Flash Economics

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Inflation in the euro zone has not been defeated

Total inflation has been rising for several months, and core inflation is stable at 2.7%. Total inflation may seem low, but this is due to the fall in energy prices (which will disappear) and the sharp fall in profit margins in industry.

In reality, with tension still high on the labour market and the absence of productivity gains, unit labour costs have continued to rise fairly rapidly and the prices of services have continued to rise sharply.

It is therefore highly unlikely that the ECB will cut interest rates by as much as the financial markets anticipate (to 1.80% at the end of 2025 for the deposit rate). As a result, with expected short-term interest rates revised upwards and with contagion from long-term interest rates in the United States, which will be pushed up by inflation resulting from the economic policies pursued by Donald Trump, we can expect a substantial rise in long-term interest rates in the euro zone.

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What is the outlook for inflation in the euro zone?

Inflation in the euro zone has been rising since September 2024 (Chart 1), and since the year-on-year fall in energy prices will disappear (Chart 2), **total inflation in the euro zone will converge towards the level of inflation excluding energy and unprocessed food** (Chart 1).

Chart 1
Euro zone: Inflation and core inflation

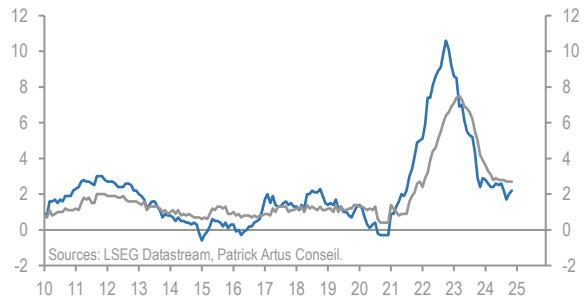
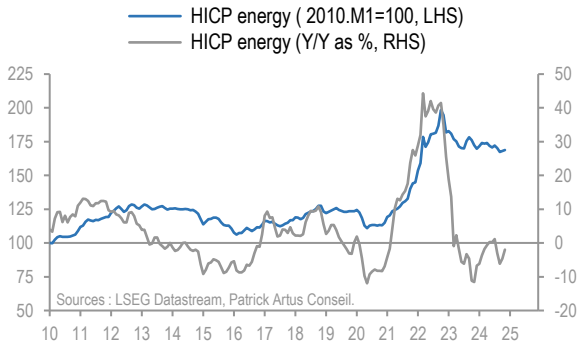


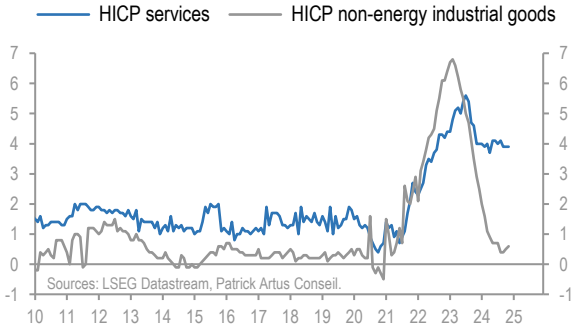
Chart 2
Euro zone: Energy consumer price index



Total inflation in the euro zone currently appears low due to:

- the fall in energy prices;
- **the squeeze of profit margins in manufacturing**, which explains the slight rise in prices of manufactured goods compared with prices of services (Chart 3).

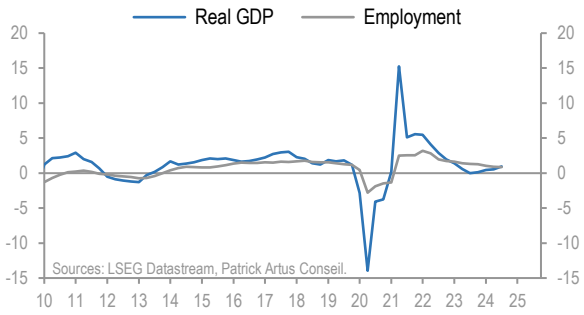
Chart 3
Euro zone: Consumer price indices of services and non-energy industrial goods (Y/Y as %)



Wage inflation set to remain high

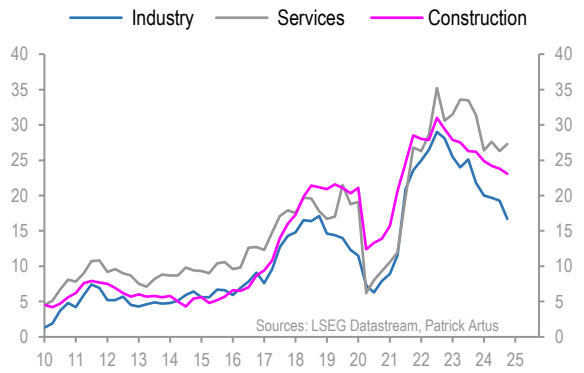
The absence of productivity gains in the euro zone means that employment continues to grow even if growth in the euro zone is weak (Chart 4).

