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EUROZONE INFLATION SLIPS AGAIN AS BASE EFFECTS UNWIND

Berenberg Macro Flash

Eurozone inflation, May, in %

	Headline	Core
Actual:	1.4	0.9
Previous:	1.9	1.2
Consensus:	1.5	1.0
Berenberg:	1.6	1.0

Low inflation: Eurozone inflation decelerated even more than expected in May as the Easter effect reversed and energy price base effects faded. Driven by energy prices, headline inflation could weaken slightly further in coming months before slowly creeping up from autumn this year onwards. Underlying price pressures remain as subdued as they have been earlier this year. For the time being, the ECB can maintain its accommodative policy stance. The data suggest no need for the ECB to raise its refinancing rate before 2019. In the meantime, the Governing Council will feel comfortable enough to turn more neutral in its risk assessment at its meeting next week, announce tapering in September and reduce the current amount of monthly stimulus of €60 bn from January 2018 onwards.

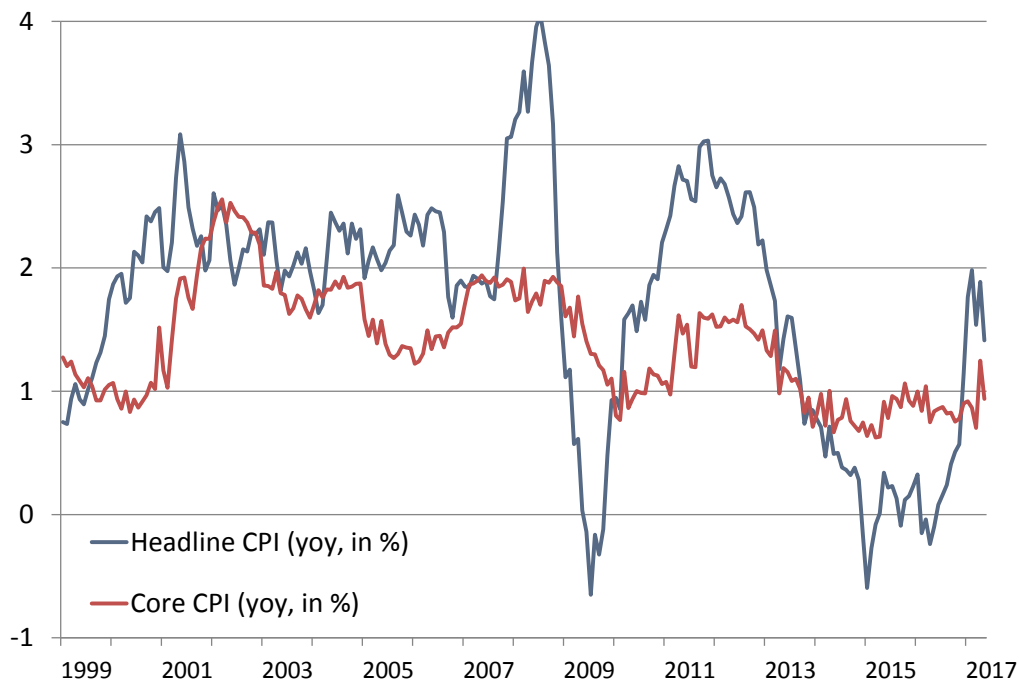
Drop in headline inflation owes to energy and services: Eurozone inflation fell from 1.9% yoy in April to 1.4% in May, the weakest reading this year, on the back of lower energy and services price inflation (see chart 1 and 2). The swing in the energy components of headline inflation, from 7.6% in April down to 4.6% yoy in May, is largely driven by oil prices. Base effects are fading and Brent dropped by more than 6% in EUR terms mom. That may have lowered the headline number by 0.2-0.3 ppt in May (see chart 3). Services price inflation, usually a reliable indicator for domestically produced inflation, fell from 1.8% to 1.3%, likely owing to lower prices for package holidays. After soaring 9.8% mom in April as Europeans set out for their unusually late Easter holidays, prices for package holidays likely fell back to normal again in May, reducing both headline and core inflation by 0.2-0.3ppt relative to the rates recorded in April. The contributions of food and non-energy industrial goods to inflation did not change much in May.

Core inflation remains subdued as it returns to the rate it has been over the last three years: Largely driven by the unwinding of the Easter effect on prices for package holidays, core inflation decelerated to 0.9% yoy in May from the one-off spike to 1.2% in April. Core inflation is now back to its February rate. We look for no more than a very gradual uptick in core inflation going forward. Despite major improvements since its peak in 2013 at 12.1%, the unemployment rate remains high at 9.3%. With a significant degree of labour market slack, wage growth remains subdued. Even in countries with high employment rates such as Germany, wage inflation has not picked up significantly. In addition, consumers' expectations about price trends over the next 12 months have fallen for the last two months – the first time since July and August 2016 last year. Many households and businesses, both financial and non-financial, still need to further repair their balance sheets after the Lehman and euro crises. Low borrowing costs can help to speed up the adjustment. Only if the output gap tightens as more idle resources are absorbed and wage growth accelerates would the conditions for a sustained rise in inflation towards the ECB's target of "close, but below 2%" be in place. While the broadening and firming of the economic recovery in the Eurozone is likely to continue, we expect the slack in the economy to be erased and underlying price pressures to edge up only very gradually. Core inflation should pick up from 0.9% in 2016 around 0.4 ppt this year, 0.3 ppt next year, with a chance it could be less.



