BRIEFING

Monetary Dialogue February 2018

European Parliament

An economic recovery with little signs of inflation acceleration: transitory phenomenon or evidence of a structural change?

Background

The EU economies are on a solid, albeit moderate growth path. Importantly, growth is broad-based across sectors and evenly shared among countries. Job creation remains robust. Yet, these positive developments come at a time when underlying inflation i.e. the headline index stripping down the inflation, remains unusually subdued.

At the Monetary Dialogue of November 2017, President Draghi stated that the persistent moderation of inflation was largely explained by the legacy of the crisis and the current non-standard monetary policy needs some time to produce its effect on inflation. Some experts, however, express doubts on the possibility to see inflation accelerate in the medium-term pointing out at the impact of globalisation and the slow-down of productivity in developed countries.

MONETARY DIALOGUE
February 2018

The publications are prepared by Policy Department A of the European Parliament and are available in the relevant section (**Monetary Dialogue**) of the ECON Committee website.

Contact us: **poldep-economy-science@ep.europa.eu**

For the February 2018 session of the Monetary Dialogue, the Committee on Economic and Monetary Affairs (ECON) of the European Parliament has asked monetary experts to analyse the EU economic recovery. References to the relevant in-depth analyses are provided below.

Policy Department for Economic, Scientific and Quality of Life Policies
Directorate-General for Internal Policies
Authors: Dario Paternoster, Denitza Dessimirova
PE 631.025 - February 2018

EN

In-depth analyses of the February 2018 Monetary Dialogue

Persistent low inflation in the euro area: Mismeasurement rather than a cause for concern? By Daniel GROS (Centre for European Policy Studies)

The huge literature on the causes of the persistent weakness in inflation in the euro area has not identified one single key factor. Moreover, inflation has also been lower than expected in many advanced countries. Low inflation expectations seem to have played an important role in reducing wage demand, both in the US and the euro area, but a residual output gap also contributes to it. The concerns about low inflation seem overblown. The Harmonized Index of Consumer Prices (HICP) used to measure inflation in the euro area differs from the indices used in most advanced countries in that it does not account for the cost of owner occupied housing. This omission has a considerable impact on measured inflation and can explain most of the difference between inflation in the US and in the euro area. If the HICP were to incorporate the available estimates of inflation in owner occupied housing, measured inflation would be close to 2 %.

Why does the recovery show so little inflation? By Christophe BLOT, Jérôme CREEL and Paul HUBERT (Observatoire Français des Conjonctures Économiques)

This paper investigates the determinants of inflation in the euro area since 2000 and shows that the most important determinants are inflation expectations and wage growth. Both indicators have contributed negatively to inflation since 2014 but inflation expectations less so since 2015 whereas the contribution of wage growth has remained negative. We suggest that structural reforms may have put a drag on the ability of the ECB to reach its inflation target rapidly.

An economic recovery with little sign of inflation acceleration: A transitory phenomenon or evidence of a structural change? by Andrew HUGHES HALLETT (Copenhagen Business School)

This paper investigates the possibility that there has been a structural shift in inflation (upward) in the euro area since the recovery in 2014 or 2015. From the perspective of policy, it is important to be sure that any such shifts are significant statistically, sustained or likely to be sustained (durable) over the near future, and are evenly distributed over the member economies so that no one of them is damaged by anti-inflation measures taken to help the others. The authors approach the problem in two steps. They first examine the circumstantial and informal evidence, and then conduct formal statistical tests for structural changes in euro area inflation in 2015 or 2016. No evidence of a structural change under the four criteria mentioned is found. The even distribution of inflation criterion is the closest to being satisfied, but the other three are far from satisfied in any formal sense. There was a brief acceleration in inflation in mid-2016 towards 2%, but it flattened out in 2017 and has been constant at 1.5% ever since. Core inflation was constant at 0.9% throughout. The question is why has there been no inflation in the recovery and how long is that likely to last? In a third step, the autors explain how low growth in real wages and self-reinforcing low productivity growth produces slow output growth and low inflation. This model fits the data pretty well, down to the lack of labour and total factor productivity and to substituting cheaper labour for excess capital stock. It implies a fall in investment spending (also seen in the data) which in turn extends the period for which low productivity-low inflation outcomes apply.

Economic recovery and inflation by Marek DABROWSKI (CASE, Centre for Social and Economic Research)

In the last decade advanced economies, including the euro area, experienced deflationary pressures caused by the global financial crisis of 2007-2009 and the anti-crisis policies that followed, in particular, the new financial regulations (which led to a deep decline in the money multiplier). However, there are numerous signs in both the real and financial spheres that these pressures are disappearing. The largest advanced economies are growing up to their potential, unemployment is systematically decreasing, the financial sector is more eager to lend, and its clients - to borrow. Rapidly growing asset prices signal the possibility of similar developments in other segments of the economy. In this new macroeconomic environment, central banks should cease unconventional monetary policies and prepare themselves to head off potential inflationary pressures.

An economic recovery with little signs of inflation acceleration: Transitory phenomenon or evidence of a structural change? by Salomon FIEDLER, Nils JANNSEN, Ulrich STOLZENBURG (Kiel Institute for the World Economy)

This paper investigates the possibility that there has been a structural shift in inflation (upward) in the euro area since the recovery in 2014 or 2015. From the perspective of policy, it is important to be sure that any such shifts are significant statistically, sustained or likely to be sustained (durable) over the near future, and are evenly distributed over the member economies so that no one of them is damaged by anti-inflation measures taken to help the others. The authors approach the problem in two steps: first examine the circumstantial and informal evidence, and then conduct formal statistical tests for structural changes in euro area inflation in 2015 or 2016. We find no evidence of a structural change under the four criteria mentioned. The even distribution of inflation criterion is the closest to being satisfied, but the other three are far from satisfied in any formal sense. There was a brief acceleration in inflation in mid-2016 towards 2%, but it flattened out in 2017 and has been constant at 1.5% ever since. Core inflation was constant at 0.9% throughout. The question is why has there been no inflation in the recovery and how long is that likely to last? In a third step, we explain how low growth in real wages and self-reinforcing low productivity growth produces slow output growth and low inflation. This model fits the data pretty well, down to the lack of labour and total factor productivity and to substituting cheaper labour for excess capital stock. It implies a fall in investment spending (also seen in the data) which in turn extends the period for which low productivity-low inflation outcomes apply.

Disclaimer and copyright. The opinions expressed in this document are the sole responsibility of the authors and do not necessarily represent the official position of the European Parliament. Reproduction and translation for non-commercial purposes are authorised, provided the source is acknowledged and the European Parliament is given prior notice and sent a copy. © European Union, 2019.
© Image on page 1 used under licence from Shutterstock.com

Administrator responsible: Dario Paternoster Editorial assistant: Janetta Cujkova
Contact: Poldep-Economy-Science@ep.europa.eu

This document is available on the internet at: www.europarl.europa.eu/supporting-analyses
IP/A/ECON/2018-32