

Research Euro Area

Rising pipeline pressures for euro inflation

Over the last months, euro inflation has surprised markets on the upside. Helped by favourable base effects from the reversal of last year's German VAT cut, increasing price pressure on the back of supply bottlenecks and the rebound in travel and tourism after lockdowns, euro area inflation surged to a decade high of 3.0% in August, while market-based inflation expectations (5y5y) have risen to 1.78% (highest since January 2017).

Energy inflation accounted for half of the increase in headline inflation during August. Lately, soaring natural gas and electricity prices have further fuelled 'stagflation' fears in the market. Gas supplies from Russia have slowed after inventories were depleted after the cold winter and the finished Nord Stream 2 pipeline is still not transporting gas to Europe. Lack of wind and rain has also been a drag on electricity production in Europe. As the winter approaches, increased demand will likely keep the upward trend in gas and electricity prices intact for the coming months, while some European governments have tried to counter the adverse price effect on consumers (see *FT story*). In sum, despite the fading tailwind from oil price base effects, **we expect euro area energy inflation to remain elevated for the remainder of this year as higher gas and electricity prices are countering falling inflation rates for transport fuels.**

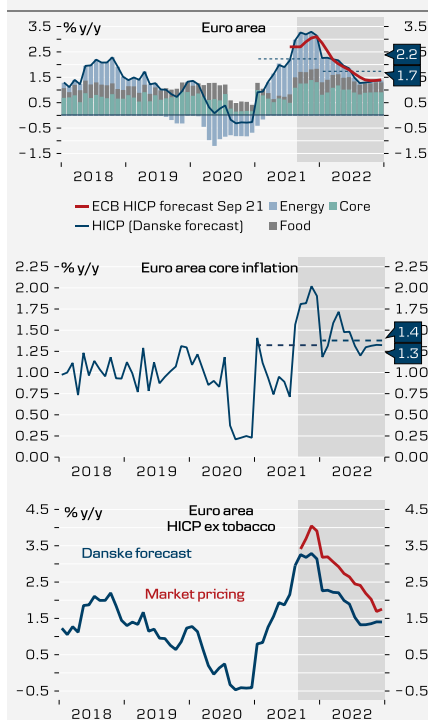
The details of the August HICP report also paint a picture of building price pressures for consumer goods. Supply chain pressures continue unabated, especially in manufacturing, and cost push inflation is increasingly working its way through the pricing chain, with producer and import price inflation for consumer goods rising noticeably during Q2 and Q3 (see charts below). Rising selling price expectations are increasingly also visible in the services sector, while reports of labour shortages are becoming more widespread. The labour market still constitutes the biggest hurdle for a more sustained rise in euro inflation in our view. There are still more than two million fewer people employed than before the pandemic and the number of workers in job retention schemes also remains substantial. Inflation expectations have risen, but not yet to levels that would likely trigger significant second round effects on wages in our view. Negotiated wages rose by only 1.7% y/y in Q2 and we expect that wage pressures over the medium-term will likely remain relatively muted. That said, we also see a risk that labour shortages become more acute, leading into a 'stagflationary' scenario (see *Research Global - Stagflation' risks on the rise*, 15 September). The 2022 wage bargaining rounds will be an important bellwether for post-pandemic wage growth in that respect.

Overall, we slightly lift our euro inflation profile for 2022, mainly on the back of higher core price inflation and a slightly longer tailwind from energy. With supply disruption expected to persist at least until early 2022 and pass-through to consumer goods prices increasingly visible, we raise our outlook for non-energy industrial goods (NEIG) inflation in 2022 to 1.2% (from 0.7% previously). For services the outlook is marginally higher due to stronger expected price increases for travel and recreational services (1.6% from 1.5% previously). We expect core inflation to peak at 2.0% in November 2021, and average 1.4% during 2022. **Our profile is broadly in line with the ECB's latest forecast, but we consider market inflation fixings to be on the high side for the remainder of 2021.**

Further reading

- *Research Global - Stagflation' risks on the rise*, 15 September
- *Research Euro Area: Europe's green transition - the heat is on for euro inflation*, 16 September