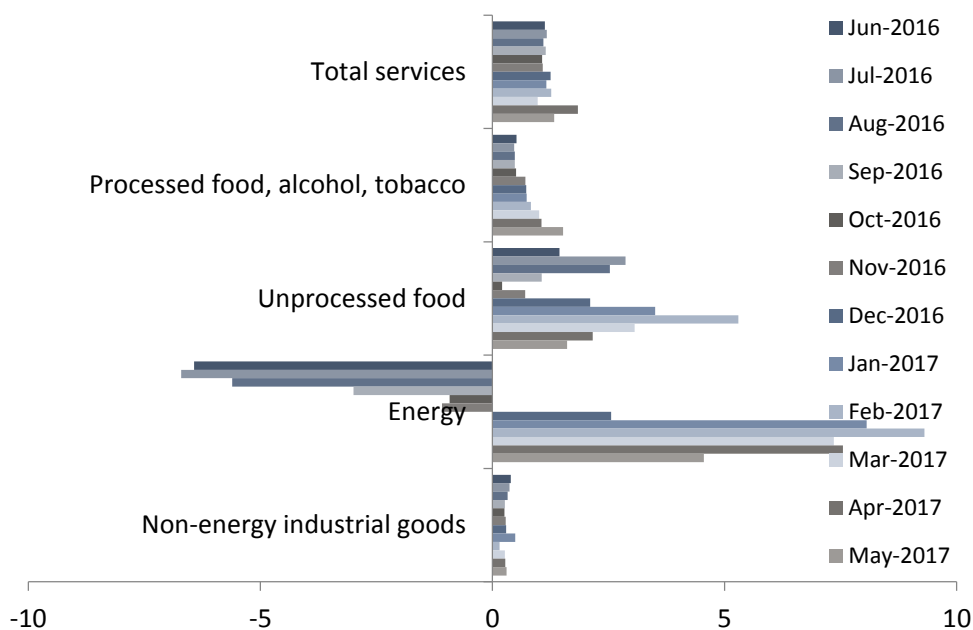
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Chart 1: Headline CPI versus core inflation (yoy, in %)



Source: Eurostat

Chart 2: Inflation by component (yoy, in %)

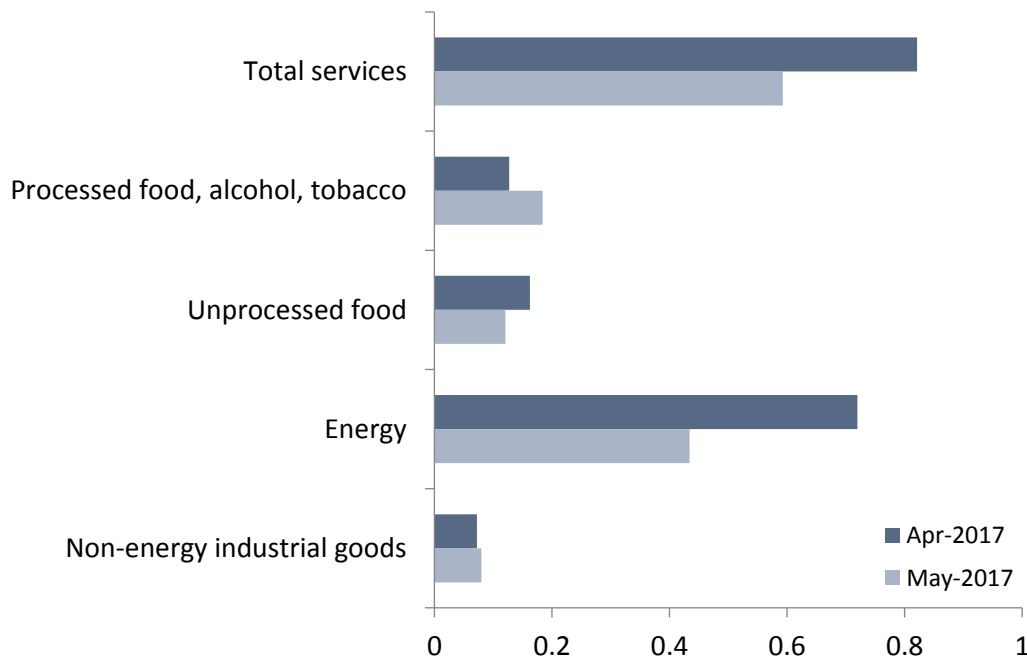


Source: Eurostat



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Chart 3: Contribution to headline CPI by component (yoy, in %)



Source: Eurostat

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