

# *ECB's core inflation forecast is still too optimistic*

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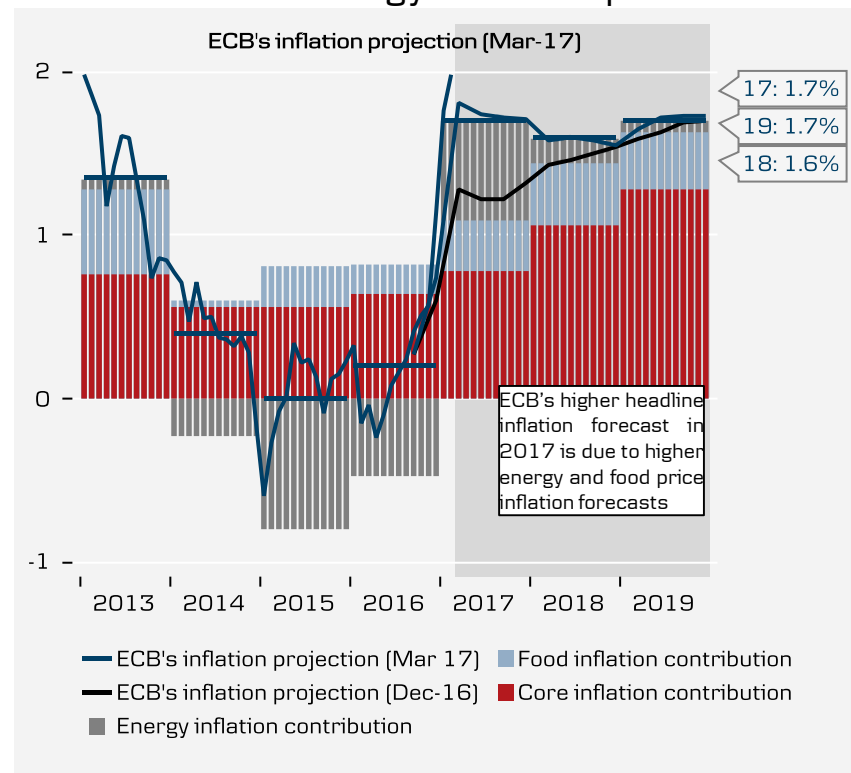
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# ECB's core inflation forecast is still too optimistic

## 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:**
  - The ECB's core inflation forecast hinges on higher wage growth
  - Labour market slack suggests wages will stay low in 2017-18
  - Even German wage growth is low despite the tight labour market
  - The ECB's model for core inflation is subject to mean reversion

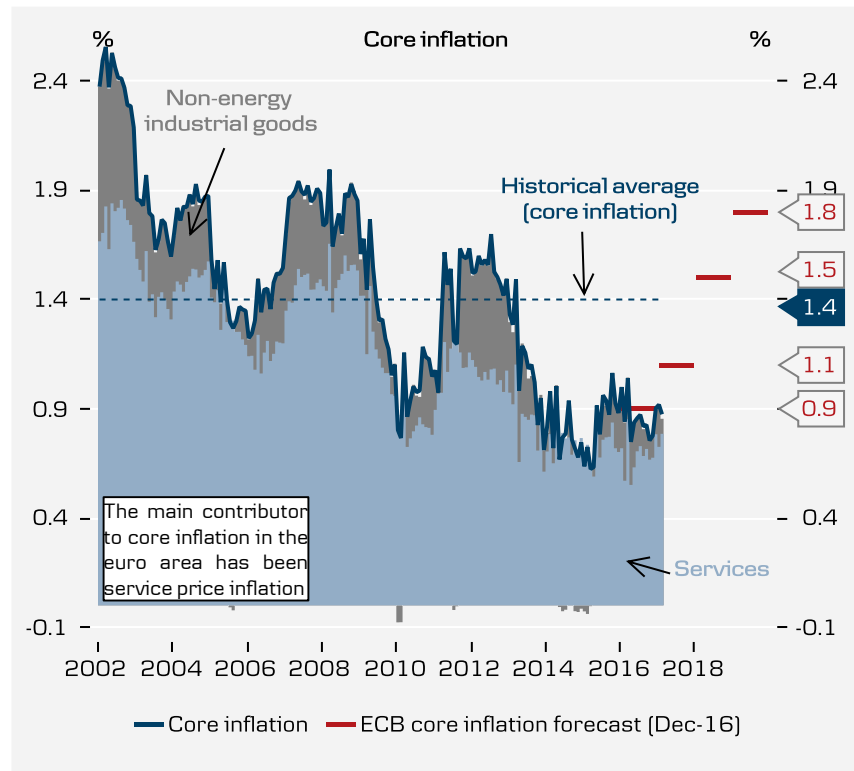
Higher ECB inflation forecast in 2017 is only due to a rise in energy and food price inflation



