Flash Economics

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Towards stagflation in the euro zone?

The financial markets are anticipating a further sharp fall in inflation and interest rates in the euro zone.

However, we favour another scenario: the emergence of stagflation with weak growth and persistent inflation.

Growth in the euro zone will be weak as a result of demographic ageing, the absence of productivity gains, and low levels of R&D spending and of investment in new technologies.

Underlying inflation will remain well above 2%, with the absence of productivity gains, the decline in the working-age population perpetuating tensions on the labour market, and the on-going conflict over income sharing between employees and companies.

As a result of this stagflationary situation, the potential for interest rate cuts is limited if the ECB keeps its inflation target at 2%.

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Financial markets anticipate a further sharp fall in inflation and interest rates in the euro zone

When we look at 5-year **inflation swap in 5 years** in the euro zone (**Chart 1**), or when we look at **short-term and long-term interest rate expectations** (**Charts 2A/2B**), we see that the financial markets continue to **anticipate disinflation and falling interest rates.**

Chart 1
Euro zone : 5-year inflation swap in 5 years (en %)



Chart 2A
Euro zone: Euribor contracts (3-month)

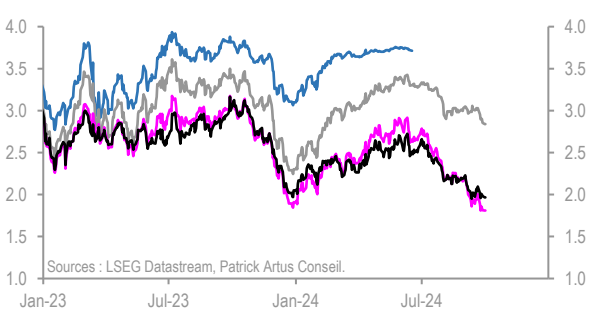
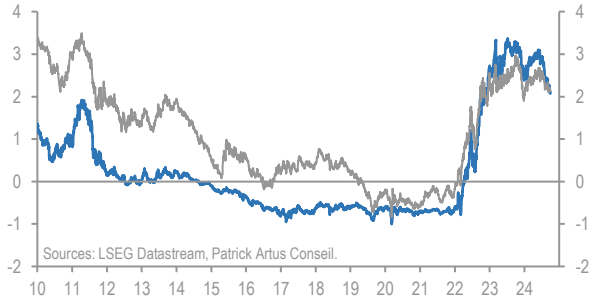


Chart 2B
Germany: Interest rate on 10-year and 2-year government bonds (as %)



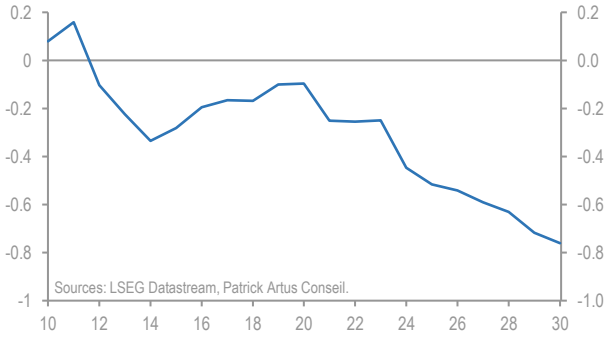
In reality, one can believe that the most likely scenario is different; **it is one of stagflation, with fairly high inflation and low growth.**

Why is growth weak in the euro zone?

