BANQUE CENTRALE DU LUXEMBOURG
EUROSYSTEM

Is Inflation back?

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Keynote Address

Bank Finance 2011 Conference

Thursday, 3 March 2011
Frankfurt, Germany

- Check against delivery -

Headline inflation in the euro area is on the rise. According to Eurostat's flash estimate euro area annual HICP inflation increased by 0.1 percentage points to 2.4% in February. This figure is more a snapshot than an incipient violation of the ECB's medium- term-oriented definition of price stability, - namely of inflation below but close to 2% - , but there is no room for complacency.

The key question is whether we are facing a "hump" – in other words, is this acceleration in headline inflation temporary –, or is it the edge of a plateau, where the pressure on prices is more persistent than currently assumed.

The judgment on this is three-forked: we envisage a good, a bad and an ugly scenario. The good scenario, i.e. the good news, is that we have been here before. Temporary increases in headline inflation have not prevented the ECB from managing to keep the average annual inflation rate in the euro area at 1.97 over the past 12 years. The bad news is that things might be slightly different this time, as forecasting inflation is, indeed, a complex task. The really ugly news is that there may be even drivers at work that could lead to errors in forecasting inflation significantly, especially in underestimating future price levels.

Let me discuss this in more detail.

The good scenario: the hump scenario is the most benign

Annual headline inflation in the euro area increased steadily in the course of 2010, from 1.0% in January to 2.2% (in December, an increase of 1.2 percentage points within one year. This 11-month increase in headline inflation is due) almost entirely to the food and energy components of the HICP.

Crude oil prices, for example, have surged by around 35% over the last half year, peaking above 120 Dollar very recently, and pushing up import prices. Recent political turmoil in some oil exporting countries in the Arabian world may lead to further price increases.

The contribution from the other components of the HICP basket was relatively stable, though mildly accelerating.

According to the consensus among monetary authorities, these sources of price pressure can and should be ignored by central banks, as long as the increases are truly temporary and inflationary expectations stay anchored at levels consistent with price stability: One-off and unpredictable price shocks cannot be tackled by the traditional instruments of monetary policy. Nevertheless, second-round effects must be avoided by all means. They materialize when a one-time shock, e.g. a transitory price hike, becomes entrenched in other prices, particularly through a wage-price spiral. Has this happened in 2010? Labour cost indicators were subdued in the third quarter of 2010 and data on euro area negotiated wages for the fourth quarter suggest an ongoing moderate growth in wages. But industrial producer prices (construction excluded) increased significantly in the course of 2010 and reached the level of 5.3 % in December.

Today we have published the ECB's staff projections on growth and inflation in the euro area. The time horizon of these staff projections is similar to that in which monetary policy has its effects, namely 18-24 months. According to the staff figures that have been significantly revised upwards from earlier projections, overall HICP inflation is projected to stay above 2% for the rest of this year, with annual inflation averaging 2.3% in 2011. Thereafter, average inflation is projected to decline to 1.7% in 2012.

The growth projection has also been revised upwards compared to December. Real GDP is expected to grow by 1.7% and 1.8%, respectively, in 2011 and 2012.

According to this scenario, one might expect a "hump" in inflation, i.e. suggesting the observed increase in the inflation rate is only temporary.

The bad scenario: the complexity of inflation forecast

The problem is that one cannot be sure that this benign scenario will come true. Forecasting inflation is a difficult task – this holds in particular for times of increased uncertainty like in the aftermath of a financial crisis and, more recently, political exceptionality.

Even in normal times, the models may be wrong. Let me mention only some potential sources of error.

- Firstly, although there are sound reasons generally to treat shocks to the economy as one-time events, the cumulative effect of a series of shocks, and thus on the development of the price level, cannot be excluded. The standard macroeconomic models also widely used in central banks tend to underestimate headline inflation. In the first 12 years since the introduction of the Euro, the staff projections performed well as far as core inflation was concerned. The projection of the head line inflation, however, was systematically too low, because – among other reasons - the scale of the pass-through of past energy or commodity price shocks into output prices has been underestimated.

- Secondly, upward risks to headline inflation stem from pronounced base effects. Base effects occur when variations in the annual growth rate of the HICP are the result of an atypical movement in the index in the base period. They tend to be particularly influential during periods when inflation volatility 12 months earlier was high, for example as a result of sharp movements in commodity prices. It is expected that 2011 will benefit from negative cumulative base effects from energy and food in 2010 of up to 0.7 percentage points.

