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ECB TO END QE IN SEPTEMBER DESPITE WEAK INFLATION AND STRONGER EURO

Berenberg Macro Flash

Eurozone inflation, December, in %, yoy

	Headline	Core
Actual:	**1.4**	**0.9**
Previous:	1.4 (flash)	0.9 (flash)
Consensus:	1.4	0.9
Berenberg	1.4	0.9

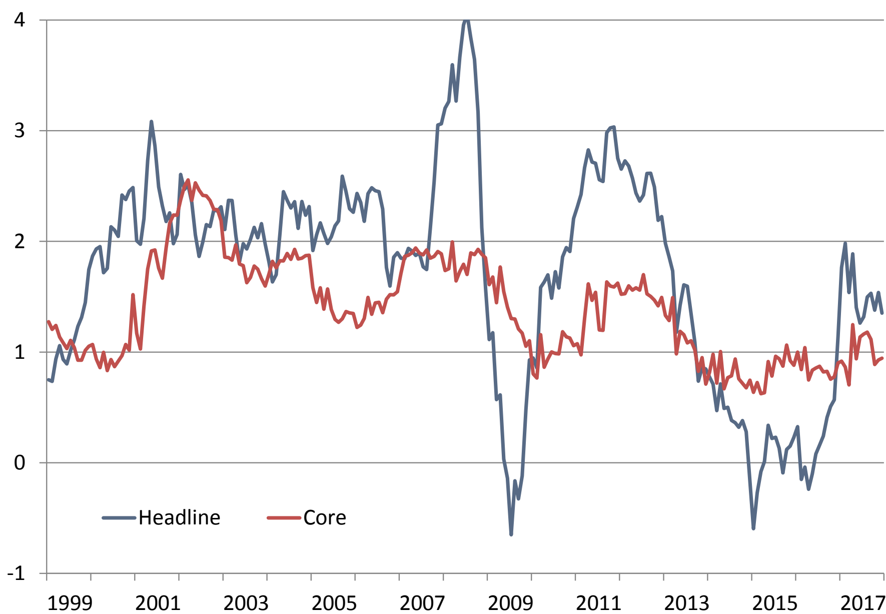
Another weak inflation reading: Subdued inflation for a third month in a row does not change our view that the ECB should and will end its asset purchases in September 2018 and deliver a first hike in its deposit rate in Q1 2019. Eurozone headline inflation fell from 1.5% yoy in November to 1.4% in December, in line with expectations and Eurostat's flash estimate (see chart 1). Lower price increases in energy were only partly offset by a (slightly) bigger rise in prices of processed food and non-energy industrial goods (see chart 2). Services inflation did not accelerate as the contribution of most components of services prices to headline inflation were roughly unchanged. A faster rise in transport costs was offset by slower price increases for package holidays (see chart 3). Looking forward, annual rates of headline inflation are likely to moderate slightly in the coming month as the base effect from the stronger increase in oil prices a year ago outweighs the recent renewed spike in oil prices. From spring onwards, inflation is likely to edge up again.

Underlying inflation is low, but wage growth continues to edge up: Core inflation, the measure that strips out volatile components such as food and energy, remained unchanged at a low rate of 0.9% (see chart 3). Underlying inflation is low because its major determinant, services inflation, remains low. This largely reflects the still very modest rates of wage inflation. The factors keeping wage inflation subdued despite well-above-trend growth in real GDP and rapid employment gains are partly structural (globalisation, technological change, preferences shift towards job security and work-life balance) and partly cyclical (more slack in the labour market, backward-looking wage setting). As demand expands faster than supply and puts strains on available resources (labour and capital), we look for the Phillips curve to reassert itself with a modest rise in wage inflation. The process already started last year as wage gains accelerated from 1.3% yoy in Q3 2016 to 1.7% in Q3 2017. We expect wage growth in the Eurozone to pick up to 2% yoy by the end of 2018, led by places like Germany where labour unions demand pay rises of 6% (and may get 6% spread out over two years, that is 3% per year).

More wage inflation, but also higher productivity growth: Will such a pick up in wage inflation also translate into higher inflation? This depends on how much unit labour costs rise. Unit labour costs are determined by wages and productivity. Will productivity growth accelerate as well? There are good reasons to believe so. Businesses in the Eurozone periphery are becoming more confident to invest in long-lived assets than before as they further shrug off the cautious mind-set of the past. In Germany with a tight labour market, businesses struggle to find workers and start to have no other option than to invest in machinery and equipment. Both could contribute to a rebound in labour productivity, and, therefore, a smaller rise in unit labour costs than the pick up in wage inflation suggests. This means the uptick in underlying inflation will likely be modest (from 0.9% yoy in Q4 2017 to 1.4% in Q4 2018).