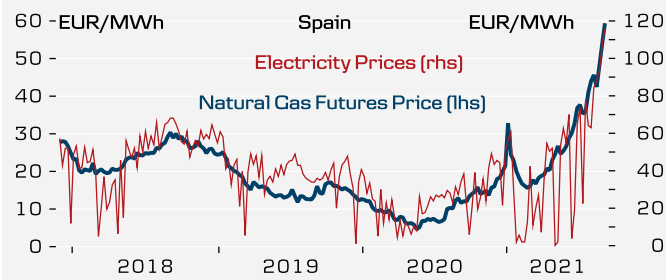
Euro inflation market pricing on the high side for 2021



Source: Eurostat, ECB, Macrobond Financial, Danske Bank

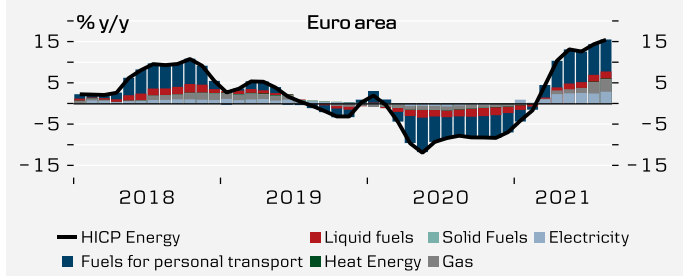
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Natural gas and electricity prices on the rise



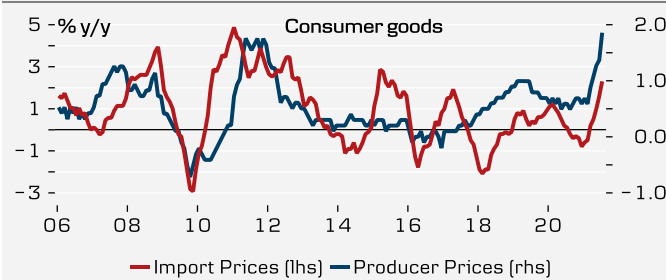
Source: ENTSO-E, Macrobond Financial, Danske Bank

Natural gas and electricity prices on the rise



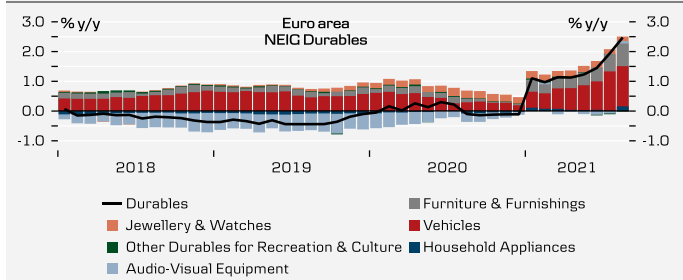
Source: Eurostat, Macrobond Financial, Danske Bank

Cost push inflation working its way through the pricing chain



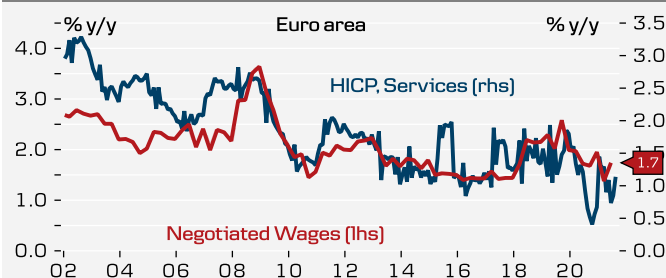
Source: Eurostat, Macrobond Financial, Conference Board

Rising vehicles prices have pushed up goods price inflation



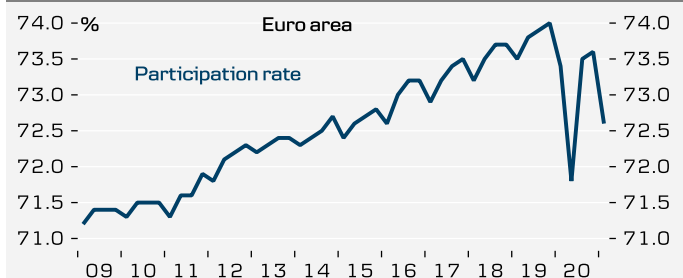
Source: Eurostat, Macrobond Financial, Conference Board

