Inflation has converged

In the decade leading to the pandemic recovery, euro area inflation behaved like a dormant volcano, averaging 0.9%. Then, the volcano erupted and, in October 2022, inflation peaked at 10.6%. Initially, energy prices fueled this spike – the "magma" of inflation – before spreading to consumer goods and services. For 22 months, inflation climbed from below target to its peak.

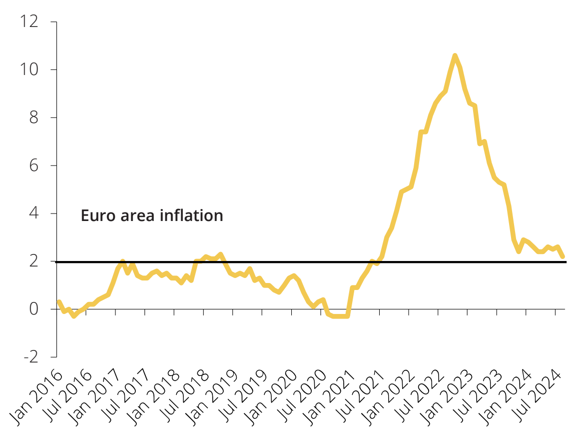
Though the rise was prolonged, the descent has been faster. In just over a year, inflation dropped to below 3%. While not exactly at 2%, it has converged closely to the European Central Bank's target. Historically, inflation has hit exactly 2% just 17 times in the euro area's 308-month history. However, it has hovered within a range of 1.5% to 2.4% about 42% of the time. And now, inflation has settled back into this desirable territory.

The "last mile" turned out to be a kilometer long

As the anecdote goes, a tall mathematician and a short statistician, both shy, meet in a pub. After noticing an attractive person, they agree on a cautious approach: each step they take will be half the size of the previous one. The mathematician is still inching forward, but the statistician has already converged – at least in probability.

Today, there may still be a few "inflation mathematicians" hesitant to declare victory, but the statistics tell a different story: inflation has converged on solid economic fundamentals. So, let's walk the slopes of inflation and explore how far we've come.

Chart 1 • Inflation is a bumpy road



Source: Eurostat.

The European economy endured a series of severe exogenous shocks. First came the pandemic, followed by a rapid recovery hampered by supply chain bottlenecks and shifts in consumption patterns. In the Fall of 2021, a spike in oil prices was later compounded by the obnoxious Russian invasion of Ukraine, which delivered an even more damaging blow to Europe through soaring natural gas prices, along with food and commodity price shocks. This sequence explains the prolonged path to the inflation peak.

However, 2023 marked the beginning of a reversal. The World Bank's November 2022 commodity price projections had already indicated this shift. By 2023, inflation averaged 5.4%, but in the first three quarters of 2024, it had fallen to an average of 2.4%. Inflation has been hovering around the 2% target, with the September figure standing at 1.8%.

Why did inflation converge?

Inflation converged to target because:

a) **Markets worked efficiently**, particularly labor markets;

b) **Monetary policy transmission** (of a record 450bps increase in interest rates) was not hindered by fragmentation;

c) **Fiscal and monetary policies were coordinated** (or even merely synchronized); and

d) **Supply-side pressures eased** as markets adjusted.

Markets, particularly the labor market, exceeded expectations. Despite high employment and low unemployment, the anticipated second-round effects of wage increases on inflation were subdued, as labor demand and supply adjusted in tandem. The significant reduction in real wages – by as much as 7% – played a key role in sustaining employment and mitigating potential inflationary pressures. Additionally, the cyclical behavior of profits further demonstrated market efficiency. Initially, profit margins rose in response to the sharp drop experienced during the pandemic, but more recently, they have been absorbing the recovery in real wages, acting as a price stabilizer and a market-based risk-sharing mechanism between employees and employers.

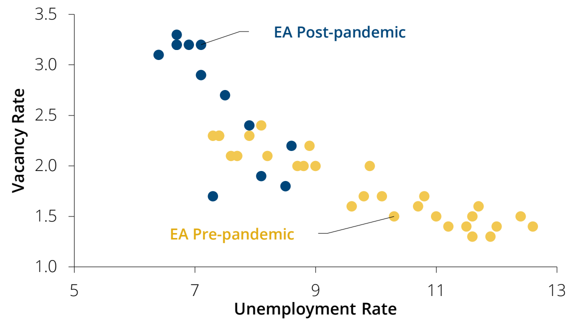
> **Workers and firms delivered above expectations and made soft landing possible.**

As argued[1], the structure of the European labor market has evolved significantly over the past decade, driven by reforms, higher skill levels and education, and a more integrated single market. These changes have fostered a dynamic and efficient adjustment, supported by:

- a shift in the composition of employment, with greater emphasis on skills, labor market churn, migration, and mobility;
- a shift in the composition of unemployment, characterized by shorter durations and reduced subsidized spells;
- increased flexibility in both working hours and real wages.