Growth in the euro zone will remain weak due to :

- The decline in the working-age population (Chart 3);

Chart 3
Population aged 15 to 64 (as % per year)



- The stagnation in productivity (Chart 4), which is linked to the low level of R&D spending and of investment in new technologies **(Charts 5A/B).**

Chart 4
Euro zone : Productivity per capita (20101 = 100)

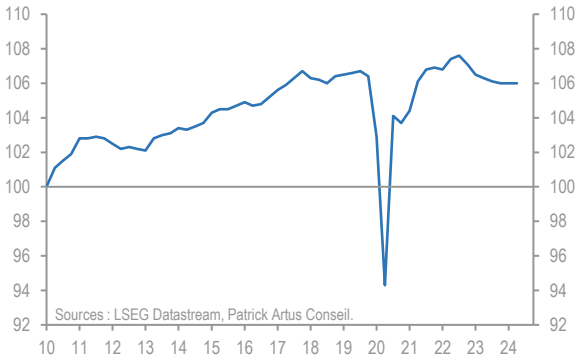


Chart 5A
Total R&D spending (as % of nominal GDP)

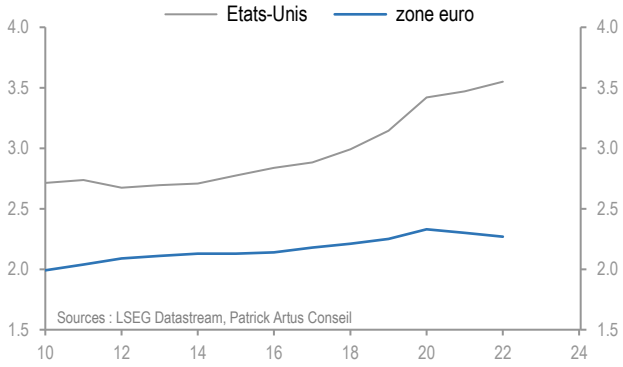
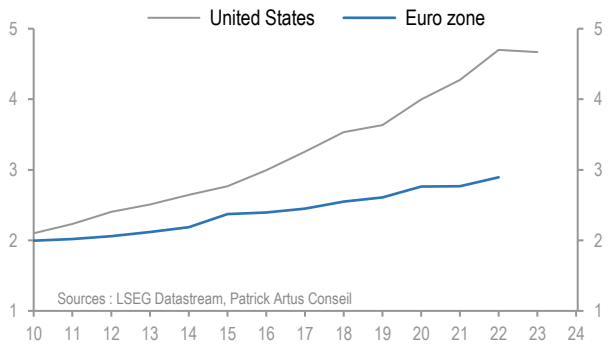


Chart 5B
ICT investment including software
(in volume terms, as % of real GDP)

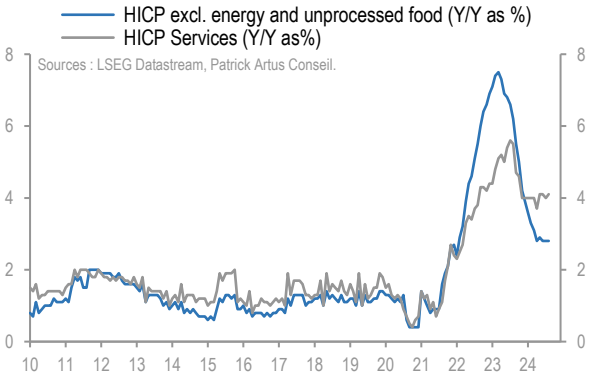


As long as there is no increase in immigration, no increase in R&D spending or investment in new technologies leading to a recovery in productivity gains, growth in the euro zone will remain weak.

Why will inflation remain fairly high in the euro zone?

Inflation excluding energy and unprocessed food remains close to 3% in the euro zone, well above the ECB's target; increases in **service prices** are above 4% (**Chart 6**).

