Investment Research — General Market Conditions

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Euro Area Research

Euro inflation in the coronavirus maelstrom

In this publication we take a look at how the coronavirus crisis is affecting the euro inflation outlook. While deflationary pressures seem relatively contained so far in the March HICP release, we look at what is in store for the rest of the year.

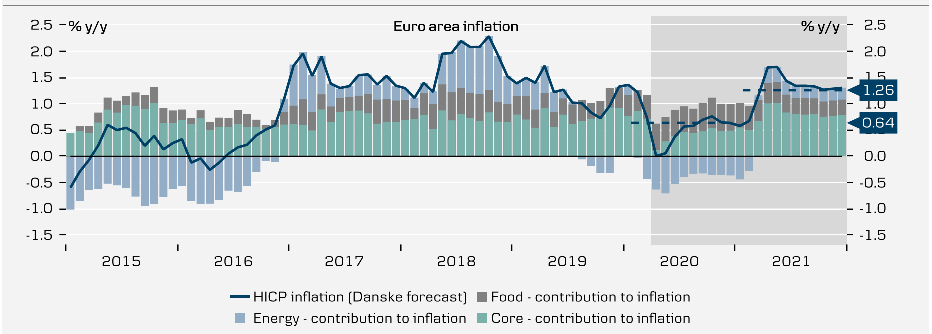
In general, the implications of the coronavirus for inflation are not clear cut in theory, as it constitutes both a demand and supply side shock. Hence, downward pressure linked to weaker demand may be offset by upward pressure from supply-side disruptions and higher production costs. However, some recent evidence suggests that the first is currently outweighing the latter. Consumer surveys across the euro area already bear witness to more cautious buying patterns in light of job insecurity and decreasing willingness to undertake major purchases – a trend that we expect to become even more pronounced in coming months. In light of this, it is not surprising that companies' price response has come swiftly. The March PMI survey showed average prices charged for goods and services falling for the first time since August 2016, as companies offered discounts to boost sales and reduce inventories, especially in the services sector.

We take a closer look at some HICP categories we expect to be affected the most by the coronavirus crisis. In sum, **a sharp drop in the oil price and significant price decreases in clothing and footwear as well as travel-related items are set to take their toll on the euro inflation outlook in the short term and we expect core inflation to average now only 0.7% in 2020** (from 1.2% previously, for details see table on page 4). That said, significant uncertainty clouds the April HICP release, as Eurostat has yet to decide how data collection and compilation will be achieved especially for recreational and cultural services. Depending on the chosen approach, that could pose upside risks to our forecasts.

Monetary and fiscal easing to lay the groundwork for inflation rebound in 2021

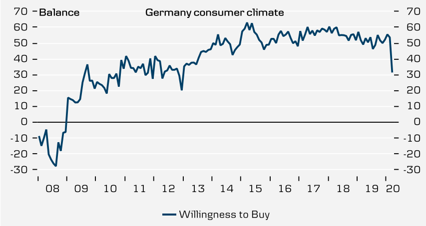
Significant monetary and fiscal stimulus measures have been announced in the euro area over the past weeks, but we doubt that they will bring a significant reflationary boost to the economy. This can be illustrated by the Fisher equation or 'Quantity Theory of Money', which states that money (M) multiplied by money's velocity (V) equals the price level (P)

Euro area inflation to slow down in 2020



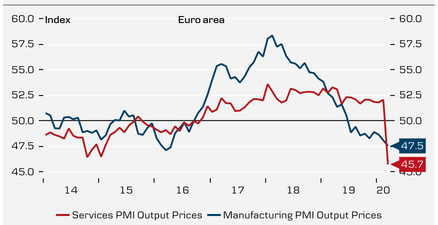
Source: Eurostat, Macrobond Financial, Danske Bank

