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UNDERLYING EUROZONE INFLATION SHOWS SIGN OF LIFE

Berenberg Macro Flash

Eurozone inflation, July, in %, yoy

	Headline	Core
Actual:	**1.3**	**1.2**
Previous:	1.3	1.1
Consensus:	1.3	1.1
Berenberg:	1.3	1.1

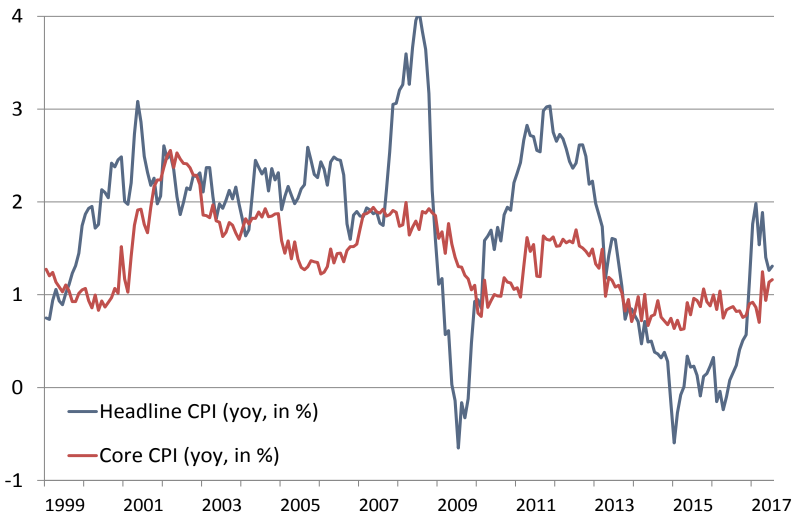
Beyond the bottom: Eurozone inflation remained unchanged in July at 1.3% yoy. Core inflation, the measure that strips out volatile components such as food and energy, accelerated to 1.2% from 1.1% in June (see chart 1). This is still below the ECB's target of "below, but close to 2%" over the medium-term. Abstracting from April, when one-off effects (package holidays) pushed the core rate to the same level, this is the highest level for underlying inflation since May 2013. Although the data may still be affected by some one-off factors, underlying inflation seems to have bottomed out. We and the ECB expect core inflation to drift up gradually on trend. Today's data should leave the ECB on track to take a step in September towards reducing its asset purchases in January 2018.

Headline inflation stable as energy prices and food prices offset each other: Headline inflation was stable in July as higher price increases for energy, non-energy industrial goods and processed foods offset lower gains for services and unprocessed food (see chart 2). Energy prices declined during July, but they fell by less than during the month a year ago. That base effect pushed the headline number and should be a driver of higher transportation costs. More details will be published with the second reading on 17 August. The slightly lower services inflation was probably a partial correction of an unusally strong contribution from package tours to the June inflation. The inflation uptick of non-energy industrial goods, besides services inflation the other component of core inflation, could be a lagged impact of euro weakness last year. With euro less weak now, the stronger core inflation should be put into perspective.

Underlying price increases well below the ECB's target, but showing signs of life: Wages and inflation have been fairly unresponsive to the recovery, for a range of possible explanations such as temporary external price shocks, more slack in the labour market and a weaker impact of slack on inflation. The past period of low inflation is also feeding these dynamics via price and wage setting. Most of the factors should pass eventually. The oil price seems to hold up, rather than weaken further. The labour market continues to improve as unemployment rates across the Eurozone decline (Eurozone to 9.1% in June after 9.2% in May, due to major drops in Italy and Spain). The currency bloc is in for another quarter of robust growth. The Q2 GDP report is due tomorrow. We expect 0.5% qoq, unchanged from a revised Q1, with a major upside risk after strong or stronger than expected country showings. Underemployment, a broader gauge of unemployment that captures the number of workers who would like to work more hours, is also falling. Philipps curve models that employ broader measures than just the headline rate of unemployment appear to be more successful in forecasting inflation.

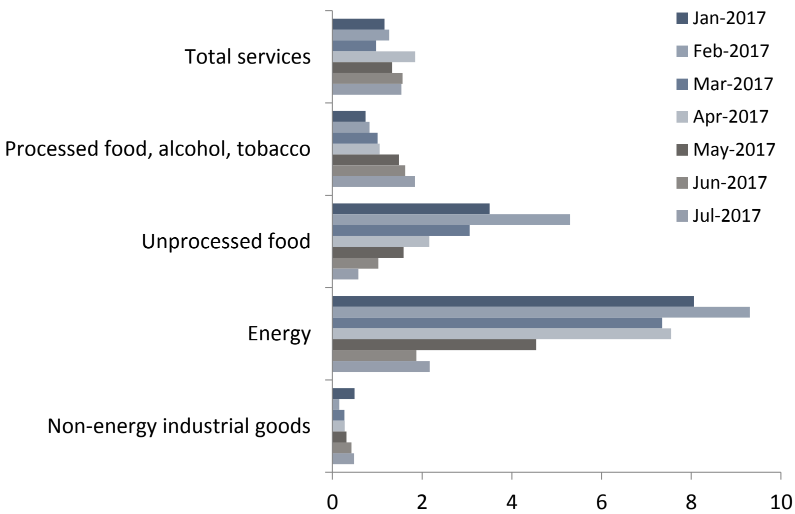
ECB likely to taper from January 2018: As labour market slack continues to be absorbed and industrial capacity utilisation rises, demand and supply should increasingly become more balanced, with wage and price gains picking up gradually. But this will take time. Accordingly, the ECB will adjust its accommodative monetary stance only very slowly. We do not expect the ECB to change its main policy rate, the refi rate, before September 2019, with a chance that they raise the deposit rate from -0.4% to -0.25% in late 2018 or early 2019 already. In the meantime, ackowledging the firmer economic recovery and that deflation risks have dissipated, the ECB will, after confirming that it is studying the options in September, likely announce more details in October. We expect the ECB to reduce its asset purchases from a monthly rate of €60 bn to €45b as of January 2018 and scale back the asset purchases in further steps of €15bn every there months thereafter.

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



Source: Eurostat

Chart 2: Headline CPI by component (yoy, in %)



Source: Eurostat

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