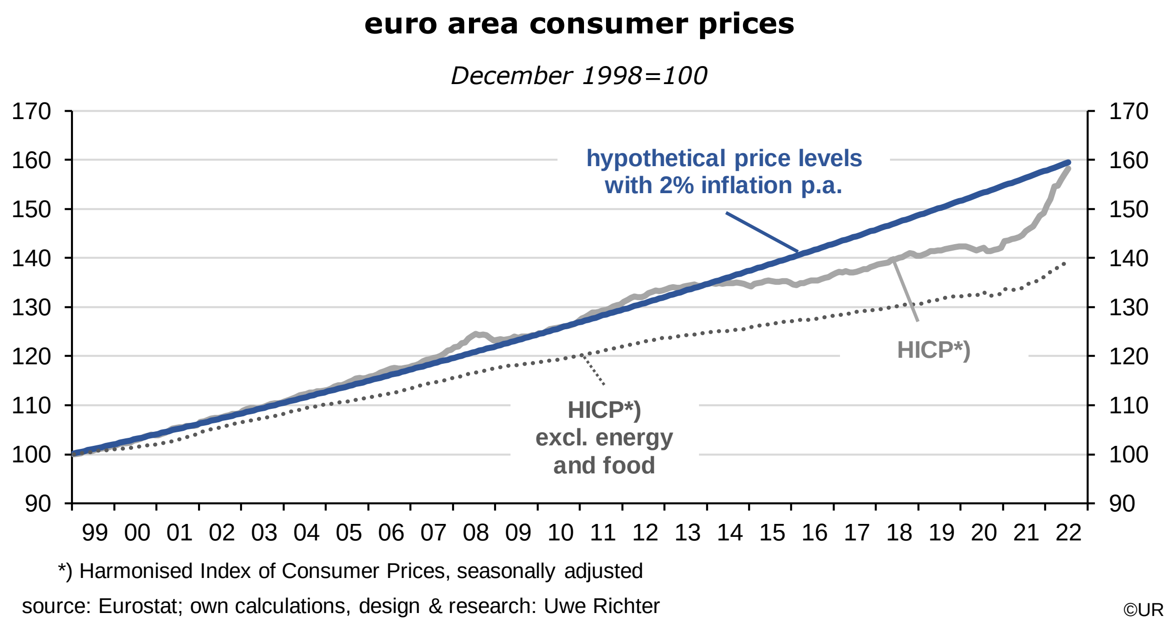
MARKET COMMENTARY

16 August 2022

European price level exactly on target - after 22 ½ years

Dieter Wermuth, Economist and Partner at Wermuth Asset Management

Hard to believe: if euro area consumer prices had increased by an average annual rate of 2%, the ECB's target since January 1999 when the euro was introduced, today's price level would be 58% higher than at the start. This is actually where it is today (except for a difference of 0.8%). This is, from the ECB's point of view, an extraordinary success story. The euro has recently been a soft currency on FX markets, but in terms of its internal purchasing power, the currency could not be harder.



In the richer parts of the world, an annual increase of the price level by 2% is regarded as price stability – if it rose by more, market participants might lose trust in the currency, if it rose by less than 2% deflation could become a dangerous possibility, as the real burden of debt would increase, market participants would stop debt-financed purchases, pushing the economy's output below its potential. In real life, all depends of course on how much inflation expectations actually deviate from the inflation target, above or below.

In the first 13 years of the euro, the consumer price index had moved closely around the ECB's 2%-target line, followed by eight years when it rose only very slowly, raising the specter of deflation: in response, the main refinancing rate was lowered to 0% and the deposit facility rate to -0.5%. In the past year and a half the wind has turned, catapulting the price level back onto its target trajectory. Similar developments were observed in other major economies of the OECD region.

One interesting statistics on the side: consumer price inflation ex food and energy, called core inflation, has increased at an average annual rate of just 1.5%, not 2%. In addition, the exclusion of those two components from the index has resulted in a much-reduced volatility. Structurally, European prices for oil products, gas and food apparently rise faster than the rest, possibly because of cartel effects (OPEC), price support via the EU's Common Agricultural Policy, or natural scarcities, I don't know. In any case, overall inflation does not fluctuate around core inflation which is thus not a useful leading indicator. Things had not been materially different in the US where annual overall and core inflation had been 2.5% and 2.2% over the same 22 ½ year period.

The ECB will not be given the opportunity for self-congratulatory comments, or for pointing out that it might be normal that some overshooting of its inflation target is now following a long period of undershooting. The public is exclusively focused on the fact that inflation has reached 8.9% y/y and the risk that it may soon exceed 10% – when households' heating and electricity bills will be raised once more this fall. The poorer parts of society will once again be faced with a purchasing power shock. They have little sympathy for the Greens' argument that even higher energy prices are exactly the medicine the doctor would have prescribed to save the climate. For them, it's not funny.

Since the European labor market is still in relatively good shape, the ECB has some room of maneuver to raise interest rates again. She will use it to slow down demand and somewhat reduce inflationary pressures. The weak euro exchange rate and the large differential vis-á-vis US policy rates also argue for higher policy rates. Priority is presently on maintaining the purchasing power of the population, not avoiding a recession. A recession cannot be avoided in any case because household incomes in Europe are increasing at a much slower rate than the general price level.

I do not have the impression that inflation might get out of control in the near future. For this to happen, unit labor costs would have to rise much faster – they are the main determinant of inflation. European wage negotiations are fairly peaceful these days, in spite of the strong position of labor and the significant reduction of real wages and salaries. It could be that the Russian invasion of Ukraine has shown that now is the time for cooperation, not confrontation.

Inflation expectations remain rather moderate, in spite of record high actual inflation. An important indicator for this is the yield of 10-year German government bonds – it is only at 0.9% and has declined a lot in recent weeks. Other positive signs are the reduction of crude prices by 20% from their recent peak, or the 30% fall of wheat prices. Things are improving on the inflation front.

I think that the ECB will raise its key policy rate, the main refinancing rate, by another 100 basis points to 1.5% between now and the first quarter of 2023, and then wait and see what the incoming data are telling. By the end of 2023, the euro area inflation rate will probably close to 3%. This prospect does not require dramatic monetary policy action. My main assumption is that there will not be a military catastrophe.

# # #

For more information please contact:

Instinctif Partners // Lars Hofer
E lars.hofer@instinctif.com
T +49 162 562 8917

Visit us: https://wermutham.com/
Follow us on Twitter and LinkedIn

About Wermuth Asset Management

Wermuth Asset Management (WAM) is a Family Office which also acts as a BAFIN-regulated investment consultant.

The company specializes in climate impact investments across all asset classes, with a focus on EU "exponential organizations" as defined by Singularity University, i.e., companies which solve a major problem of humanity profitably and can grow exponentially. Through private equity, listed assets, infrastructure and real assets, the company invests through its own funds and third-party funds. WAM adheres to the UN Principles of Responsible Investing (UNPRI) and UN Compact and is a member of the Institutional Investor Group on Climate Change (IIGCC), the Global Impact Investing Network (GIIN) and the Divest-Invest Movement.

Jochen Wermuth founded WAM in 1999. He is a German climate impact investor who served on the steering committee of "Europeans for Divest Invest". As of June 2017, he is also a member of the investment strategy committee for the EUR 24 billion German Sovereign Wealth Fund (KENFO).