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EUROZONE: ECB READY TO GO DESPITE A SMALL DIP IN CORE INFLATION

Berenberg Macro Flash

Eurozone inflation, September, in %, yoy

	Headline	Core
Actual:	**1.5**	**1.1**
Previous:	1.5	1.2
Consensus:	1.6	1.2
Berenberg:	1.6	1.2

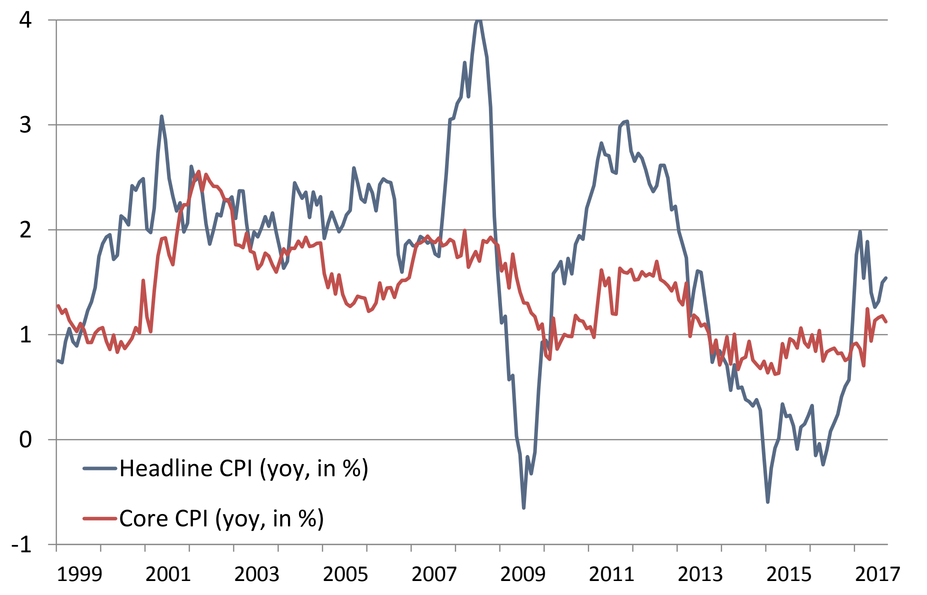
Unexpected correction: Eurozone headline inflation rose only marginally in September from 1.50% yoy to 1.54% (compared to expectations of 1.6%) according to a flash estimate. Surprisingly, core inflation, the measure that strips out volatile components such as food and energy, fell from 1.2% to 1.1% (see chart 1). Abstracting from the one-off swings between March and May, the core rate had slowly but steadily edged up since the beginning of this year. The correction in September suggests that the overall uptrend in underlying inflationary pressures will remain gradual. September inflation is the last reading available to the ECB's Governing Council when it meets on 26 October. The small correction in core inflation does not change our view that the ECB will decide to scale back its asset purchases as of January 2018.

Headline marginally up, core down: Lower price increases for services and energy mostly offset higher prices for non-energy industrial goods, processed and unprocessed food in September (see chart 2). Although pump prices rose in September by 1.9% mom, the yoy rate (4.8%) fell slightly because of a base effect. This year's appreciation of the euro may have contributed to a slightly softer reading for services inflation. The euro is up 12% against the US dollar and 6% against a trade-weighted basket of currencies. The exchange rate towards the US dollar rose to 1.19 on average in September compared to 1.18 in August, despite some losses this week. However, the inflation data do not yet indicate a major exchange rate effect. Exchange rates have little impact on mostly domestically generated services inflation (which fell in September) and more on inflation of non-energy industrial goods, which accelerated slightly in September. Going forward, underlying inflation is likely to rise modestly. Yesterday's European Commission's economic sentiment survey showed that firms had higher selling price expectations in September. More inflation details will be published with the second reading on 17 October.

Tightening labour market translates into strengthening wage growth and inflation: Underlying inflation remains subdued, but is creeping up. It is textbook economics: As demand increases and supply does not keep pace, prices rise. As companies create jobs, and the available pool of workers does not rise correspondingly, wages improve. The Eurozone has created 6.7 million jobs between 2013 Q2 and 2017 Q2 – 0.4 million every quarter. With around 0.8 million more jobs required to return to the pre-crisis average employment rate between 2005 and 2008, and assuming that the pace of job gains stays at the 1.6% yoy rate of Q2, the Eurozone could be back to normal at the end of this year – just as the ECB will likely start to withdraw some of its monetary accommodation. With more signs of labour shortage here and there, wage growth picks up (see chart 3). Eurozone compensation per employee rose from 1.4% to 1.6% yoy in Q2, the strongest rate since 2013 Q4. It may lead the ECB to raise its wage growth projections in December for the first time since 2015 Q1 when QE started. An update to the core inflation outlook could follow suit.

