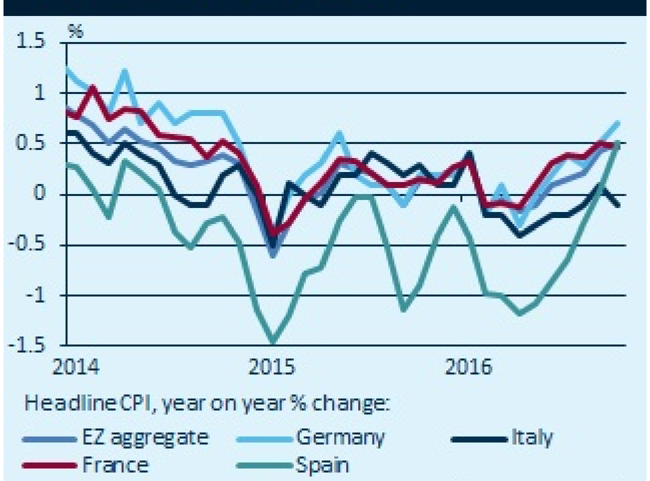
Target practice

Headline inflation in the Eurozone has been almost non-existent over the past two years, with prices even falling in annual terms from time to time. In October, the harmonised measure of consumer price inflation came in at 0.5% growth on the year; the highest rate in the currency union since April 2014. Drilling down to member state level, German inflation continues to lead the way, growing 0.7% in the year to October, while Spain stands out for its rapid acceleration in recent months, returning to positive territory for the first time since June 2014 (see Chart 6). Conversely, Italian consumer prices fell again in annual terms (-0.1%) in October, making September the only month of 2016 that the country has seen positive year-on-year (y/y) inflation (0.1%). **With November's inflation numbers due out this week, any hopes of big upside surprises are likely to be dashed.**

The main driver of the weakness in aggregate headline inflation over the past few years has been energy prices, which fell significantly in late 2014 and again in late 2015/early 2016 (see Chart 7). Commodity prices rebounded from their lows early this year and have been broadly stable over recent months. This stability means that the disinflationary impulse from lower energy prices has started to fall out of annual inflation rates. As the base effects from energy prices continue to wash out in the coming months, we expect aggregate headline inflation to continue to converge towards core inflation, which came in at 0.8% y/y in October, unchanged from the August and September readings. **While core inflation has been, and continues to be, higher than the headline figure, thanks to the exclusion of energy prices, both remain far from the European Central Bank's (ECB) mandated target of close to, but below, 2% inflation.** We expect headline inflation to average 1.2% in 2017 from 0.2% in 2016; a shift up from the current rate, but still too low. What is holding inflation back?

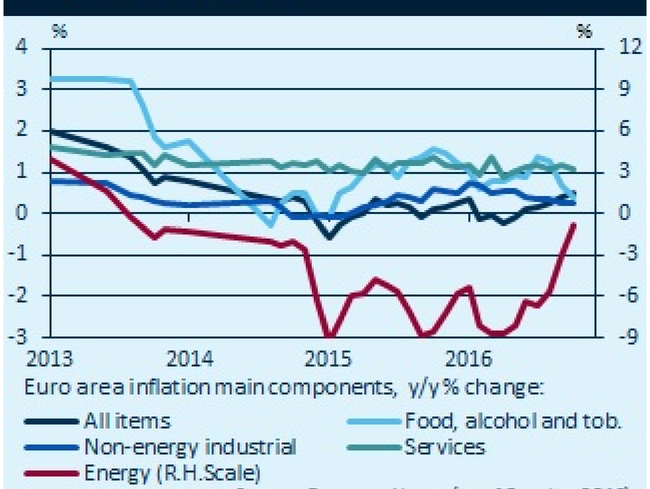
Ordinarily, as spare capacity in the labour market is eroded, we see upward pressure on wages, unit labour costs and finally consumer prices (via the Phillips curve relationship). Progress has been made on the labour market recovery; the unemployment rate was considerably higher a few years ago, peaking at 12.1% in 2013. It has since come down to a five-year low of 10%, which has remained stock-still through July to September. The OECD estimates that the equilibrium unemployment rate, or NAIRU, in the Eurozone was 9.4% in 2015. So, it appears that spare capacity has been falling, but there is still room to go. That said, the current level of NAIRU is difficult to estimate. **Labour market reforms in members like France and Italy may be reducing the NAIRU by boosting employment, which would suggest that inflationary pressures are even further away. However, structural reforms take time to feed through and it can be difficult to predict how effective they will be. Moreover, there is a risk that the NAIRU has actually risen more than the OECD believes, on account of hysteresis in the labour market following a painful double-dip recession.** Regardless, even when the unemployment rate does reach the NAIRU, the feedthrough to wage pressures and consumer price inflation can be slow – in more technical terms the Philips curve can be flat. With inflation still a long way from target, we expect the ECB to extend its asset purchase programme at the upcoming December meeting.

Chart 6: Multi-speed Europe



Source: Eurostat, Haver (as of October 2016)

Chart 7: Energy drag



Source: Eurostat, Haver (as of October 2016)