This efficiency can be gauged by the movement along the pre-crisis Beveridge curve towards the left: less unemployed for each open vacancy. In contrast, the US Beveridge curve has shifted upward and to the right, signaling less efficient labor market outcomes.

Chart 2 • Unemployment resists the first quarters of lower vacancies

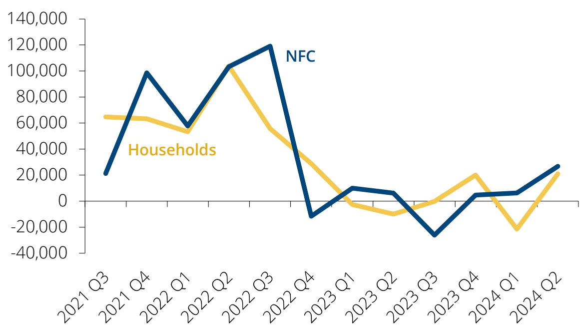


Source: Eurostat.

The efficiency demonstrated by the euro area labor market must be safeguarded. Otherwise, we risk more than the soft landing.

Monetary policy transmission was effective and fast. As expected, credit flows to both firms and households declined, with net reductions observed as early as the fourth quarter of 2022. Still, in most euro area countries, interest rates on household loans are fixed, at least over a period, delaying monetary policy transmission.

Chart 3 • Credit flows from falling to stable



Sources: Eurostat and ECB.

Transmission can be hindered by fragmentation. To preserve financial stability, the ECB introduced the Transmission Protection Instrument in July 2022 to prevent unjustified market segmentation.

1. https://www.bportugal.pt/sites/default/files/praise_to_the_euro_area_labor_market.pdf

Europe struggled for decades with the seemingly difficult task of **coordinating monetary and fiscal policies**. Opposing forces stood in the way of achieving common goals and a repeated complaint (from both sides) that monetary policy was "the only game in town" resonated. The price was always paid in public support for the euro project. In 2020, fiscal and monetary policy pulled in the same direction. Public support contained price pressures for economic agents more exposed to inflation, while the EU programs revitalized the economy. Despite the increase in spending, government bond markets avoided stress – a testament to the enormous risk reduction observed up until 2019 and the financial instruments adopted in the pandemic crisis. This is the path forward.

Supply restrictions have eased. Today, the manufacturing slack is large in several countries; low PMIs in most western economies and the dire situation of the Chinese industrial base. The supply shocks have now become deflationary.

In the end, it is the economy

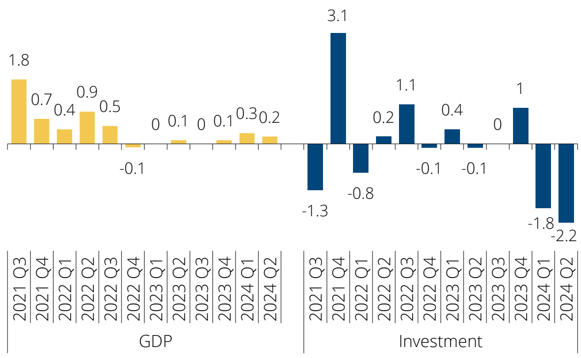
The convergence of inflation should not come as a surprise – it reflects the underlying economic reality. The European economy is neither growing nor investing; more precisely, it's not investing, and, therefore, not growing. Productivity has stalled. It is worth noting that labor demand (the willingness of firms, the *arbeitgeber*, to hire at a given wage) is a derived demand. If markets do not grow, employment growth becomes unsustainable.

In the two years since the ECB first raised interest rates, the euro area economy has expanded by just 0.7%, and inflation has converged – a so-called "soft landing." However, considering the severe tightening of financial conditions, this outcome is a success in itself. The sacrifices made by euro area economic agents to reduce inflation – compared to other regions – are evident in the low growth and weak investment, which could have lasting consequences.

> **The inflation convergence should not come as a surprise: it is the economy. The risk now is undershooting.**

In the four years leading up to the pandemic, the euro area grew 0.5 percentage points annually below the U.S., resulting in a cumulative shortfall of 2%. Since then, the divergence has widened to 1.2 percentage points per year, leading to a total gap exceeding 5%. Despite strong employment growth, overall economic activity in the euro area continues to lag behind the U.S.

Chart 4 • No economic growth; absent investment



Source: Eurostat.

Risks ahead

The euro area's weak economic performance heightens its exposure to various risks, which stem from three main sources:

a) Labor market resilience may falter;

b) China and global trade could once again exert deflationary pressures;

c) Consumption, which has been the driving force behind the projected recovery, may not grow as expected.

Employment numbers are still high (152.8 million in 2022:2 vs 156.6 million in 2024:2). European firms have shown remarkable resilience in maintaining strong employment. **Unemployment** has also decreased, from 11.2 million to 10.8 million, as the labor market continues to absorb the increased labor supply. This is the bright side of the story.

