Flash Economics

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The difficulty for the ECB arising from the large differences between inflation in services and inflation in industry

The ECB is faced with a situation where:

- Total inflation is slightly above 2% (2.3% in November 2024); excluding energy and food, it is 2.7% (year-on-year in November) and, as the year-on-year fall in energy prices disappears, inflation will reach the level of underlying inflation;
- The rise in services prices (3.9% year-on-year in November 2024) reflects the rise in unit labour costs (4.5% year-on-year);
- The rise in industrial product prices (0.7% year-on-year in November 2024) is weak despite the rise in unit labour costs in industry (more than 5% year-on-year in Q3 2024) due to the sharp fall in profit margins in industry;
- Nominal wages continue to rise rapidly (4.5% year-on-year in Q3 2024), reflecting the persistent tightness in the labour market caused by the lack of productivity gains.

If the ECB focuses on headline inflation or core inflation or wage inflation, it has little room for manoeuvre in cutting interest rates; but if it focuses on low manufacturing inflation and falling profit margins and output in industry, it may be tempted to cut interest rates sharply to support industry.

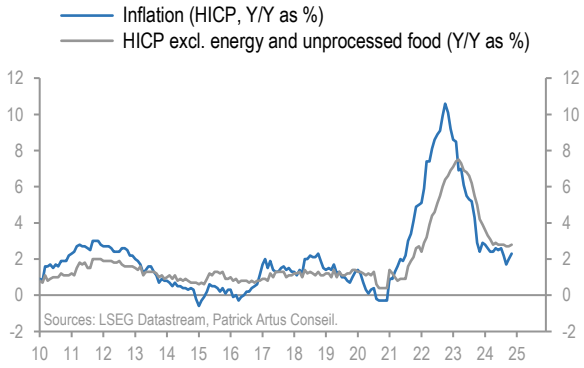
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Strong differences between inflation in services and inflation in manufacturing in the euro zone

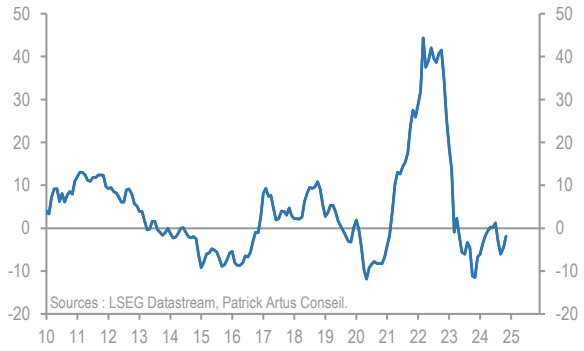
Total inflation was 2.3% year-on-year in the eurozone in November 2024 and has been rising gradually since September; core inflation excluding energy and unprocessed food was 2.7% year-on-year in November 2024 and has been stable for several months **(Chart 1).**

Chart 1
Euro zone: Inflation and core inflation



The fall in **energy prices** will disappear in a few months (**Chart 2**), and **total inflation will therefore return to the level of underlying inflation**.

Chart 2
Euro zone: Energy consumer price index (Y/Y as %)



Wages continued to rise by 4.5% year-on-year, both in the economy as a whole and in industry (**Chart 3**).

Chart 3
Euro zone: Nominal wage per head in the overall economy and in the manufacturing sector (Y/Y as %)



Since **labour productivity** is falling at least as fast in the economy as it is in manufacturing (**Chart 4**), **unit labour costs** (**Chart 5**) are rising in line with wages, i.e. rapidly (**Chart 5**).

Chart 4
Euro zone: Productivity per head in the overall economy and in the manufacturing sector (Y/Y as %)

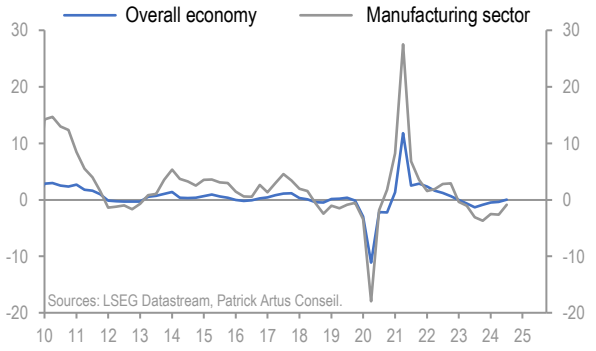
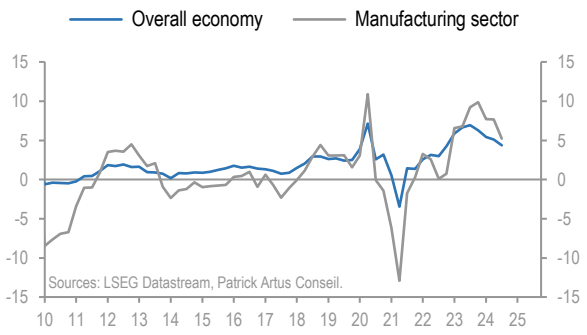
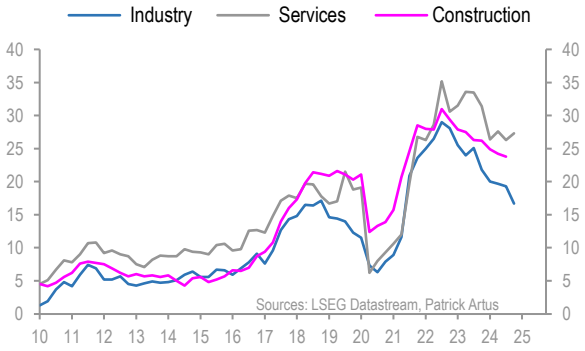