Consumers are adopting more cautious buying patterns



Source: GfK, Macrobond Financial, Danske Bank

Companies have tried to boost sales by lowering output prices



Source: Markit, Macrobond Financial, Danske Bank

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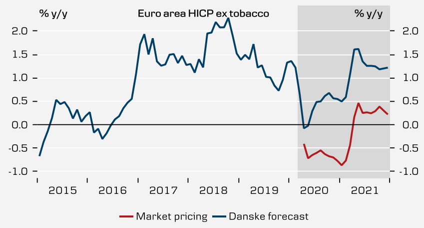
multiplied by the volume of transactions (T), i.e. MV=PT. With governments' lockdown measures to tackle the health crisis, we are currently witnessing a sharp fall in the volume of transactions and an increase in 'forced' savings. This consequently gives rise to a decline in money's velocity, which can be seen as a measure of how often money shifts hands in an economy. How inflationary the easing measures will be hence depends on (1) whether the expansion of the money supply (M) overcompensates the drop in V or (2) to what degree (and how swiftly) velocity rebounds. While these are abstract phenomena, we see current liquidity measures more as something that compensates for the sharp drop in velocity, but the inflationary impact might rise over time, as countries gradually start to open up again and velocity increases. Hence, while **we do not expect announced fiscal and monetary measures to result in a marked inflationary boost for the euro area economy**, we think they will lay the groundwork for a strong rebound of the economy in H2 20 (see *Flash Comment: Europe's economy in freefall*, 24 March) and hence a normalisation of the inflation outlook in 2021. In that light, **we consider current inflation market pricing as too subdued.** See also *The Big Picture*, 27 March.

Inflation market pricing too subdued

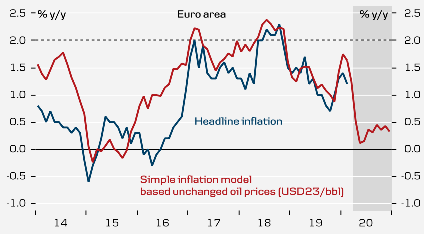


Source: Eurostat, Macrobond Financial, Danske Bank

Energy prices

Since the onset of the coronavirus crisis, the oil price has collapsed by more than 50%, not only due to faltering global demand amid the virus standstill, but also due to a price and supply war breaking out between OPEC (Saudi Arabia) and Russia. Although a possible 'intervention' in the oil market by the US administration remains a wild card, we now expect Brent oil to average only USD35/bbl this year and USD44/bbl next year. Consequently, energy price inflation is set to remain a significant drag on euro area headline inflation for the rest of the year in our forecast. Gauging the second-round effects from the oil price collapse on core inflation through inflation expectations is more difficult. Although we look for a deep euro area recession in H1, we also expect to see a sharp rebound in growth rates in Q3 and hence the short-lived nature of the crisis could limit the impact of any adverse second-round effects.

Oil price fall to take its toll on inflation outlook

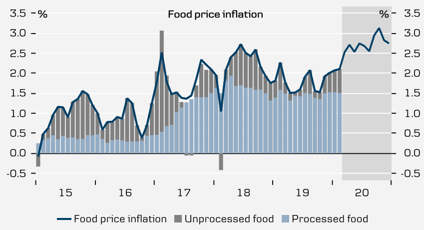


Source: Eurostat, Macrobond Financial, Danske Bank

Food prices

Euro area food price inflation has been on an uptrend since October 2019 and we look for elevated food prices for the remainder of this year. The food segment has been one of the few notable exceptions to the decreased turnover otherwise observed in retail trade, as consumers reacted with panic-buying to lockdown announcements. Data from *Destatis* showed that sales figures of food and sanitary products reached extremely high levels in Germany during March. However, so far the price response seems to have been limited: with the exception of vegetables and dairy products, food prices exhibited only moderate price increases during the month. That said, we see several reasons that will stoke food price inflation in coming months, including more prevalent supply chain disruptions within Europe combined with continued high demand for processed foods as well as labour shortages of seasonal workers in the agricultural sector.

Food prices to stay elevated



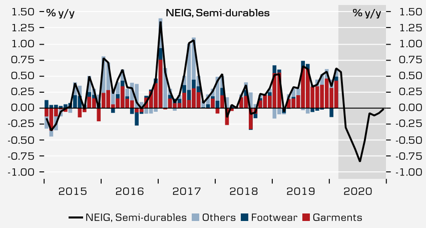
Source: Eurostat, Macrobond Financial, Danske Bank

Semi-durables (clothing and footwear)

The fashion industry currently faces a big dilemma: while the closure of physical stores turns large parts of the current spring/summer collections into a 'shelf warmer', deliveries for the upcoming autumn/winter collections are already in the pipeline and risk overwhelming the storage capacity of many firms. Supply-side issues are further aggravated by flagging demand for fashion now that a large part of the population works from home and job insecurity is on the rise. Large online discounts have hence become the only escape for many fashion retailers to avoid a liquidity and storage crunch.

Interestingly, the March country CPI figures did not yet bring much evidence of such large scale discounts being applied. In Saxony – which is usually a good gauge for German CPI trends as a whole – inflation rates in clothing and footwear even accelerated from 1.2% to 2.8% in March, with the introduction of the new spring/summer collections. This might, however, turn out to be the 'calm before the storm' with online retailers such as H&M currently offering discounts of up to 70%. We expect inflation rates in semi-durable goods to tank in the coming months as the fashion price war kicks off.

