Europe’s Stubborn Inflation Problem

Even with the tailwind of falling energy prices, Europe’s inflation problem looks persistent, which is bad news for European assets.

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Inflation in Europe is running at multidecade highs, and core inflation has yet to slow, even though energy prices have fallen back to pre-invasion levels. While the increase in European inflation was initially concentrated in energy prices and goods, the problem is now very clearly broad-based across categories. Most concerning, nominal wages, bolstered by very tight labor markets, have begun to pick up across Europe. Higher incomes, in turn, will fuel a self-reinforcing cycle of spending, making it harder for the ECB to achieve its goal of 2% inflation without a material contraction in activity. Even with the significant slowdown in growth that we expect, inflation looks likely to remain uncomfortably high. From here, if Europe is to remedy an inflation problem that is looking increasingly entrenched, we think tighter financial conditions will be needed—and more is coming. The ECB is priced to continue hiking short rates, and quantitative tightening is scheduled to start in March. This combination of higher short-term rates and quantitative tightening to combat stubborn inflation will be a headwind that looks under-reflected in the relatively benign pricing in European bonds and equities.

Over the last couple of months, European assets have benefited from the one-off tailwind of a massive decline in energy prices that brought down headline inflation and supported real spending, even as the ECB tightened policy. Another drop of this magnitude looks unlikely to us, and, if anything, the risk is that China’s reopening could provide support for higher commodity prices. As gas prices have come down, activity in Europe has rebounded a little but remains below potential. We expect further weakness from here, given the headwind of higher interest rates has yet to fully pass through to consumer spending. At the same time, headline inflation has fallen from peaks but remains above 9%, and core inflation has been sustainably around 5% for the past few months. These conditions are challenging for policy makers and likely call for a continued restrictive stance, which will be a headwind to European assets.
With Europe’s Inflation Problem Clearly Ongoing, an Easing Seems Unlikely in the Near Term

Below, we show European short rates along with their discounted forward path. The ECB has increased interest rates 2.5% since beginning to tighten and is discounted to increase interest rates another ~1%. Given the complexion of the recent strength in inflation, the need for further tightening in Europe is clear. Absent a material decline in inflation or a clear contraction in activity that would be on course to crack the labor market and bring inflation down sustainably, it is unlikely we see the ECB pivot away from restrictive policy. This is consistent with policy maker commentary that affirms the need to get inflation under control.

**President Lagarde:** “While energy inflation has recently been coming down, underlying inflation continues to rise. As a result, it is vital that inflation rates above the ECB’s 2% target do not become entrenched in the economy. We must bring inflation down. And we will deliver on this goal.” [January 2023]

**President Lagarde:** “What really matters—and I think that’s embedded in that decision that we took today—is the destination. Where do we want to go? As I said, we have more ground to cover.” [December 2022]
The reality of Europe’s inflation problem and the policy that will be needed to bring it under control looks under-reflected in European bonds and equities. European equities have rallied over 20% from their lows last year as it has become clear that Europe avoided the worst-case scenarios of the energy crisis. At the same time, it has become increasingly clear that the ECB will need to see a meaningful deterioration in economic and labor market conditions in order to reverse course on policy.
Broad-Based Strength in Inflation Is Being Supported by Europe’s Tightest Labor Market in Decades

Inflation is running hot across every major category and is being propped up by high and increasing wages. While some reversion in goods prices is almost certainly ahead of us, persistently high services prices will likely continue to push inflation above the ECB’s target. As you can see below, services inflation remains sticky, we have yet to see evidence of goods inflation beginning to revert, and housing inflation continues to grind upward. The persistence of above-target core inflation, even after a significant tightening, makes it unlikely that we see a pivot in ECB policy until we see evidence of a material and self-reinforcing downturn taking root and of a turning point in core inflation.
The tightness in the European labor market has contributed to the increase in inflation to date and will likely put a floor under how quickly inflation can fall. As the charts below show, Europe's unemployment rate is at multidecade lows, and wages are rising at a very rapid clip. As companies continue to face rising labor costs, they will likely push those costs out to consumers to protect profits. The chart below on the right shows Europe-wide wage growth, along with a timelier measure of the wages posted on online job listings. This measure gives a sense for the clearing price for new workers and is consistent with some cooling off from peaks, but the accumulated divergence suggests that there is likely to be a sustained period of catch-up as wages increase across all workers.

The tight labor market and increased strength in wages have increasingly been a focus of policy makers:

**President Lagarde:** “Wage growth is strengthening, supported by robust labor markets and some catch-up in wages to compensate workers for high inflation. As these factors are set to remain in place, the Eurosystem staff projections see wages growing at rates well above historical averages and pushing up inflation throughout the projection period.” [December 2022]
Falling Energy Prices Have Provided a Partial Relief, but Structurally Higher Energy Prices Are Likely to Be a Multiyear Story

A mild winter and government policies targeted at curbing the industrial uses of natural gas have led to a collapse in energy prices off their prior peaks. The chart below on the right shows Western Europe’s natural gas use since the beginning of 2022 compared to its average consumption—as you can see, Europe is using considerably less energy today than typical for this time of year. The fall in natural gas prices has, in turn, brought down headline inflation and provided some cushion to real spending. That said, Europe’s energy problem is structural, and the economy likely faces years of much higher commodity prices.
European Activity Is Likely to Remain Weak and Slow Further from Here, as the Impact of the Tightening to Date Flows Through to Consumers with a Lag

The two charts below show nominal and real retail sales, indexed to the end of 2019. Increased household spending on energy has weighed on other forms of consumption, causing retail sales volumes to contract. Given the rapid decline in energy prices, we’d expect to see a one-off support to real volumes as household spending is freed up away from energy. But over the next several months, as the impacts of the tightening become more widespread, we’d expect to see further weakness.

![Nominal Retail Sales (Indexed to Dec 2019)](chart1)

![Real Retail Sales (Indexed to Dec 2019)](chart2)

The tightening to date has already begun to pass through to less supportive conditions facing households. Higher borrowing costs have made new mortgage borrowing significantly less attractive and pushed up the debt service costs of existing borrowers. This has already led to a decline in home prices. As these falling prices pass through to a decrease in household wealth, we’d expect to see households spend somewhat less to offset the declines.

![Mortgage Rate](chart3)

![Home Prices (6m, Ann)](chart4)
Surveys of both households and businesses are consistent with weakness though have improved a little in the most recent period. It is difficult to disaggregate exactly how much the surveys are reflecting general dissatisfaction with higher energy prices and the war in Ukraine, but even accounting for those distortions, consumer sentiment has been particularly weak. Confidence remains at secular lows, even as conditions have improved in the short term. PMIs are also consistent with a mild contraction in activity across both manufacturing and services.
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