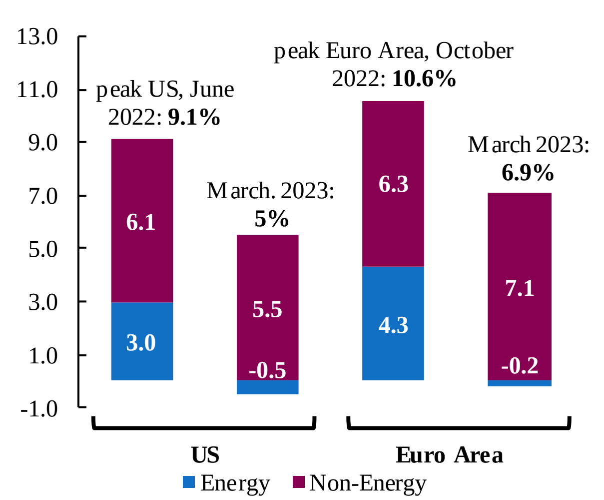
Economic Commentary

A harder than expected inflation battle in the US and Europe

Inflation has been one of the major concerns for the global economy over the last several quarters. This has been particularly pronounced in advanced economies, leading to the most aggressive monetary policy tightening cycle in decades. But headline inflation rates have fallen since the peaks reached last year, and inflation fears have moderated. While the European Central Bank (ECB) and the US Federal Reserve (Fed) are still likely to hike policy rates further, investors and analysts are now focused on understanding when monetary authorities will pivot, i.e., to pause the rate hiking cycle and perhaps even start easing.

There is no doubt that high inflation rates are set to moderate further over the coming months. However, in our view, it will be difficult for the ECB and the Fed to bring inflation back below the 2% target without maintaining higher policy rates for longer. Two main factors that support our view are related to inflationary pressures from energy prices and the tight labor market conditions in the US and the Euro Area (EA).

Inflation Breakdown in the Euro Area and US
(%, year over year)

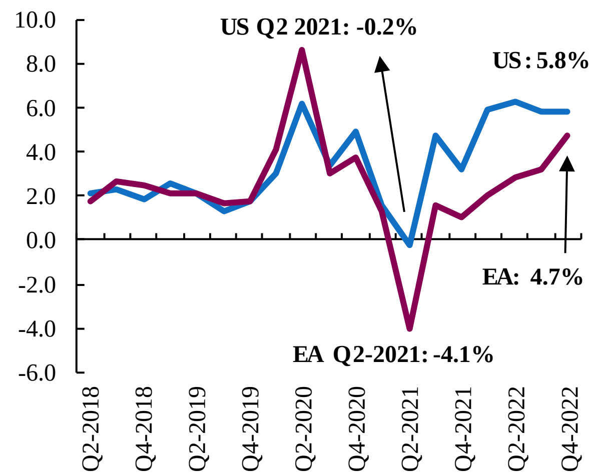


Source: US Bureau of Labor Statistics, Eurostat, QNB analysis

First, falling energy prices have been an important factor behind the easing of headline inflation since the peak in mid- to late 2022. But this downward trend may be exhausted. The Brent oil price peaked at around USD 124 per barrel (p/b) in June of last year, and averaged USD 73.4 in March 2023. The drop in energy prices had a significant impact on overall inflation. At the inflation highs in 2022, energy costs explained 3 and 4.3 percentage points (p.p.) of the headline measure for the US and the EA, respectively. More recently, the contributions of energy actually implied negative impacts of -0.5 p.p. in the US, and -0.2 p.p. for total inflation in the Euro Area, therefore explaining a large proportion of the drop in inflation rates from their peaks.

However, oil prices have recently increased after the surprise announcement by OPEC+ members of a petroleum production cut of 1.15 million barrels a day (mb/d). Furthermore, despite the market view that the recovery in economic activity in China is not as strong as expected and has already come to an end, we believe that there is further upside in China’s overall post-Covid recovery. From our perspective, this will strengthen demand and provide further support for rising energy prices in the medium term. Consequently, we would anticipate inflationary pressures from energy going forward.

Unit Labor Costs in the Euro Area and the US
(%, quarterly, year over year)



Source: OECD, QNB analysis

Second, core measures of inflation that exclude volatile items, such as food and energy, are showing significant persistance, suggesting that underlying price pressures remain firm in spite of the record monetary policy tightening measures implemented by the ECB and the Fed. One of the main drivers for non-energy inflation are tight labor markets, which continue to put pressure on labor costs. This is an indirect but important factor that influences all non-energy price components.

In the US, the unemployment rate averaged 3.5% this year so far, close to its historical minimum, while the labor force participation rate still has not recovered to pre-pandemic levels. In Europe, the unemployment rate at 6.8% is also close to its historical minimum. These tight labor market conditions result in the growth of wages, and therefore the costs for firms. The most recent releases of unit labor costs, for the last quarter of 2022, showed increases of 4.7 and 5.8% for the EA and the US, respectively, with an upward trend in the case of the European economy.

This increase in costs will continue to put pressure on inflation going forward, particularly in the labor intensive service sector, as firms mark up prices to minimize compression in their profit margins. In the US, non-energy inflation has fallen to 5.5% in March, implying a drop of only 0.6 percentage points since June, which is still far from the 2% target. Even more striking, in the Euro Area, non-energy inflation is rising and reached 7.1% in March.

The behaviour of core inflation is particularly important since monetary policy has little influence on commodity prices. In addition, central banks would like to see more definite signals that interest rate hikes are having a concrete effect on inflation fundamentals to guide their future decisions.

All in all, in spite of the significant moderation of headline inflation, it is too early to declare a victory against high inflation, and to expect the ECB and the Fed to pivot. Positive developments with headline inflation have been heavily dependent on volatile energy prices, and core inflation remains too high for comfort in a context where labor markets are still tight and producing high wage growth.

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