Labour market slack should hold wage pressures at bay



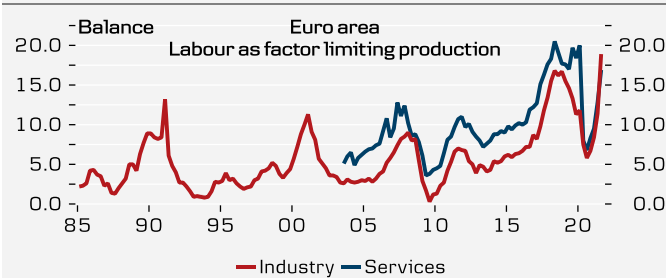
Source: Eurostat, ECB, Macrobond Financial, Danske Bank

Labour participation rate still below pre-pandemic levels



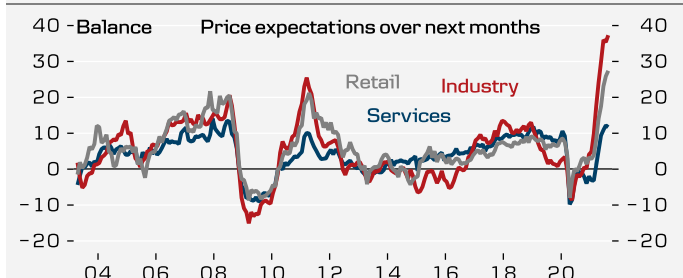
Source: Eurostat, Macrobond Financial, Danske Bank

Labour shortages are starting to emerge in some sectors



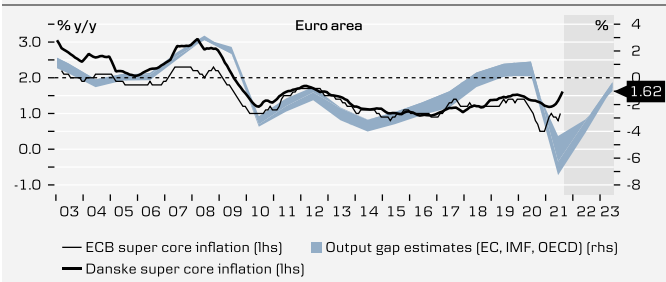
Source: Eurostat, Macrobond Financial, Danske Bank

Selling price expectations remain elevated



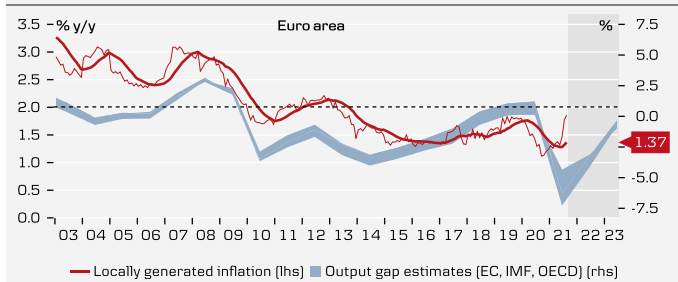
Source: Eurostat, Macrobond Financial, Danske Bank

Super core inflation has trended upward



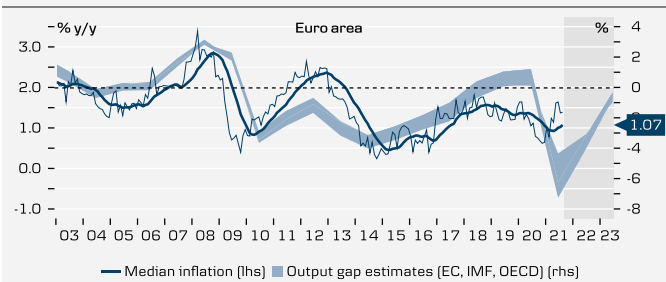
Source: Eurostat, ECB, Macrobond Finacial, Danske Bank