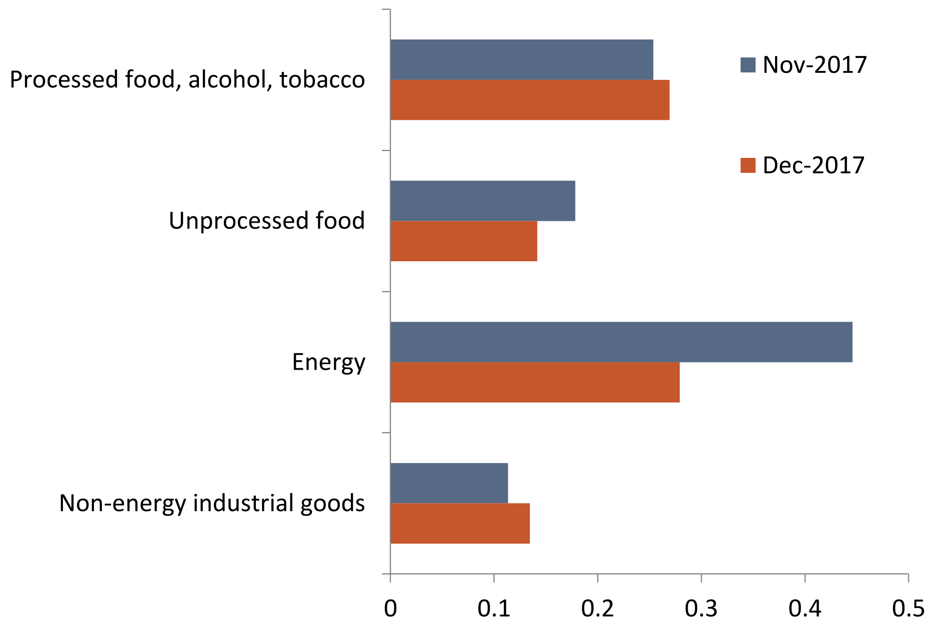
The ECB should and will likely stop asset purchases after September: Recent hawkish comments, including the minutes of the last meeting, point in that direction. Becoming ever more confident in the convergence of inflation towards its target, and possibly also fearing to fall behind the curve, the ECB will likely adjust its forward guidance and policy. However, in order to not trigger a further appreciation of the euro, the ECB will likely change its communication only cautiously and gradually – and not in January already. We expect changes at the meetings in March (downgrading the notion that QE could be extended and scaled up if need be and delinking asset purchases from current inflation) and June (announcing the end of purchases in September). For the time being, the stronger euro (2% versus the US dollar ytd) poses only a small risk to the inflation outlook, and is more than offset by higher oil prices. On a trade-weighted basis, the euro gains have been smaller anyway (less than 1%), so the pickup in the bilateral exchange rate owes as much to the euro's strength as to the US dollar's weakness. Still, the ECB will likely try to slow down the euro's rise by warning against sudden moves or the like at its meeting next week as some ECB board members have started to do already this week.

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



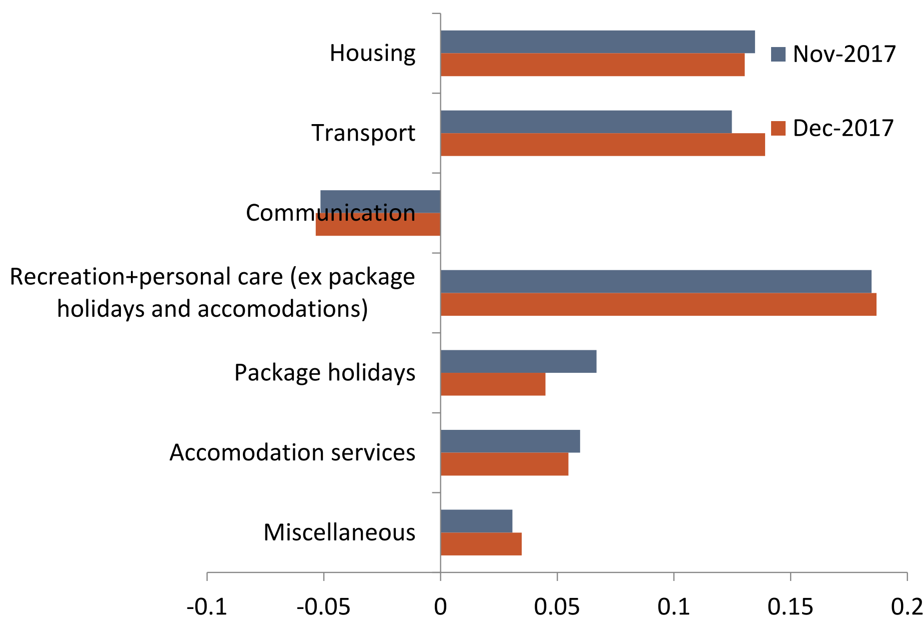
Source: Eurostat

Chart 2: Contribution to headline CPI by goods components (yoy, in ppt)



Source: Eurostat

Chart 3: Contribution to headline CPI by services components (yoy, in ppt)



Source: Eurostat

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