Source: ECB, Eurostat, Danske Bank Markets

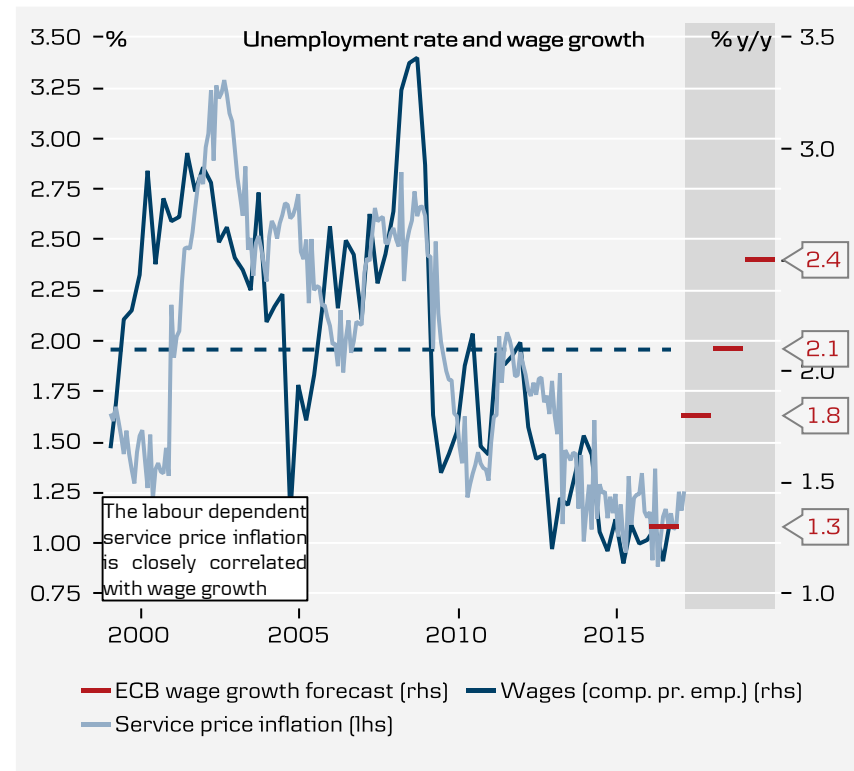
# #1: ECB's core inflation forecast hinges on higher wage growth

ECB expects core inflation to exceed its historical average in both 2018 and 2019



Source: ECB, Eurostat, Danske Bank Markets

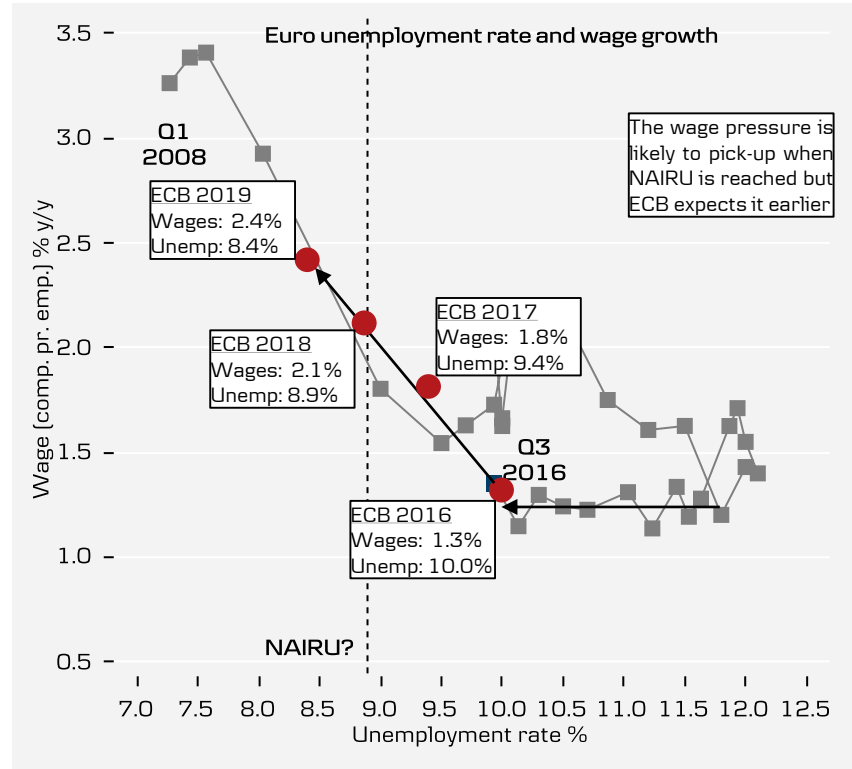
The higher core inflation hinges on higher wages as it should lift service price inflation



