Florian Hense, Economist | florian.hense@berenberg.com | +44 20 3207 7859

EUROZONE INFLATION PICKS UP AS SHOPS SHUN SUMMER SALES

Berenberg Macro Flash

Ignore the noise: Price pressures are and will likely remain subdued in the Eurozone. The final Eurostat reading of July Eurozone inflation adds further colour to the somewhat counterintuitive rise in the headline rate from 0.3% yoy in June to 0.4% and, in particular, to the surge in the core rate from 0.8% yoy to 1.2% yoy in July (see Chart 1 and 2).

Two major drivers explain the rise in inflation:

1. **Non-energy industrial goods (NEIG, 26% of the total basket):** Price increases for non-energy industrial goods shot up from 0.2% yoy in June to 1.65%, the fastest gain since early 2002 (see Chart 3). NEIG split up into (1) semi-durables (10%) such as clothing and footwear, books, recreational equipment etc., (2) durables (9%) such as cars, furniture, household appliances, PCs etc., and (3) non-durables (7%) such as electronic goods for personal care, pharmaceutical products, newspapers etc.. While price gains for durables and non-durables slowed, inflation of semi-durable goods rose from -0.5% to 3.8% (see Chart 4). Key drivers were clothing/footwear, which make up roughly 6% of the total basket. Clothing and footwear inflation shot up from -0.9% yoy in June to 6.3% in July – by far the strongest yoy price increase since the start of the euro in 1999. Many clothing and footwear shops have apparently changed the pattern of summer sales. Usually, retailers slash clothes prices between June and July by 13-14% to clear out their summer ranges ahead of the autumn season. This year, however, the drop in clothing and footwear prices of 6.8% mom in July was unusually small. Most shops had offered discounts over previous months already. Others may be waiting a little longer to sell their inventories before giving discounts after the lockdown cut short the summer period. The clothing and footwear base effect alone added more than 0.3ppt to the headline and core rate. The contribution of the semi-durables and NEIG in total added 0.45ppt and 0.4ppt, respectively, to the headline rate (see Chart 5 and 6).
2. **Energy (makes up 10% of price basket):** The yoy rate of the energy component turned less negative from -9.3% in June to -8.4% in July (see Chart 3) on the back of a 0.6% mom rise in energy prices and a small base effect. In 2019 energy prices had fallen by 0.6% mom between June and July. This pushed the yoy headline inflation rate up by 0.1ppt in July relative to June (see Chart 6).

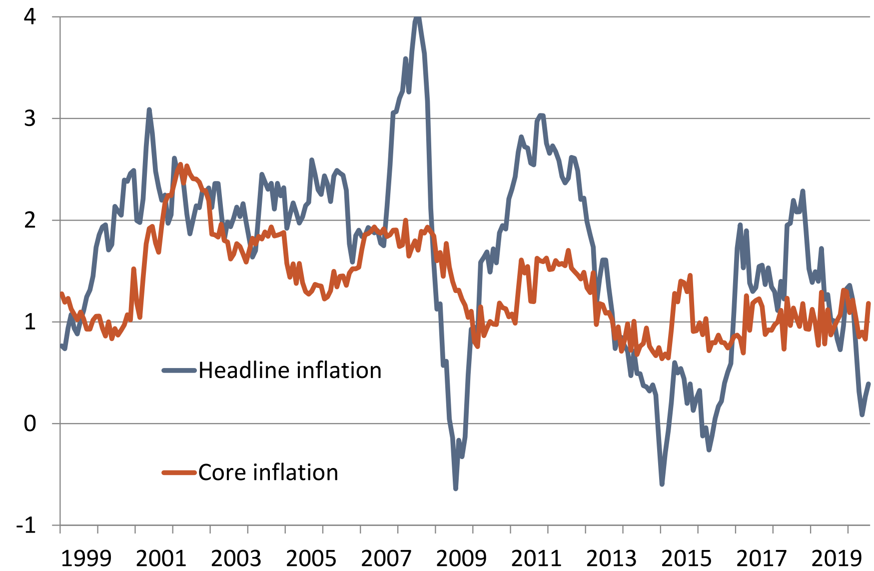
A number of deflationary forces offset the rise a little:

