Danske Bank

24 November 2020

Research Denmark

Modest inflation pickup and choppy waters ahead

- **Core inflation has remained stable due to imputed prices and tobacco.**
- **New consumption pattern and return of tourism will increase volatility.**
- **We expect inflation to increase from 0.4% this year to 0.8% and 1.3% in 2021 and 2022 respectively.**

Imputed prices soften crisis blow to inflation

Danish CPI inflation hit zero in the spring almost entirely driven by falling oil prices. Core inflation has drifted stably around 1% since February as opposed to eurozone core inflation. That said, COVID-19 has had a significantly negative impact on some prices. In particular, we have seen price declines in hotels and household equipment. Some of the obvious effects are not registered because prices are imputed, on for example package holidays, international air fares, concerts etc. The price declines have been countered by increasing tobacco prices in the wake of the tax increase in April and thus NPI inflation (which excludes taxes) stands at just 0.2% in October.

Key questions for Danish inflation going forward relate to rents, the impact from higher tobacco taxes and the timing of a vaccine and the following impact on air fares, package holidays, hotels, etc. Besides, we could be heading for choppy waters over the coming years as big changes in our consumption pattern will impact CPI weights going forward.

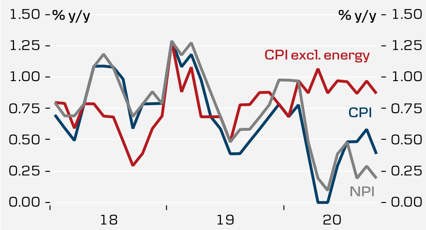
Rent increases will remain low

Looking at rent increases, which weighs 21% of total CPI, they have declined from above 2% in 2013 to 0.9% in the last two years. We know that rents in the regulated part of the private rental market are capped by inflation itself, so low inflation is self-reinforcing here. In the social housing sector, where rents are set according to costs, the low level of interest rates is helping to keep rents subdued. Hence, there is nothing really to indicate that upcoming rent increases should be much higher than has been the case in recent years. We expect an unchanged rent increase of 0.9% in February 2021 but a slightly higher increase in 2022 as inflation has increased in the meantime.

Tobacco gives steady push higher

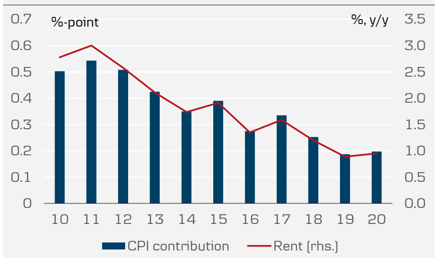
Since the tobacco tax was increased in April, such that a 20-pack cigarettes increases from approximately DKK41 to DKK55, prices have climbed 24% and there is another 8% to go before the full impact is reached. Stock piling of cigarettes and old tax stamps are the key reasons for the delayed impact. Tobacco consists of three subcategories in the CPI; cigarettes, cigars and ‘other tobacco goods’ with weights of 1.30%, 0.01% and 0.26%, respectively. Cigarette prices only have another 5% to go before full impact from the tax increase but the pace has decreased almost to a standstill. Cigar prices still have not increased much, but make up a negligible share of tobacco. The price of ‘other tobacco goods’, which is made up of 90% pipe tobacco, has only increased 8% so far. We expect this slow but steady trend of both to continue. In January 2022, the price of a 20-pack cigarettes is increased to DKK60 and we expect the price impact to be much quicker.

Primarily energy that has pulled inflation down



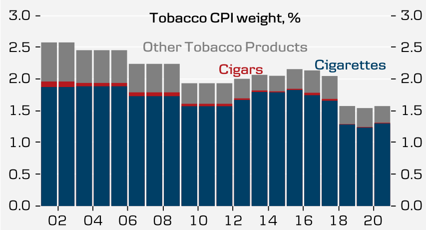
Source: Statistics Denmark, Macrobond Financial

Rent contribution has declined



Source: Statistics Denmark, Danske Bank

Tobacco weight has stabilised



Source: Statistics Denmark, Macrobond Financial

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New rules from the government limit the amount of extra old tax stamps that can be acquired before the tax increase from 5% to 2% extra compared to normal turnover. At the same time, it will be forbidden to sell cigarettes at the old price just three months after the tax increase. The turnover on other tobacco is much lower and we expect the price impact here to be significantly slower as we have also seen with the previous tax increase. The tax on e-cigarette fluids increases in July 2022 but the price impact will likely drag out and the weight is negligible.

