

Flash Comment

Inflation will remain far below ECB's 2% target in 2015

Inflation in the euro area declined to 0.7% in October. The very low figure was not a one-off but the result of the combination of low wage pressure and the end of the super-cycle in commodity prices.

Following the weaker-than-expected inflation figure we now project average inflation at 0.8% in 2014 and an increase to 1.1% in 2015.

The projection is based on the following forecast for the subcomponents.

- **Core inflation** will remain low in 2014 and slowly start to increase in 2015. Core inflation mainly depends on prices in the service sector, which are highly dependent on labour as an input, so the subdued core inflation in 2014 reflects the high unemployment rate and the low wage pressure. In 2015, when economic growth is expected to pick up, the unemployment rate will start to decline and there will be a moderate wage pressure.
- **Inflation in food prices** is also expected to slow down due to the end of the super-cycle. In the first 10 months of 2013 average inflation in food prices was 3.0% and was above overall inflation. The end of the super-cycle implies food prices are expected to increase around an average of 1.5%. Hence, overall growth will be closer to core inflation.
- **Inflation in energy prices** is projected to continue to be negative until mid-2015. This follows as supply is getting a boost due to new technologies to make most of the countries' shale formations in terms of natural gas and oil output. Additionally, growth in oil demand is slowing as growth in China is lower and less energy intensive.

There is an upside risk to our inflation forecast for 2014 stemming from the increase in the Italian VAT in October 2013. So far it does not seem that the higher VAT has spilled over to consumer prices but it can take some time before inflation starts to increase. In case the VAT increase affects consumer prices, the effect on inflation is expected to come in gradually and should add 0.2pp to euro inflation during 2014. However, the effect from the higher VAT will not change the underlying development in inflation and will drop out in 2015.

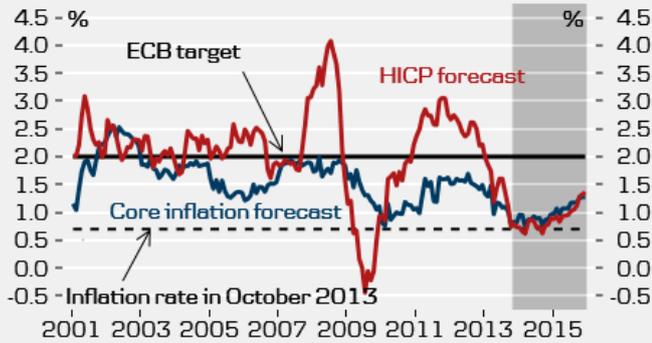
The lower euro inflation is a result of a decline in inflation in the periphery as well as in the core countries. Most core countries inflation rates are moving below the 2% target and the inflation rates in the periphery countries are generally balancing around deflation.

The outlook for inflation being much lower than the ECB's 2% target implies we expect the ECB to cut the refi rate by 25bp at the ECB meeting in December.

The lower inflation adds support to growth in the euro area. Lower inflation – driven by commodity prices – increases real income and hence purchasing power. In the euro area real wage growth is now rising 0.8%. This is a clear improvement from the decline in real wages of around 1% that took place in 2011 and 2012.

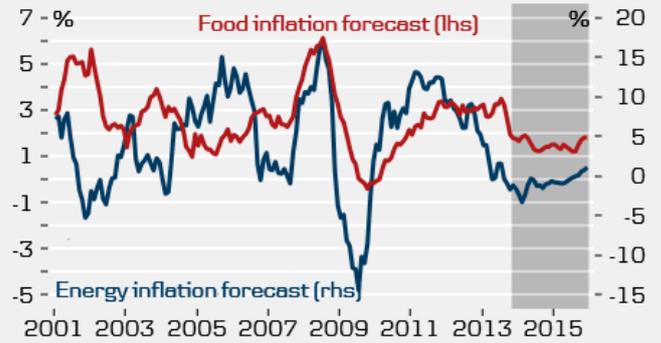
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Inflation expected to remain below ECB target in 2014 and 2015



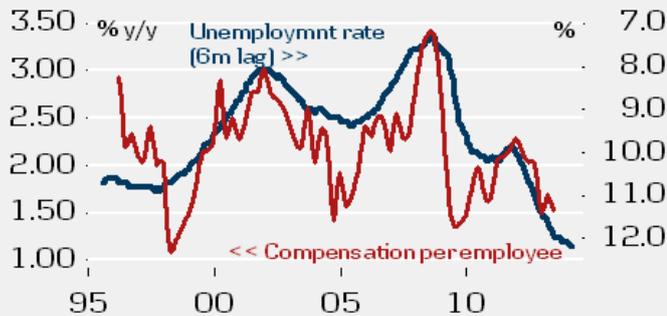
Source: Eurostat, Danske Bank Markets

Inflation in food and energy will be lower looking ahead



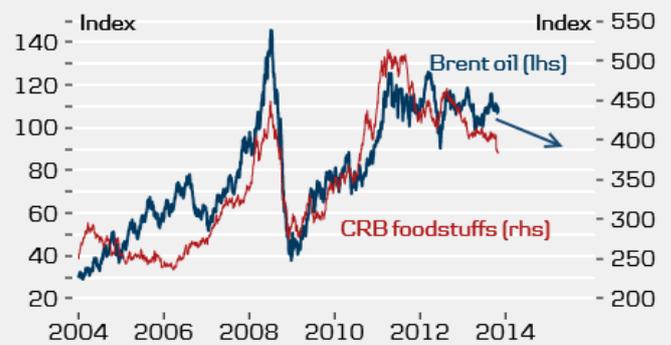
Source: Eurostat, Danske Bank Markets

High unemployment gives low wage pressure



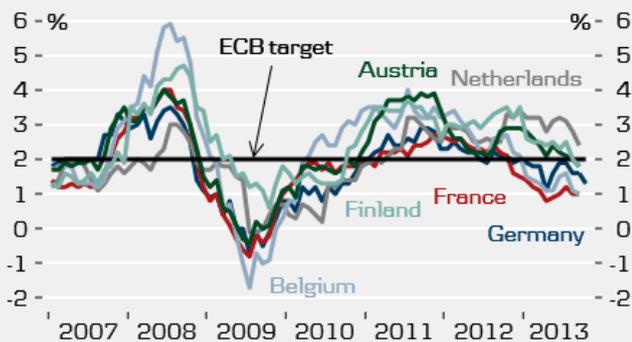
Source: Reuters EcoWin

End of super-cycle results in lower commodity prices



Source: Macrobond

Core countries inflation rates moving below ECB's target



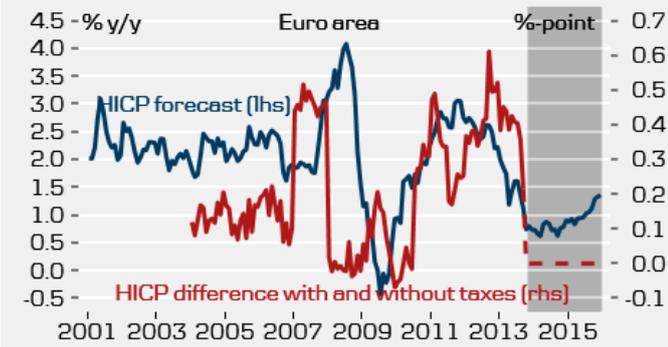
Source: Eurostat

Balance around deflation in periphery countries



Source: Eurostat

Upside risk to inflation forecast from higher Italian VAT



Source: Eurostat, Danske Bank Markets

Lower euro inflation gives lift to real wage growth



Source: Reuters EcoWin

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