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EUROZONE UNDERLYING INFLATION SHOWS MORE SIGNS OF LIFE

Berenberg Macro Flash

Eurozone inflation, August (yoy, in %)

	Headline	Core
Actual:	**1.5**	**1.2**
Previous:	1.3	1.2
Consensus:	1.4	1.2
Berenberg:	1.4	1.1

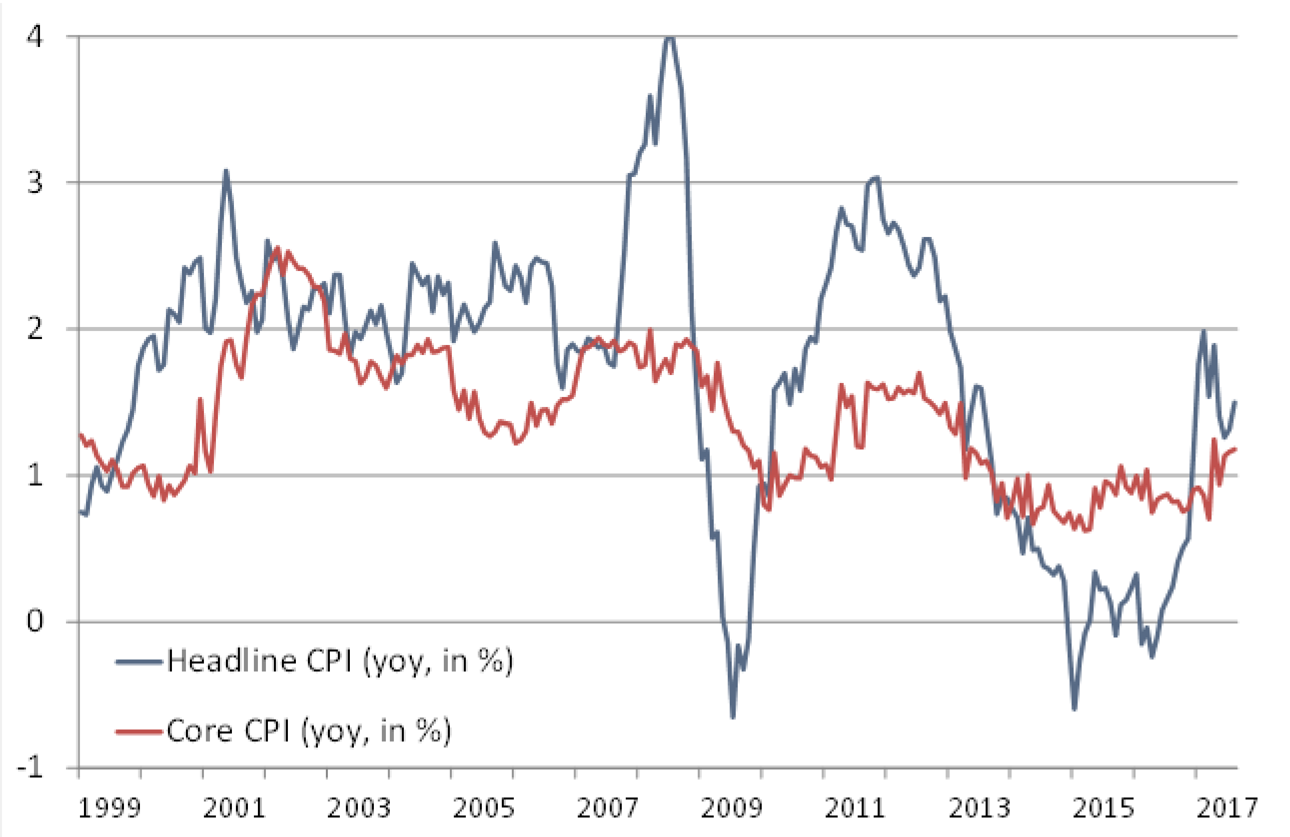
Beyond the bottom: Eurozone inflation did not move much in August. Headline inflation picked up by more than expected (1.5% yoy after 1.3% in July and 1.4% expected), the highest reading in four months, owing to higher fuel prices. Core inflation, the measure that strips out volatile components such as food and energy, remained stable at 1.2% yoy (see chart 1). Looking at the two-digit number it rose slightly to 1.18% after 1.16% in July and 1.14% in June. Underlying inflation seems to have bottomed out. Abstracting from the swings between March and May, when one-off effects (package holidays) distorted the monthly inflation readings, core has slowly, but steadily edged up since the beginning of this year. After April this year, it is at the highest rate since May 2013. We and the ECB expect core inflation to drift up gradually on trend – the prospect of which is enough for the ECB to announce next week that they are starting to discuss the options of tapering – without committing to anything, yet.

Headline inflation picks up on higher energy prices: Higher price increases for energy, non-energy industrial goods and processed foods drove headline inflation higher in August. This time the other components of the inflation basket did not offset these gains. Services inflation and price gains of unprocessed food remained at the previous month's level (see chart 2). Energy prices increased in August and by more than in July compared to the previous year. That should also drive transportation costs higher. More details will be published with the second reading on 18 September. That non-energy industrial goods, besides services inflation the other component of core inflation, were up compared to the previous month is somewhat surprising given the recent euro strength. It confirms yesterday's reading of the European Commission's economic sentiment index that showed firms reporting higher selling price expectations in August.