Source: ECB, Eurostat, Danske Bank Markets

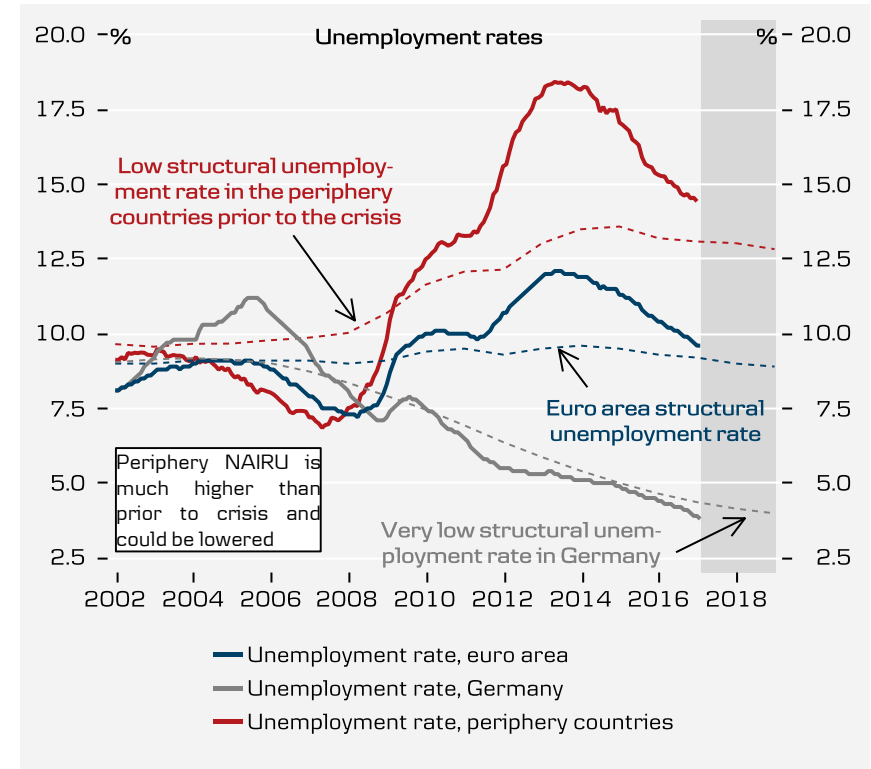
## #2: Labour market slack suggests wages will stay low in 2017-18

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



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

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



Source: European Commission, Eurostat, Danske Bank Markets

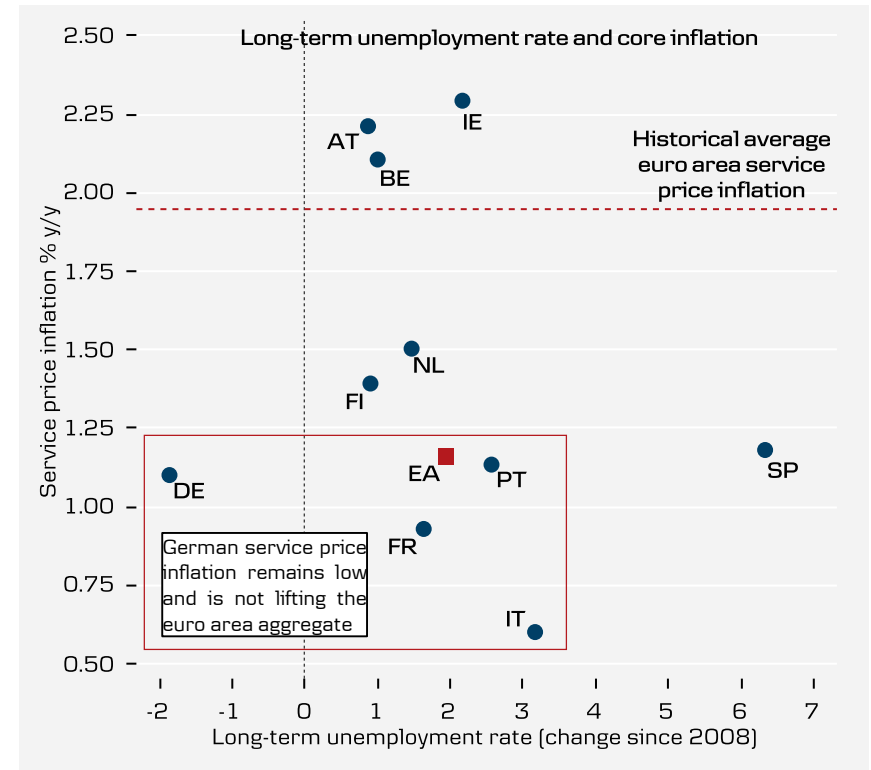
### #3: Even German wage growth is low despite tight labour market

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



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

German service inflation also contributes modestly despite the strong labour market