1. **Services (45%):** Service inflation, a proxy for underlying, domestically generated price pressures, fell further from 1.2% yoy in June to 0.9% in July (see Chart 3). It shaved off more than 0.1ppt from the headline inflation yoy rate (see Chart 6) and also weighed on core inflation. Price pressures in transport, communication, package holidays and accommodation services softened in particular (see Chart 7 and 8). The slowdown in services inflation from an average of 1.6% yoy in January/February (see Chart 3) highlights the disinflationary impact of the Covid-19 recession. Even though supply remains below its pre-crisis capacity, aggregate demand has fallen by more, and does not recover as quickly. Contrary to most shops and factories which could just re-open, household consumption and business investment cannot be switched on that easily. Underlying price

pressures will reverse only once demand outpaces supply growth. This will unlikely happen before early 2021.

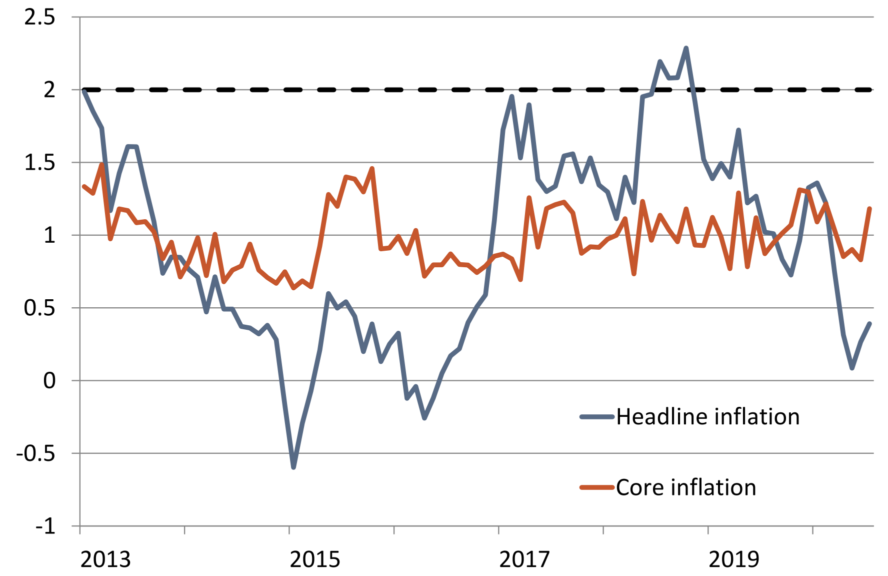
2. **Food (19%):** Yoy price gains in processed and unprocessed food slowed further from 2.3% yoy in June to 1.6% in July and 6.0% to 3.1%, respectively (Chart 3). As food purchases make up 19% of the price basket, the slower price gains shaved off roughly 0.25ppt from the headline rate (Chart 6). In response to food hoarding purchases in the early stages of the lockdowns, prices, especially of unprocessed food, had jumped by the most in years between March and May. As economies have opened up again over the past months and shopper behaviour has normalised significantly, unprocessed food prices have come down by c4% from their peaks in April/May to their pre-crisis March levels.
3. **German VAT cut:** The cut in German VAT in July 2020 pulled the German inflation rate lower by roughly 1ppt. Taking into account that the VAT fell by 3ppt for some goods, by 2ppt for others and not at all for some, German businesses probably passed on around 50% of the VAT cut to consumers. The German price basket makes up around 28% of the total. Thus, without the German VAT cut, the Eurozone headline inflation rate could have been almost 0.3ppt higher in July.
4. **A stronger euro:** A stronger euro makes imports cheaper and therefore further cuts into the gains of the price basket. Since early May, the euro has appreciated from 1.08 US dollar to almost 1.20 US dollar now. The trade-weighted exchange rate has risen by 5% yoy and 9% since mid February. A 10% rise in the effective exchange rate usually translates into a lower inflation of around 0.4-0.5ppt. But this effect may take a few months to show up.

