Flash Economics

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Inflation remains an issue in the euro zone, yet it has not been addressed so far by the ECB

Although annual inflation in the euro zone stood at just 2.2% in April 2025, core inflation – which excludes energy and unprocessed food – rose to 2.7% year-on-year (up from 2.5% in March 2025), driven by accelerating service prices, which increased by 3.9% over the year to April (compared to 3.5% in March).

The pace of inflation remains broadly consistent with wage growth – negotiated wages rose by 4.1% in the fourth quarter, with an estimated increase of around 3.5% expected by the end of 2025 – in a context of stagnant productivity (which pushes inflation up) and declining corporate profit margins (which exerts downward pressure on inflation). In its March 2025 economic outlook, the ECB forecasted a 3% rise in unit labour costs in 2025, followed by a 2% increase in 2026, with productivity expected to recover, particularly in 2026, and corporate margins expected to decline mainly in 2025.

However, if productivity fails to recover and corporate profit margins stabilise, core inflation is likely to remain close to 3% by the end of 2025, rather than converging towards 2%.

There is therefore a significant risk that inflation will remain well above 2% at the end of 2025, casting doubt on the financial markets' scenario, which still anticipates two interest rate cuts by the ECB in 2025 (bringing the deposit rate down to 1.75%). Similarly, the long-term inflation expectations priced in by financial markets may well prove too optimistic.

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Core inflation is no longer slowing in the euro zone

While **headline inflation** in the euro zone continues to ease (standing at 2.2% in April 2025), largely due to falling energy prices (**Chart 1**), **core inflation** – which excludes energy and unprocessed food – remains high at 2.7% in April. This is driven by persistent strength in services inflation (**Chart 2**).

Chart 1
Euro zone: Inflation and energy consumer price index

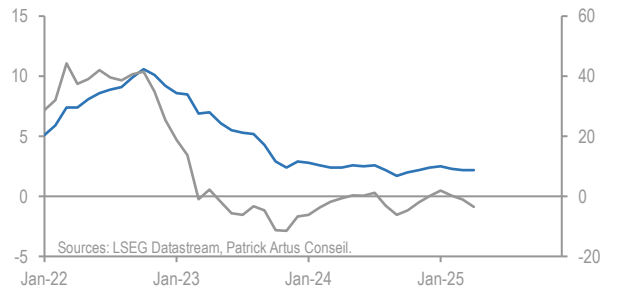
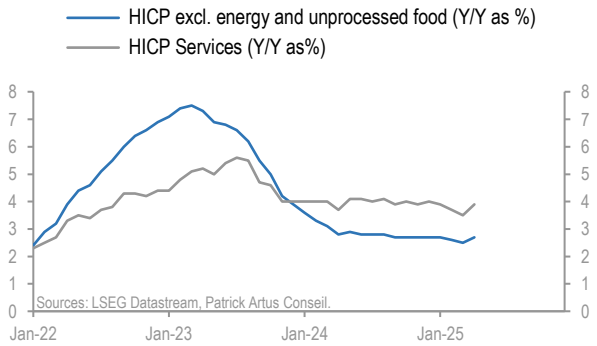


Chart 2
Euro zone: Core inflation and services inflation (as %)



The inflationary pressure stems from rising unit labour costs and changes in corporate profit margins

Per-head wage growth reached 4.1% in the fourth quarter, and **unit labour cost growth** also stood at 3.7% in the same period (**Chart 3**).

Chart 3
Eurozone: nominal wage per employee and unit labour costs (Y/Y as %)



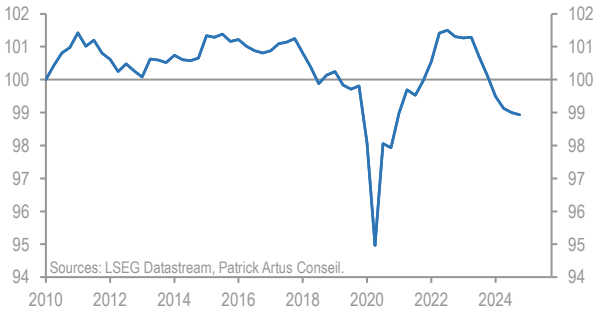
The euro zone has suffered from a **lack of labour productivity gains** since 2017, which has contributed to upward pressure on unit labour costs (**Chart 4**).

Chart 4
Euro zone: Productivity per head (Y/Y as %)



Conversely, inflation has been dampened **by a decline in corporate profit margins**, a trend visible since early 2023 (**Chart 5**).

Chart 5
Euro zone: Ratio between GDP deflator and unit labour cost (2010.Q1 = 100)



If productivity fails to pick up and if profit margins stabilise, core inflation in the euro zone is likely to remain well above 2%

According to the **ECB's March 2025 macroeconomic projections**, the central bank anticipates:

- A 3% rise in unit labour costs in 2025, followed by a 2% increase in 2026;
- A rebound in productivity beginning in 2026;
- A decline in corporate margins during 2025.

Based on these assumptions, the ECB forecasts core inflation of 2.2% in 2025 (driven by lower margins) and 2% in 2026, which would then align with the pace of unit labour cost growth (supported by a productivity recovery).

However, the ECB does not consider the possibility that margins could stabilise as early as 2025 and that productivity may fail to recover.

In reality, profit margins have already begun to contract at a slower pace since late 2024 compared to 2023 and early 2024. At the same time, productivity growth has remained subdued throughout 2024.

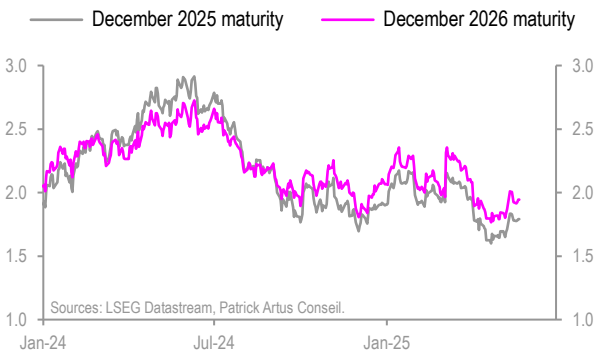
If these conditions persist, **core inflation is likely to stay above 2.5% – and could approach 3% – by the end of 2025**.

Summary: The financial market scenario should be viewed with caution

Financial markets currently expect:

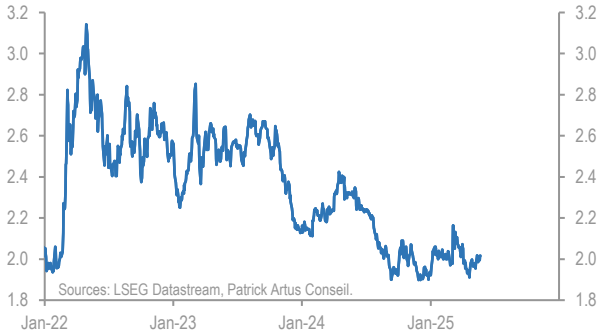
- **That the ECB will cut interest rates by a further 50 basis points in 2025 and will only raise them modestly in 2026**;

Chart 6
Euro zone: Euribor contracts (3-month)



- That long-term inflation will stabilise at around 2% annually (Chart 7).

Chart 7
Euro zone : 10-year inflation swap (as %)



Both assumptions made by financial markets will prove incorrect if core inflation remains close to 3%: interest rate cuts will be halted, and long-term inflation expectations will rise.

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