> **Recent job starters fell by 10% and job vacancies by 21% since 2022 Q2.**

However, there are early signs of a cooling job market. The number of **recent job starters** (those with less than three months' tenure) has dropped by 10%, from 7.8 million to 6.9 million. **Vacancies** have also declined, falling from 3.3% to 2.6% of total employment – a 21% reduction. At the same time, **recent job leavers** have increased by 2%, rising from 4.3 million to 4.4 million. These numbers are hard to overlook – some flashing more urgent warning signs than others, but all pointing toward a potential reversal in the labor market.

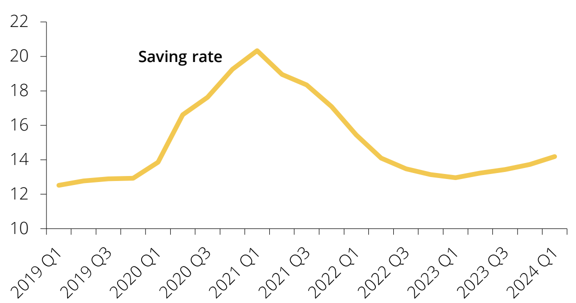
The weakening outlook for **wages** has significant implications. Without sustained economic growth, maintaining current employment levels will become increasingly difficult unless wages adjust. Although wage growth remained modest throughout the inflationary period, real wages finally rose in Q4 2023. Negotiated wage growth peaked at 4.8% in Q1 2024, but is expected to decline by early 2025, which is encouraging news for inflation control. We should not repeat the first quarter strategy of waiting until contained wage growth materializes.

China is the elephant in the room. Much of the rapid growth in international trade during the first two decades of the 21st century – outpacing global GDP – was driven by China's integration into the world economy. This opened significant opportunities for European companies, especially German firms with their high-skilled manufacturing sectors, while contributing to lower prices globally. Supply grew faster than both Chinese and international demand.

However, these dynamics have at least stalled. The bursting of China's real estate bubble and its vast manufacturing overcapacity – estimated at nearly 2% of global GDP – have shifted the landscape. In early 2024, the utilization rate of China's finished solar power industry stood at just 23%. In this environment, it is reasonable to expect lower prices, which pose a challenge to European firms and their sources of growth.

According to ECB forecasts, **consumption** is expected to remain the primary driver of growth. This projection hinges on a robust wage recovery, increased consumer confidence – though ongoing war and policy uncertainty present obstacles – and a gradual reduction in interest rates. However, supported by higher interest rates and the need to rebuild depleted savings, household savings are on the rise across Europe.

Chart 5 • Replenishing wealth buffers?



Source: Eurostat.

Additionally, political uncertainty remains high. Without a clear political strategy to enhance the competitiveness of the euro area, a significant boost in consumer confidence seems unlikely. In the short term, cautious savers are likely to prevail over optimistic consumers.

Undershooting spells trouble

The materialization of these risks will complicate stabilizing inflation at 2% and hinder economic recovery. Achieving the inflation target and executing a soft landing were possible because of the groundwork laid before the pandemic. This time it was different: we were prepared. When the crisis hit, coordinated and stabilizing responses were implemented. This time, we were smarter.

However, now we face a new risk: undershooting target inflation, which could stifle economic growth. Fewer jobs and reduced investment would add to the sacrifice ratio already endured. A sluggish economy would reinforce, in a vicious cycle, inflation undershooting.

The policy response

Financial stability is a pre-requisite to price stability. Europe has enjoyed financial stability in the last years, contrary to what happened in the previous crises. Throughout most of 2010s, the threat of a breakup loomed over the euro area, resurfacing at every economic or political shock. Not in 2020s.

The new European budgetary rules should result in a continuing reduction of the expansionary stance, building on the business cycle, to generate fiscal space for the future. This is the most desirable outcome. Fiscal policy must not be a source of stress, unlike recent experiences in the USA and the UK, or in Europe in the not-so-distant past.

Additionally, the institutional landscape requires improvement. Advancing the Banking Union and the Capital Markets Union would send a powerful signal, as both initiatives would help channel EU savings into investments in climate and digital transitions.

Europe must increase productivity. There are no productivity gains without new skills (workers) and new projects (investment).

To achieve this, Mario Draghi recently proposed a set of reforms aimed at boosting private investment, complemented by targeted public leveraging.

There is no such thing as a money-less investment recovery. But if money is invested, the economic return shall justify it. Europe must redevelop a culture of risk taking, which it lost during the financial and the sovereign debt crisis.

Price stability is the primary objective of monetary policy. Euro area inflation has been well-anchored and converged to the 2% target. Thus, it is worth asking: What can monetary policy do to stimulate the euro area economy? Can it help preserve the labor market?

A monetary policy that remains tight for too long risks causing inflation to undershoot its target. Speed is of the essence. The current state of the euro area economy, along with the prevailing price and labor market conditions, necessitates a response from the ECB: a reduction in interest rates.

Achieving a better equilibrium with a stable transition path requires a gradual, steady, and predictable reduction in interest rates to their neutral level, coupled with improvements in the institutional landscape and fiscal conditions. All these elements are essential for fostering confidence among investors and consumers.

In the symphony of meetings and data, each decision resonates, shaping the future we create for Europe.