Chart 4
Euro zone: Real GDP and employment (Y/Y as %)



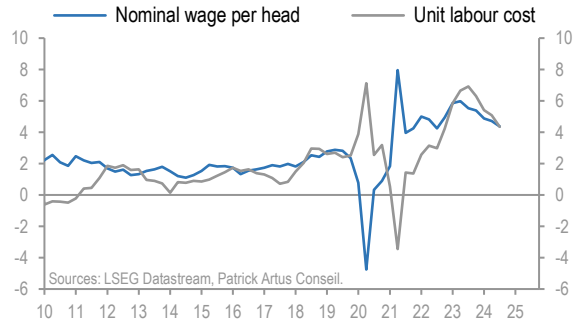
As a result, **pressure on the euro zone labour market** remains high (**Chart 5**), even though growth is weak.

Chart 5
Euro zone: Companies experiencing recruitment difficulties (as %)



As a result, **wages and unit labour costs** are rising rapidly, by 4.5% in 2024 and probably by 3.5% in 2025 (**Chart 6**).

Chart 6
Euro zone: Nominal wage per head and unit labour cost (Y/Y as %)



This increase can also be seen in **the manufacturing industry** (**Chart 7**).

Chart 7
Euro zone: Nominal wage per head and unit labour cost in the manufacturing sector (Y/Y as %)



The result is:

- **rapidly rising prices for services** (**Chart 3** above);
- the **fall in profit margins in industry** (**Chart 8**), which results from the contrast between the weakness of price rises due to foreign competition and the weakness of industrial activity (**Chart 9**) and the rapid rise in production costs.

We can expect total inflation to remain close to 2.5% next year, with wage costs and service prices rising rapidly, well above the ECB's target.

Chart 8
Euro zone: Ratio between value added deflator and unit labour cost in manufacturing industry (2010.Q1 = 100)

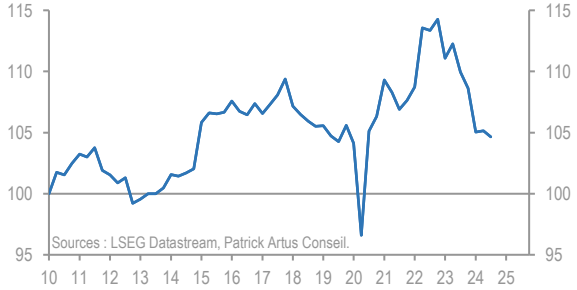
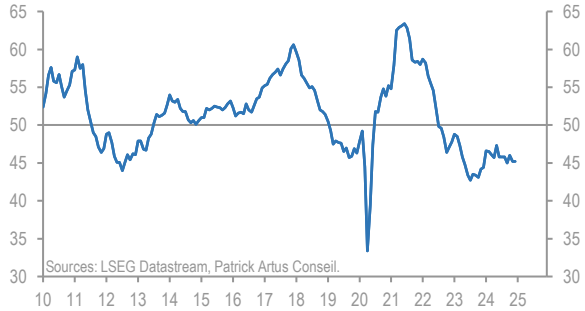


Chart 9
Euro zone: Manufacturing PMI (index)



What is the outlook for monetary policy and long-term interest rates?

Financial market participants **believe that the ECB will cut its key rate from 3.0% to 1.80%** by the end of 2025 (**Chart 10**).

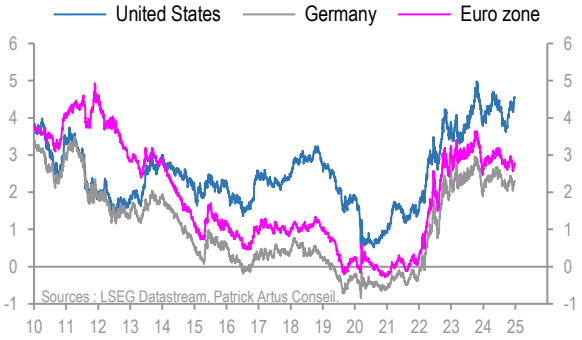
Chart 10
Euro zone: Euribor contracts (December 2025 maturity, 3-month)



Even if growth in the euro zone is going to be weak (around 1% in 2025), **the excess of inflation over the inflation target will very probably push the ECB to be more cautious and to lower its interest rates less** (with a terminal rate of 2.50%?).

The upward revisions in short-term interest rate expectations and the transmission to the euro zone of the rise in long-term interest rates in the United States will then cause the **long-term interest rate in the eurozone to rise substantially** (**Chart 11**).

Chart 11
Interest rate on 10-year government bonds (as %)



Summary: inflationary pressures remain strong in the euro zone

The absence of productivity gains is leading to a persistently tight labour market and a rapid rise in unit labour costs.

Wage inflation and the rise in service prices therefore remain high, with total inflation reduced by the fall (which will disappear) in energy prices and by the sharp reduction in profit margins in manufacturing, while unit labour costs in manufacturing industry keep rising rapidly.

We can therefore expect:

- the ECB to cut its key interest rates by less than the financial markets are expecting;
- long-term interest rates in the euro zone to rise from the very low level of December 2024.

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