ECB’s core inflation forecast is still too optimistic

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ECB’s core inflation forecast still optimistic:

- The ECB revised its headline inflation projection considerably higher in 2017, lifting it slightly in 2018 while keeping it unchanged in 2019. The higher near-term inflation forecast reflects higher energy and food price inflation forecasts from the ECB whereas the core inflation projection was unchanged at 1.1% in 2017.

- The ECB revised its core inflation forecast slightly higher for 2018 and 2019 by 0.1pp in both years due to 'some indirect and second-round effects from higher oil prices, as well as some upward effects from the lower euro exchange rate', see March 2017 ECB staff macroeconomic projections for the euro area.

- In our view, the ECB’s core inflation forecast is still very optimistic due to the following:
  1. The ECB’s core inflation forecast hinges on higher wage growth
  2. Labour market slack suggests wages will stay low in 2017-18
  3. Even German wage growth is low despite the tight labour market
  4. The ECB’s model for core inflation is subject to mean reversion

Higher ECB inflation forecast in 2017 is only due to a rise in energy and food price inflation

Source: ECB, Eurostat, Danske Bank Markets
ECB expects core inflation to exceed its historical average in both 2018 and 2019.

The higher core inflation hinges on higher wages as it should lift service price inflation.

#1: ECB’s core inflation forecast hinges on higher wage growth

Source: ECB, Eurostat, Danske Bank Markets
#2: Labour market slack suggests wages will stay low in 2017-18

The ECB expects the Philips curve to steepen sharply – and even before NAIRU is reached

Downward pressure on euro area NAIRU as it is likely to be lowered in the periphery

Source: ECB, European Commission, Eurostat, Danske Bank Markets

Source: European Commission, Eurostat, Danske Bank Markets
#3: Even German wage growth is low despite tight labour market

German wage growth is not rising strongly as the strength of the labour market suggests.

German service inflation also contributes modestly despite the strong labour market.

Source: Eurostat, Danske Bank Markets

Note: The service price inflation figures are from January 2017 whereas the latest long-term unemployment figures are from Q3 2016.
#4: ECB’s model for core inflation is subject to mean reversion

In ECB’s model for core inflation, the figure will converge towards 1.7% in three years.

The mean reversion in the inflation model is also seen in the headline inflation forecast.

Some ECB members expressed concern that the models used to produce inflation forecasts are subject to mean reversion.

Source: ECB, Eurostat, Danske Bank Markets
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