Underlying inflation shows more 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 has held up. The currency bloc is in for further robust growth, though at a slightly more moderate pace than in the first half of the year owing largely to the euro strength. We expect GDP growth to slow down to 1.9% annualised after 2.3% in the first two quarters of 2017. The labour market continues to improve as unemployment rates across the Eurozone decline, even though the rate for the Eurozone average remained unchanged at 9.1% in July. Underemployment, a broader gauge of unemployment that captures the number of workers who would like to work more hours, has been falling. Philipps curve models that employ broader measures rather than just the headline rate of unemployment appear to be more successful in forecasting inflation.

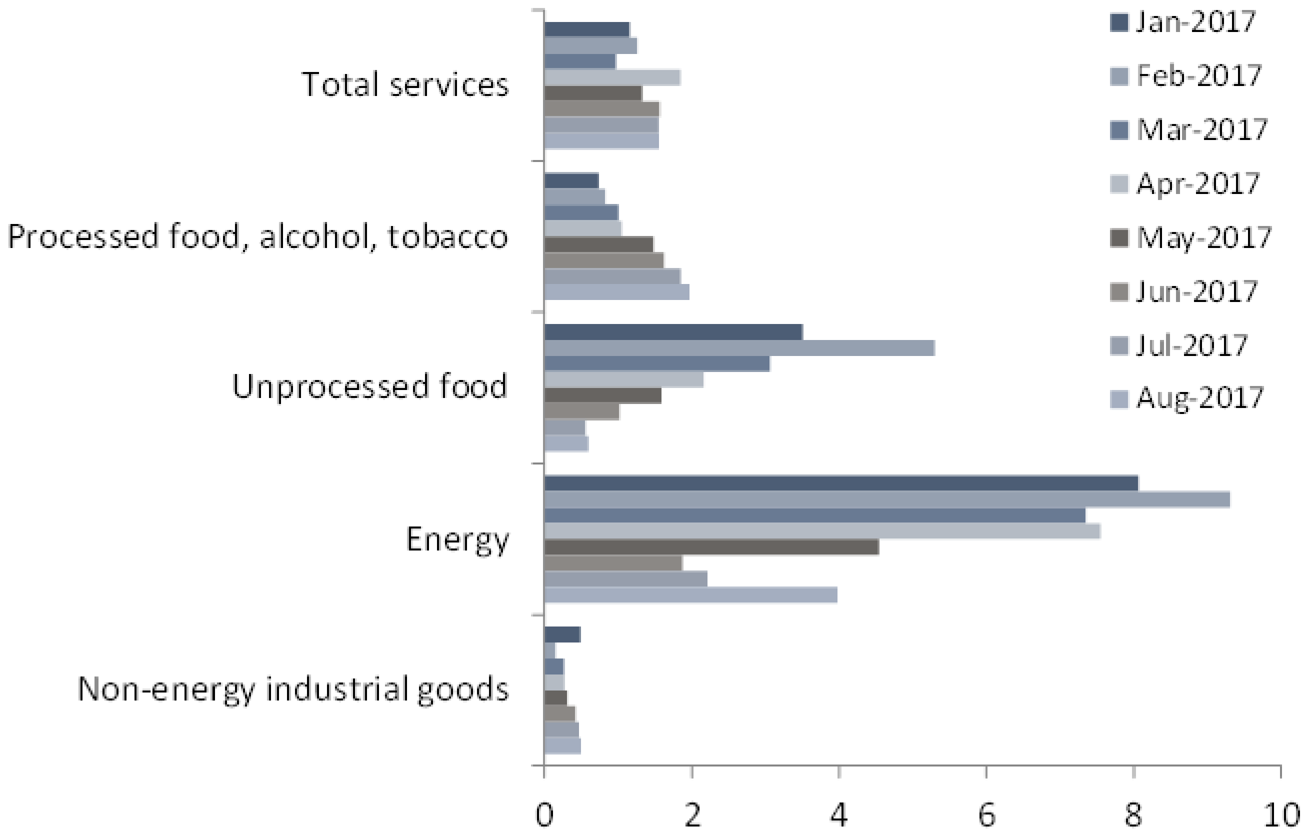
For the ECB, it's October: August's inflation reading, both headline and core, remain below the ECB's target of "below, but close to 2%". The euro's 5-6% appreciation versus a trade-weighted basket of currencies since Q2 limits the upside potential for inflation in the months ahead. We expect the ECB to acknowledge this in three ways: 1) The ECB will likely downgrade its inflation forecasts for 2018 (1.3%) by 0.1ppt and for 2019 (1.6%) by 0.2ppt when it publishes its new round of staff projections next Thursday. 2) The ECB will announce next week that it will start looking at a number of options of how to withdraw the current monetary accommodation. The ECB will probably communicate the details of by when and how at its 26 October meeting. We expect monthly purchases of €45bn from January 2018 onwards. 3) The ECB will make sure to avoid any unwarranted tightening of financial conditions. This could mean that they will not provide a definite tapering path, but will stress the open-endedness of tapering. If the reduction of asset purchases in Q1 does not cause any unwarranted tightening of financial conditions and inflation keeps edging up, we expect the ECB to reduce their net purchases by €15bn each quarter. In the case that the exchange rate gains renewed momentum, tapering could last longer than we currently expect, say 12-15 months instead of 9 months. In any case, the ECB can stress that even in a tapering world, the stance will remain very accommodative for a long time. The ECB will unlikely change its main policy rate, the refi rate, before September 2019.

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



Sources: Eurostat.

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



Sources: Eurostat.

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