In 2021, the PSO tariff on electricity will be phased out completely. It currently makes up 3% of the consumer price on electricity and will deduct 0.07 percentage points from total CPI inflation once phased out by the end of 2021. There remains uncertainty for the future of the registration fee on electric and hybrid cars, which will increase if nothing else is agreed. So far in 2020, electric and hybrid cars have made up 18% of the number of newly registered cars, so this is a significant upside joker.

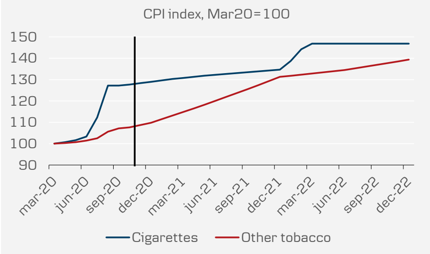
Reopening and new weights will add to inflation volatility

The direct effect on CPI inflation from travel restrictions on hotels was -0.12 percentage points in October. We expect prices to remain low as long as travel restrictions are in place and we have pencilled in a rebound in late 2021 assuming tourists will be back. Package holidays will likely remain imputed for a long time, considering how the price collection goes six months ahead of the registered price (and the actual holiday). With a weight of 1.5%, the impact can be big, when prices are collected again, but the sign of the price correction is difficult to predict, not least because the last registered price dates back to March. Lower flight capacity could cause higher prices and excess hotel capacity could cause lower prices. International air fares are collected in advance and right up to the actual flight and thus might be registered sooner. We have pencilled in a solid rebound in air fares in Q4 21.

The composition of consumption has completely changed in 2020 due to restrictions. This will be reflected in the CPI weights already in 2021. At the time of writing, Eurostat is working on how to adjust the weights, but the result could well be a large decline in the weights of particularly package holidays, air fares and hotels. The seasonality of the series can cause significant volatility in the CPI contributions if weights are changed. To illustrate: if the weights on these components were halved in 2019, the accumulated contribution would have ranged between -0.26 and +0.20 percentage points over the year. In reality with almost unchanged weights, the contribution ranged from -0.02 to +0.18 percentage points. If the weights are reduced further, the effect will be bigger. Another potential candidate for volatile contributions is vacation centres etc. The weight was halved in 2019 for technical reasons with a resulting large negative contribution of -0.3 to -0.4 percentage points over the summer months. The opposite effect could easily occur, if weights are adjusted to reflect 2020 consumption. At least, nights spent in holiday houses by Danish nationals have increased 71% in 2020 so far. This seasonality caused by weight changes remains speculative until we know the actual impact of the new consumption pattern on CPI-weights. Thus, it is not pencilled into our inflation outlook.

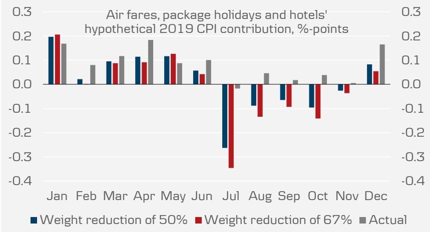
In October, hotel prices and imputed air fares and package holiday prices deducted about ½ a percentage points from service inflation. Inflation on other services is not lower than what we have seen in recent years. Despite a rebound in economic activity next year, the output gap will remain negative for the foreseeable future and with modest wage increases in sight we expect service inflation to remain subdued. We expect inflation to increase from 0.4% in 2020 to 0.8 in 2021 and 1.3% in 2022.

Quicker impact on cigarettes in 2022



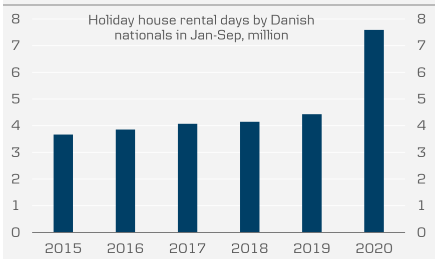
Source: Statistics Denmark, Danske Bank

New weights and seasonality add volatility



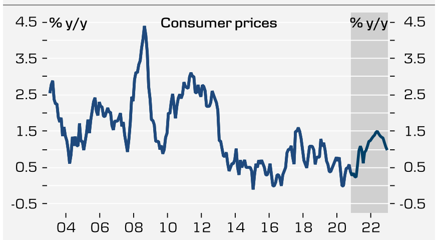
Source: Statistics Denmark, Danske Bank

Holiday house rentals have increased massively



Source: Statistics Denmark, Danske Bank

Inflation will increase as we go back to normal



Source: Statistics Denmark, Macrobond Financial, Danske Bank

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