Chart 1: Headline and core inflation since 1999 (yoy, in %)



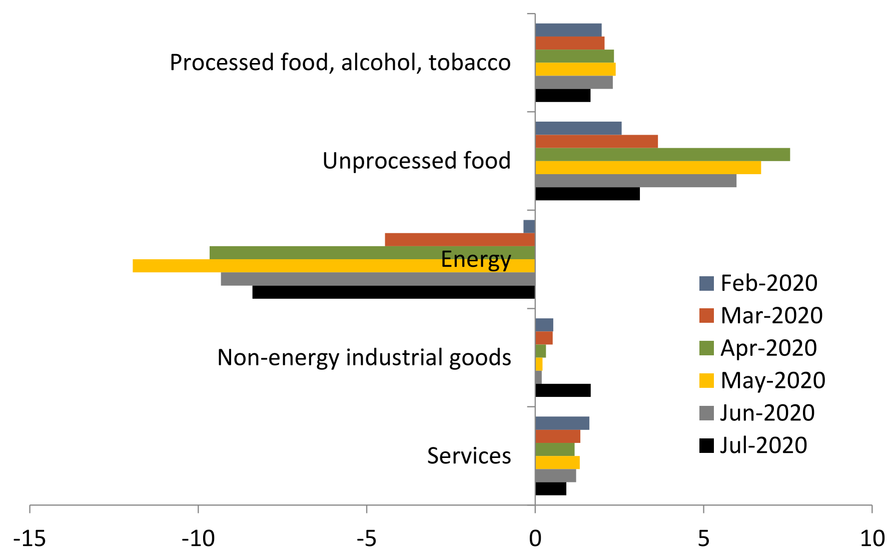
Source: Eurostat, Berenberg

Chart 2: Headline and core inflation since 2013 (yoy, in %)



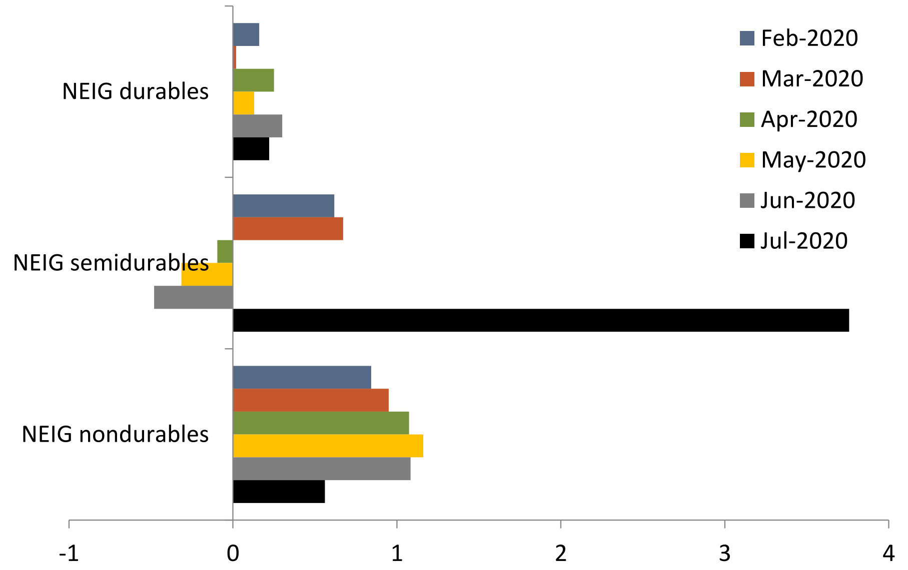
Source: Eurostat, Berenberg

Chart 3: Inflation by component (yoy, in %)