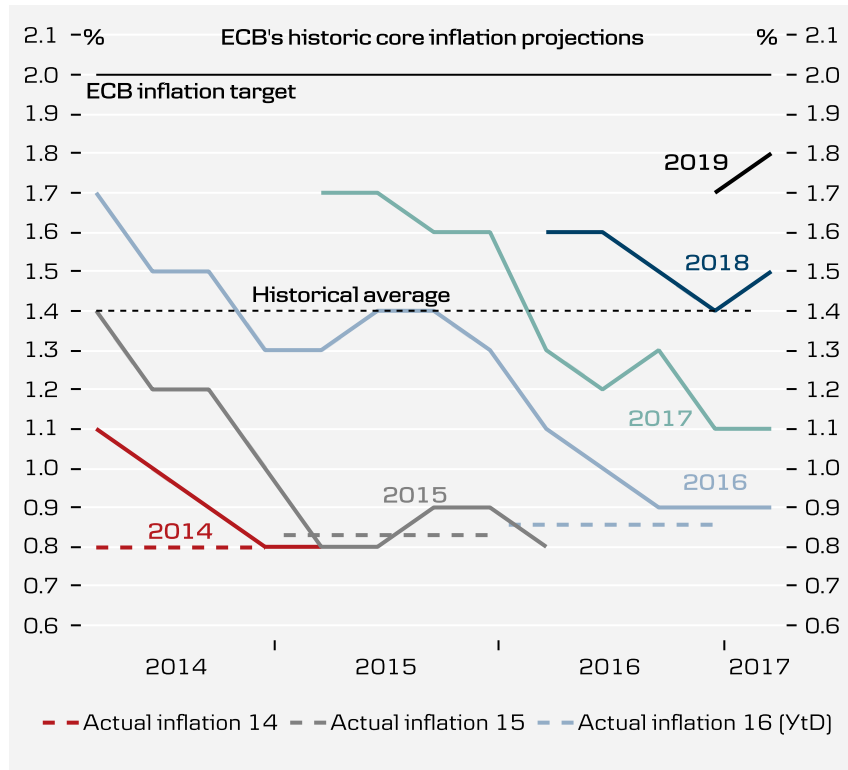


Source: Eurostat, Danske Bank Markets

Note: The service price inflation figures are from January 2017 whereas the latest long-term unemployment figures are from Q3 2016

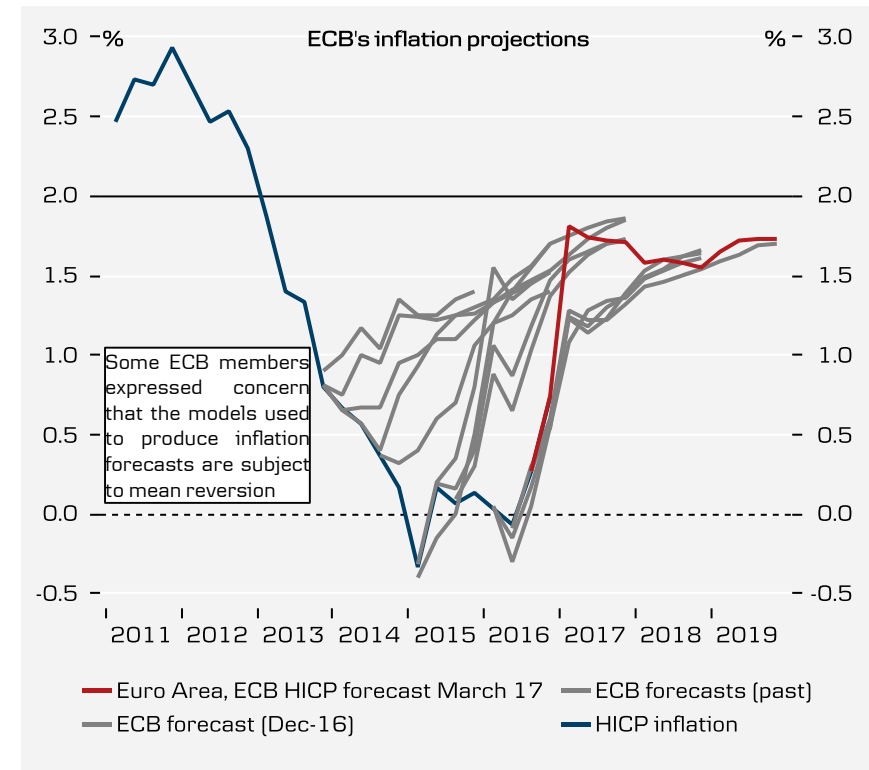
## #4: ECB's model for core inflation is subject to mean reversion

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



Source: ECB, Eurostat, Danske Bank Markets

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



Source: ECB, Eurostat, Danske Bank Markets

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