Chart 5
Euro zone: Unit labour cost in the overall economy and in the manufacturing sector (Y/Y as %)



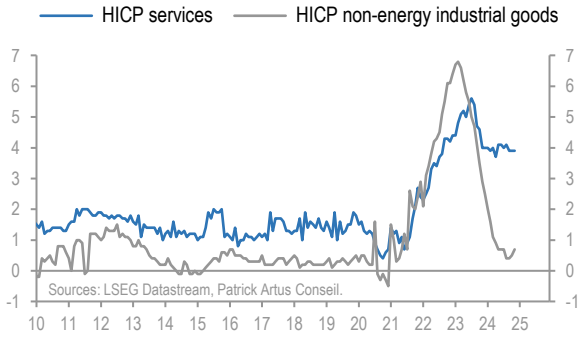
The absence of productivity gains means that even if growth remains weak, employment continues to rise, and since the working-age population is declining, **tension on the labour market remains high** (**Chart 6**), which explains why wage increases remain high.

Chart 6
Euro zone: Companies experiencing recruitment difficulties (as %)



One can see **that service prices are rising at roughly the same rate as unit labour costs, while manufactured goods prices are rising very slowly** (0.7% year-on-year in November 2024), **Chart 7**.

Chart 7
Euro zone: Consumer price indices of services and non-energy industrial goods (Y/Y as %)



The big differences between price rises in services and manufactured goods is due to foreign competition, which is holding back industrial prices, and to the fall in industrial output (**Charts 8/9**).

Chart 8
Euro zone: Manufacturing and services PMI (indices)

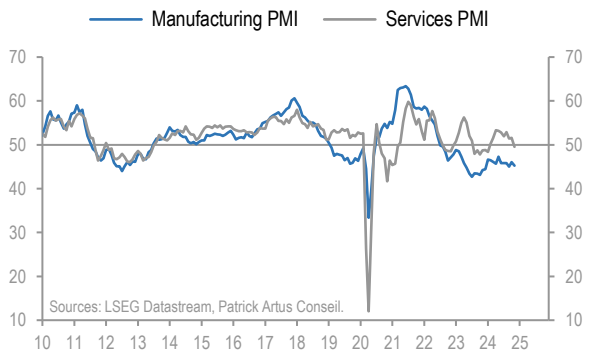
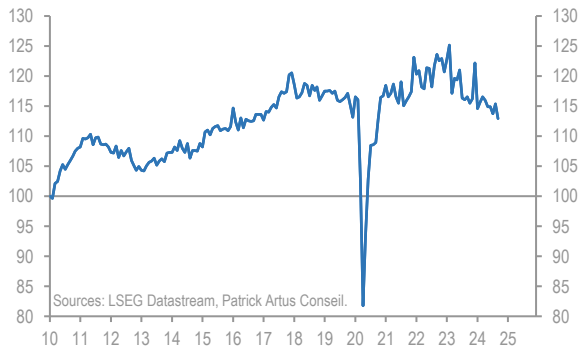
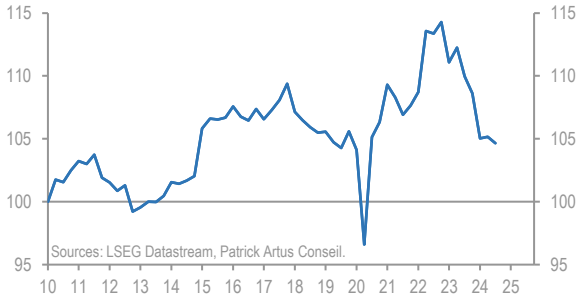


Chart 9
Euro zone: Manufacturing production (2010.M1 = 100)



As a result, **profit margins in the manufacturing industry have fallen sharply** (**Chart 10**) since the beginning of 2022.

Chart 10
Euro zone: Ratio between value added deflator and unit labour cost in manufacturing industry (2010.Q1 = 100)



This difference between the rise in prices of services and that of manufactured goods has major consequences:

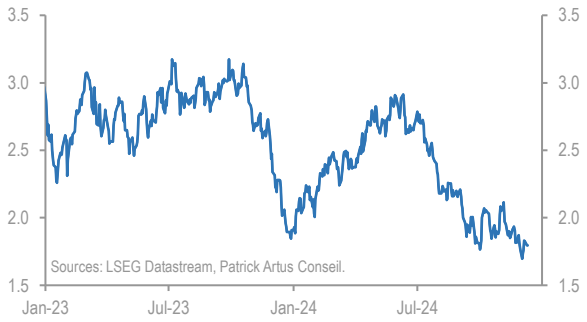
- discouragement of investment in industry, and **distortion of the economy in favour of services** (the 'Dutch disease') ;
- **difficulties in determining the ECB's monetary policy stance.**

Summary: How will the ECB react?

While the ECB is essentially reacting to the outlook for inflation, underlying inflation and unit labour costs, since inflation will remain well above 2% (it is converging towards underlying inflation), **it has limited scope for cutting interest rates** (the deposit rate is currently 3.25%).

But the markets believe that the ECB will cut interest rates significantly (the short-term interest rate at the end of 2025 is expected to be 1.80%, **chart 11**).

Chart 11
Euro zone: Euribor contracts
(December 2025 maturity, 3-month)



This shows that financial market operators are making the assumption **that the ECB will react to weak activity in industry and falling profit margins in industry**, and not to overall inflation or rising unit labour costs.

There is a risk that the markets will overestimate the extent to which the ECB will cut its key rates, since it is hard to believe that the ECB will cut interest rates aggressively if inflation is above 2.5% in a few months' time.

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