– Thirdly, the choice of leading sub-indicators is a tricky one. Let me give an example. In recent years energy prices, namely for crude oil, contributed to an increasing extent to the volatility of headline inflation. There is, in fact, not just one price for “oil”. Traditionally West Texas Intermediate (WTI) commands a higher price than Brent crude. Most recently the price differences between the two benchmark sorts of crude oil showed anomalies: on 1 March, WTI was trading around 100 US Dollar per barrel, while Brent was at 114 US Dollar per barrel. While this huge difference could be partially explained by regional factors like the cold winter in Europe and the large stock of WTI oil in the US, the reliability of these prices to signal global scarcity can be questioned.

– Fourthly, one major driver of inflation is the dynamics of the economy. To measure the slack in the economy, the deviation of aggregate demand from the economy’s potential supply - the so-called “output gap” - is often seen as a helpful guide for policymakers. On this logic, inflation rises, when aggregate demand exceeds potential output. However, the concept of a stable relationship between output gap and inflation is not only frequently challenged in theory but also hard to apply in practice. The operational appropriateness of the output gap as a guide to policy is limited by the availability of reliable real-time estimates. For example, estimates of the euro area output gap, as published by international organizations from 1999 to 2004, underwent significant revision. Some revisions matched or even exceeded the original estimate of the gap itself.

Complexity has increased further because of the financial crisis: In this context, the crisis has had two effects:

– In the first place, the crisis triggered a probable one-off permanent loss in the level of potential output, in particular because of the downsizing of the financial and construction sectors. Whether the longer-term growth rate of potential output will also be affected, remains to be seen. In any case, the reliability of output-gap measures as real-time clues to future inflation is weakened.

– In the second place, the financial crisis has impacted the effectiveness of monetary policy. The exceptional liquidity requirements of banks after the drying-up of the money market in the summer of 2007, as well as the severe tensions in some segments of the market for euro-area government bonds, have affected the transmission channels of monetary policy in the euro area. To restore the effectiveness of monetary policy, the authorities have had to adopt several unconventional measures of temporary nature.

The general complexity of the art of forecasting inflation, coupled with heightened uncertainty in the aftermath of the financial crisis, calls for prudence and humility. Policy makers have to be wary when deducing real-time policy implications from inflation forecasts. For the euro area, a thorough exchange of views between all members of the governing council of the ECB is of utmost importance in bringing to bear a great wealth of experience.

The ugly scenario: the threat of a plateau

At the current juncture, new sources of inflationary pressure may emerge. Below the surface may lie new potential threats to price stability. Let me highlight three of them.

- Firstly, the combination of dynamic economic growth, accompanied by accelerated inflation in emerging markets, and an intensification of world-wide linkages bears the risk that imported inflation will come to play a larger role in domestic price levels in the industrialized world. For instance, the current increases in prices of certain agricultural products and raw materials may be more persistent than currently assumed. In other words: The disinflationary impact of globalization, from which the industrialized world has benefited in the last 20 years, could turn into an imported inflationary impact.

  The lagged effect of food prices could still add a layer of headline inflation.

- Secondly, in several countries of the euro area, the diminishing labour force presents a demographic challenge kicking in 2013. There is anecdotal evidence that, in countries characterized by a dynamic recovery, there is already a shortage of skilled workers such as electricians. With resistance to adjust pension ages or to extend participation rates among age or gender cohorts with low employment, this all in all may cause an upward pressure on wages, bearing the risk of a wage-price spiral. Informal contacts with NFC point to expectations of wages rising in 2011 in line with inflation.

- Thirdly, the output gap may be closing faster than anticipated - not to mention the measurement problems attached to that leading indicator of inflation. As the economic recovery continues, there are new indices, which we will have to follow closely. For example, capacity utilization is coming back very rapidly to normal. In accordance, the European Commission’s February 2011 surveys in the manufacturing sector have shown a particularly steep rise in selling price expectations to a level even surpassing the 2008 peak. Spillovers to producer prices and producer prices of consumer goods are only a question of time. Moreover, the momentum for structural reform to lift potential growth is still a bit lackluster. A raised potential for growth could somewhat ease inflationary pressures.

Concluding remarks: Credible and effective alertness

The scenarios I mentioned should not be interpreted as predictions. Nor can one attach precise probabilities to any of them. They indicate, however, that our assessment of risk to the medium-term outlook for the price level in the euro area needed to be adjusted upwards.

The Governing Council of the ECB will make sure that the uncomfortable scenario will not materialize, and that the assumed temporary increase in the inflation rate will not prevail over the medium term.

If indirect and second-round effects were to materialize on large scale, monetary policy would be reactive instead of being ahead of the curve. Once the genie of inflation is out of the bottle it might be too late. In order to avoid these effects, we will exert strong vigilance.

Therefore, be assured that any threat to price stability in the medium term will be combated preemptively and vigorously. We will not let the genie out of the bottle.