Domestic inflation pressures are rising



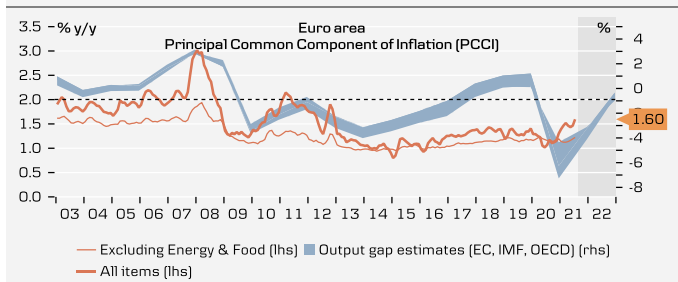
Source: Eurostat, Macrobond Finacial, Danske Bank

Median inflation has trended upward



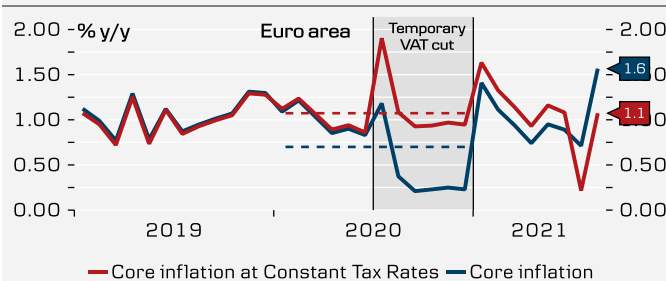
Source: Eurostat, ECB, Macrobond Finacial, Conference Board

PCCI on the rise



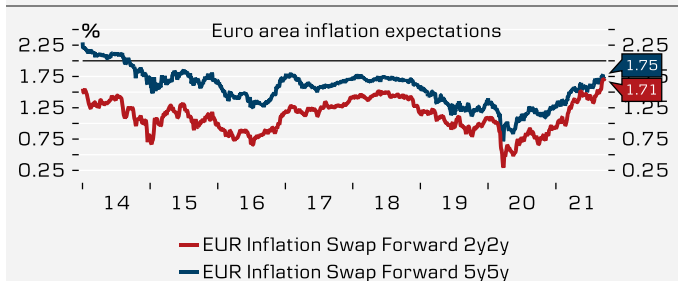
Source: Eurostat, ECB, Macrobond Finacial, Conference Board

Core inflation artificially boosted by German VAT effects



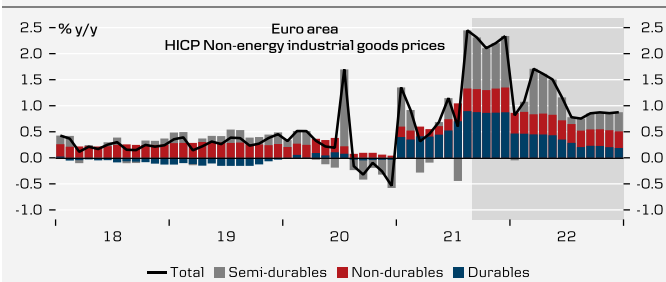
Source: Eurostat, ECB, Macrobond Finacial, Conference Board

Market-based inflation expectations have risen



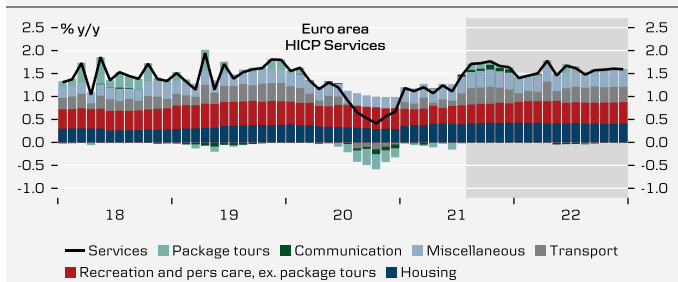
Source: Eurostat, ECB, Macrobond Finacial, Conference Board
Past performance is not a reliable indicator of current or future results.

NEIG inflation to stay elevated in 2022



Source: Eurostat, Macrobond Finacial, Danske Bank

Recreation and travel to boost services prices



Source: Eurostat, Macrobond Finacial, Danske Bank

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Aila Mihr, Senior Analyst.

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Ad hoc.

Date of first publication

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