Chart 6
Euro zone: Core inflation and consumer price index for services

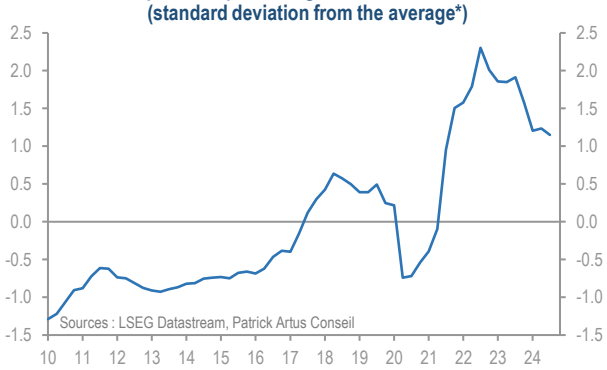


This persistent inflation is the result of:

- The absence of productivity gains (Chart 4 above);

- Persistent tension on the labour market (Chart 7) due in particular to the absence of productivity gains, which must be compensated by the creation of many jobs;

Chart 7
Companies experiencing recruitment difficulties
(standard deviation from the average*)



(*) Weighted average, standardised data

- A conflict in the distribution of income between wages and profits, with companies trying to restore their profit margins (**Chart 8**) and employees trying to gain purchasing power despite the absence of productivity gains, leading to sharp rises in wages and unit labour costs (**Chart 9**).

Chart 8
Euro zone: Ratio between GDP deflator and unit labour cost (2010 Q1 = 100)

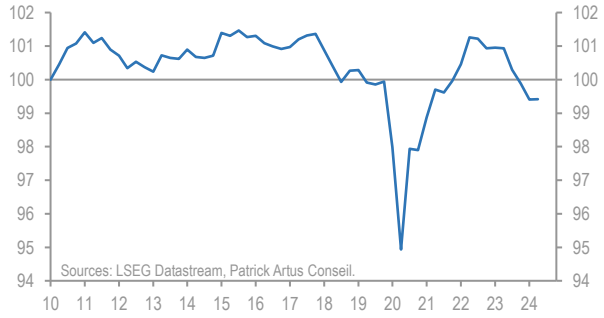
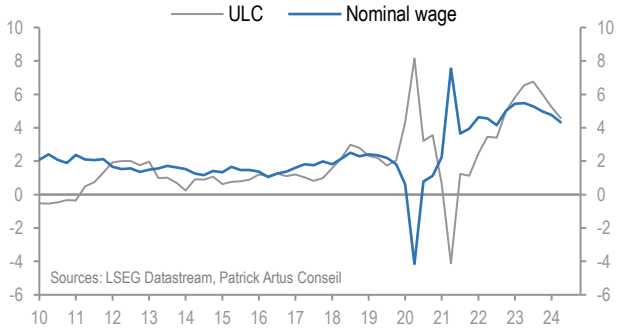


Chart 9
Euro zone: nominal wage per capita and unit labour costs (Y/Y as %)

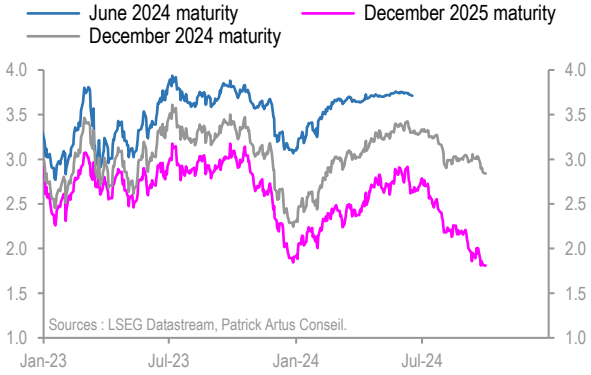


Summary: stagflation is the worst situation for a central bank

We therefore favour the scenario of stagflation (low growth and resilient inflation) in the euro zone. Stagflation is the worst scenario for a central bank because there is a contradiction between the objective of supporting growth and that of fighting inflation.

As long as the ECB maintains its inflation target of 2%, the fact that inflation (once energy prices stabilise) remains well above 2% will limit its ability to cut interest rates. The financial markets anticipate interest rates falling to 1.8% by the end of 2025 (**Chart 10**), but this will be extremely unlikely if underlying inflation remains close to 3%.

Chart 10
Euro zone: Euribor contracts (3-month)



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