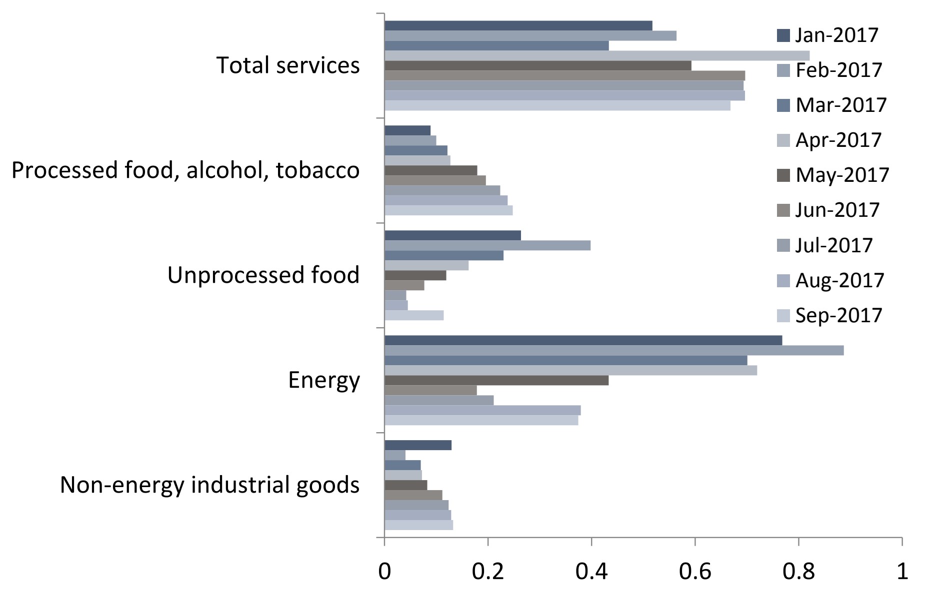
The ECB is ready to go: We expect the ECB to announce in October to reduce its monthly asset purchases from €60bn to €40bn as of January 2018 for a minimum period of six months, followed by a further cut to €20bn in July 2018 and an end to such purchases in late 2018. We continue to forecast the first 25bp refi rate hike for September 2019.

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



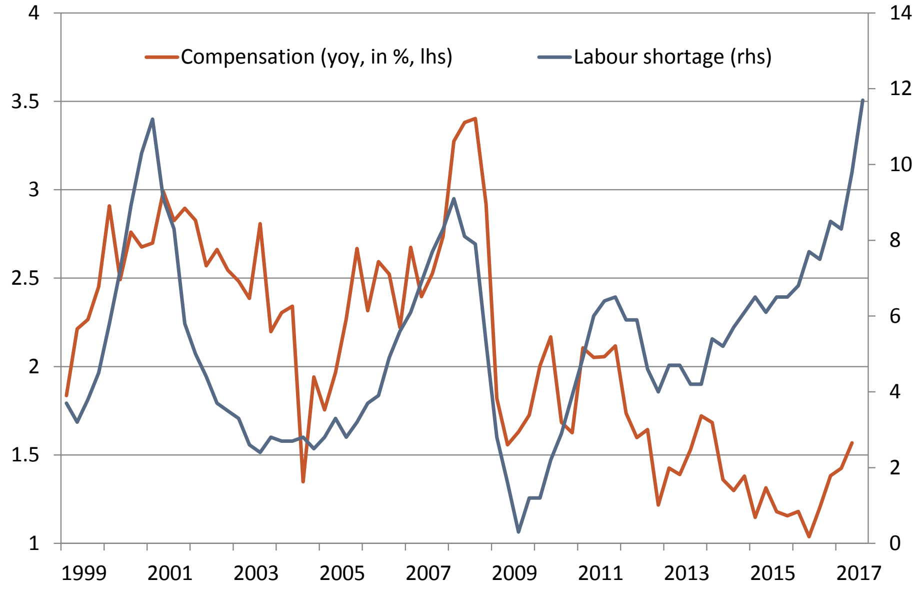
Source: Eurostat

Chart 2: Contribution to headline CPI by component (yoy, in %)



Source: Eurostat

Chart 3: Compensation (yoy, in %) versus labour shortage



Labour shortage refers to the European Commission's economic sentiment survey's question of what limits the production of manufacturing companies.
Source: ECB, European Commission

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