Fashion discount war to depress NEIG inflation



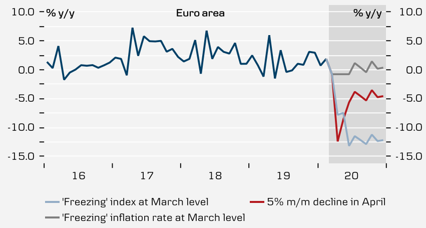
Source: Eurostat, Macrobond Financial, Danske Bank

Recreational and cultural services (including package tours)

Predicting the inflationary impact from recreational and cultural services constitutes currently a major challenge. With large parts of the industry at standstill/in lockdown due to government initiatives to stem the virus outbreak, many firms have been severely hindered in their price response, although anecdotal evidence suggests that some travel companies and airlines tried to cut prices in the early stages of the crisis to recoup demand. This is also corroborated by the preliminary Saxony CPI data, which points to a decrease in euro area package tours' inflation already in March.

Even more uncertainty than the March price changes in package tours pertains to the April data. **According to Eurostat, it is currently too early to say how the coronavirus disruptions will affect the release of inflation data for April.** Many European statistical offices have made increasing use of price collections on the internet through web scraping e.g. for clothing, technical products, train prices and telecommunications services or by using the average price development of a type of good where specific price information is missing.

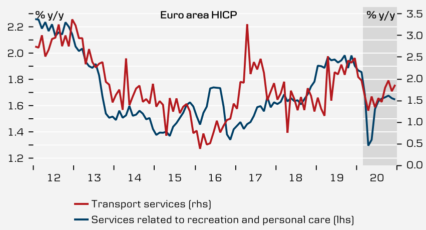
What will happen to package tours' inflation in April?



Source: Eurostat, Macrobond Financial, Danske Bank

However, this approach will likely not be practicable in the case of package tours where the 'products' as such have ceased to exist (at least temporarily). We see three possibilities how Eurostat could handle the 'package tours conundrum', each with different repercussions on the (core) inflation outlook (see chart). In case no price is available, an imputed (estimated) might be used, derived from other real time data or anecdotal evidence, (which both suggest steep discounts, see *FT*). Even using a relatively conservative estimate of a 5% m/m decline in package tour rates will result in a deeply negative inflation rate over the coming year, lowering core inflation by 0.1pp on average. Alternatively, Eurostat could choose to exclude or 'freeze' the index value or inflation rate at the last registered reading (March). Both will likely create conceptual problems in the case of package holidays, which have considerable seasonal variations.

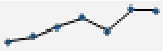
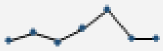
Inflation rates in travel and recreational services to take a beating



Source: Eurostat, Macrobond Financial, Danske Bank

Package tours will not be the only item within recreational and cultural services that is creating problems. Similar issues relate to e.g. 'Restaurants, Hotels and Catering Services' (25.6% of core inflation) and 'Transport by air' (1.2% of core inflation). While we do not know which approach Eurostat will choose, we at least have incorporated some price decreases in these items in the coming months in our baseline forecast. However, uncertainty is high at the current stage, not only with respect to the statistical approach but also to the companies' price response in the opening up phase. **Excess capacity and hard competition would drive down prices, but it might just as well be the case that so much capacity in airlines, restaurants, stores etc. has already been reduced that the (pro-inflationary) supply constraints take over. This constitutes an important upside risk to our forecasts.**

Overview euro area inflation outlook

			Danske forecast			
	Current	Sparkline (last 6M)	2020 avg.	2021 avg.	HICP weight	Core weight
HICP	0.74		0.64	1.26	100	
Energy price inflation	-4.29		-3.57	1.31	9.8	
Food price inflation	2.43		2.56	1.86	19.1	
HICP ex tobacco	1.14		0.55	1.17	97.7	
Core inflation	1.00		0.71	1.09	71.1	100
Non-energy Industrial Goods	0.52		0.20	0.39	26.2	36.9
- Durables	0.16		0.10	-0.20	9.2	13.0
- Semi-durables	0.62		-0.13	0.61	10.3	14.5
- Non-durables	0.84		0.84	0.88	6.7	9.4
Services	1.28		1.01	1.51	44.9	63.1
- Communication	0.01		0.12	-0.10	2.6	3.7
- Housing	1.52		1.49	1.42	10.9	15.3
- Package tours & accommodation	1.89		-4.28	0.27	3.6	5.1
- Recreation & personal care	1.86		1.63	2.05	11.8	16.6
-Transport	1.96		1.68	2.11	7.4	10.4
- Miscellaneous	1.52		1.45	1.36	8.5	12.0

Source: Eurostat, Danske Bank

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