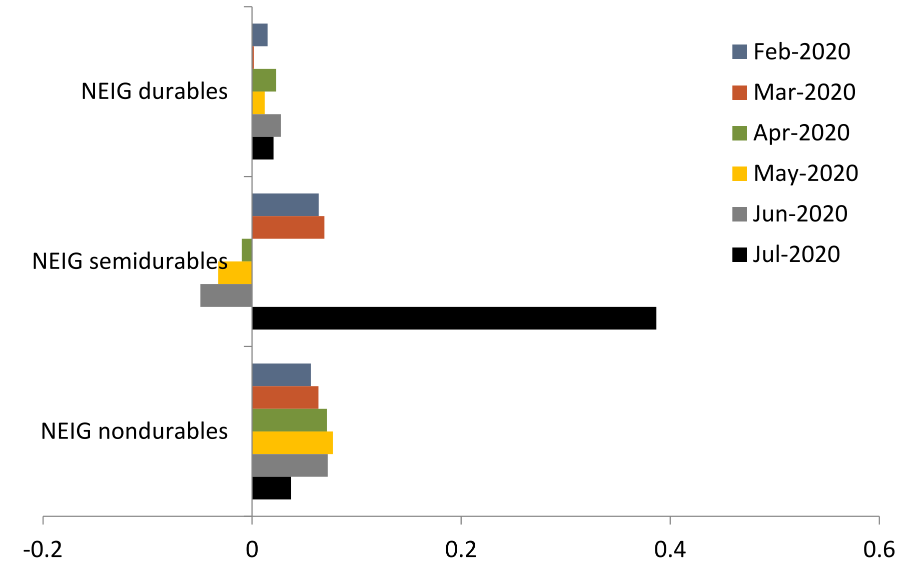
Source: Eurostat, Berenberg

Chart 4: Inflation by non-energy industrial good (NEIG) component (yoy, in %)



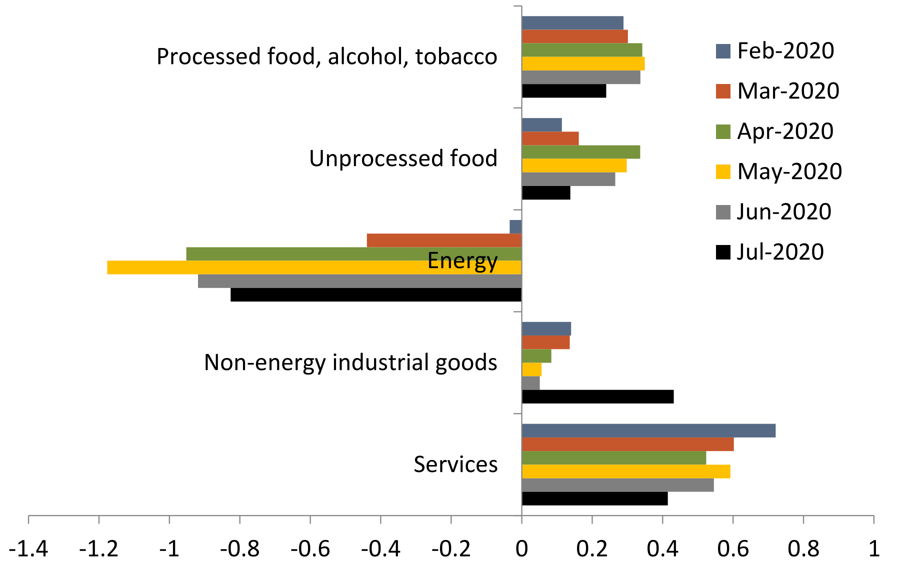
Source: Eurostat, Berenberg

Chart 5: Contribution to yoy headline inflation by non-energy industrial good (NEIG) component (in ppt)



