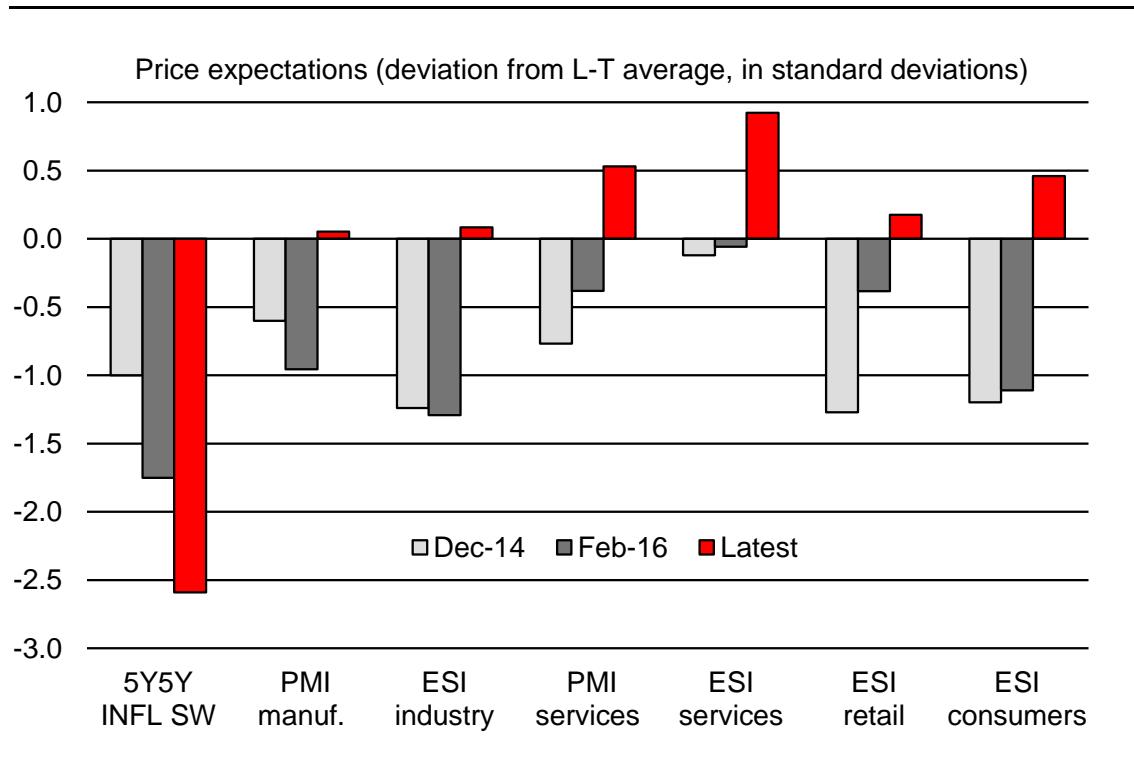


Inflation expectations in the eurozone: Markets and the real economy disagree



Source: Bloomberg, EC, Markit, UniCredit Research

- Market-based measures of inflation expectations in the euro area are in free fall. The 5Y5Y inflation swap, which measures inflation expectations over the five-year period starting five years from now, entered a steep declining trend at the end of 2018 and recently fell to an all-time low below 1.15%. Together with rising downside risks to the growth outlook, this has put pressure on the ECB.
- However, the real economy does not seem to share the concern of financial markets – and, probably, of the ECB – when it comes to future price trends. Our chart shows output prices and selling-price expectations as recorded by the PMI (Purchasing Managers’ Index) and ESI (Economic Sentiment Indicator) surveys across businesses in the manufacturing, industrial, services (ex-retail) and retail sectors, as well as inflation expectations among consumers. We compare the latest available data with that just before key ECB policy easing announcements that took place in January 2015 (beginning of QE), and March 2016 (cut in the deposit rate to -0.40%, expansion of monthly asset purchases to EUR 80bn and new TLTROs). The message from the chart is clear; price gauges from the real economy are currently in line with or above their long-term averages, which stands in stark contrast to the situation at the end of 2014 and in early 2016.
- When gauging risks to price stability, information from the real economy and financial markets should be considered complementary. On the one hand, price-setting behavior is influenced by firms and households, not by financial market participants, and a five-year assessment five years from now is too far out to have an effect on actual price setting. On the other hand, the 5Y5Y measure signals that market participants do not believe the ECB has the tools to return inflation sustainably to target, especially if downside risks to economic activity materialize. The ECB faces a tricky balancing act.

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