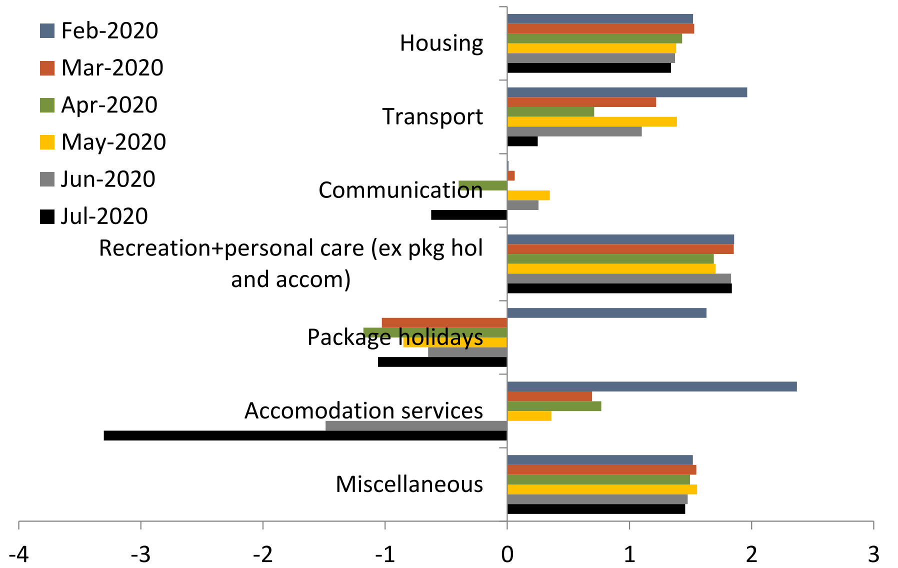
Source: Eurostat, Berenberg

Chart 6: Contribution to yoy headline inflation by component (in ppt)



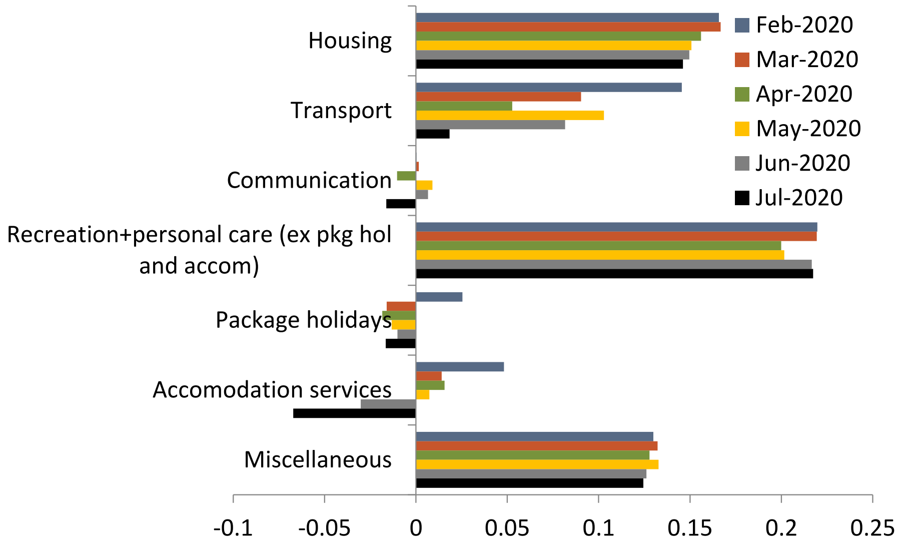
Source: Eurostat, Berenberg

Chart 7: Inflation by services component (yoy, in %)



Source: Eurostat, Berenberg

Chart 8: Contribution to yoy headline inflation by services component (in ppt)



Source: Eurostat, Berenberg

Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7859
www.berenberg.com
florian.hense@berenberg.com