Florian Hense, Economist | florian.hense@berenberg.com | +44 20 3207 7859

EUROZONE INFLATION UNDERPINS SLOW ECB EXIT

Berenberg Macro Flash

Eurozone inflation, January, in %, yoy

	Headline	Core
Actual:	**1.3**	**1.0**
Previous:	1.4	0.9
Consensus:	1.2	1.0
Berenberg	1.3	1.0

Core inflation slightly up: Eurozone core inflation ticked the 1% mark for the first time in four months in January on the back of stronger price gains of non-energy industrial goods and a marginal upwards shift in services inflation (see chart 1). Since its drop in October to below 1%, core inflation has edged up, but only slowly and remains subdued. It means that despite real GDP growing well-above trend the ECB will have to go slowly when removing its monetary stimulus.

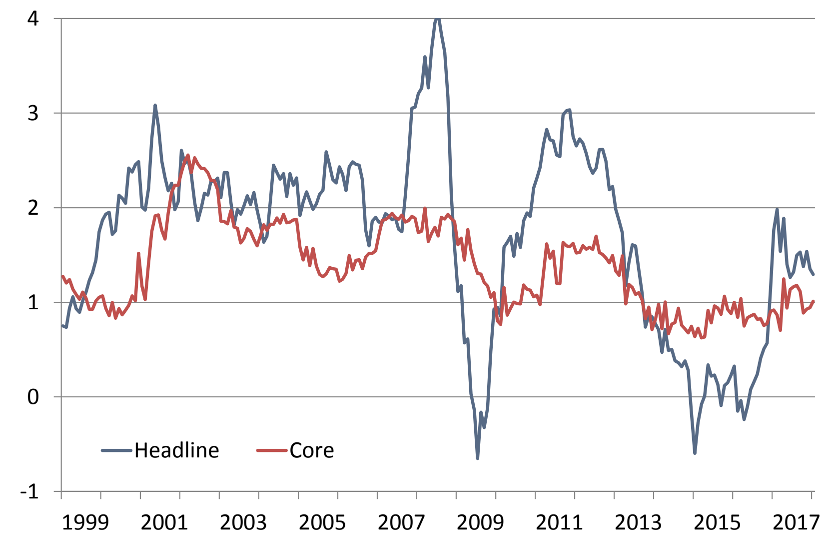
Headline rate down: Headline inflation, which also includes the food and energy components, slowed from 1.4% to 1.3%. Oil price base effects and lower price increases in unprocessed food offset a rise in core components and processed food. Looking forward, annual rates of headline inflation may remain flat in the coming month as the base effect from the stronger increase in oil prices a year ago compensates the recent renewed spike in oil prices. From March onwards, inflation is likely to edge up again.

Cyclical indicators signal inflationary pressures are building: Core goods inflation is on a gradually rising trend since last year (for its contribution to headline inflation, see chart 2). While the evidence for rising services inflation is less clear, underlying forces suggest services price inflation should gain momentum throughout the year, too. Supply constraints are replacing lack of demand as the limiting factor to business ever more, according to yesterday's Economic sentiment index. Narrow and broader measures of unemployment have fallen to levels last seen at the beginning of the financial crisis. Among manufacturers, labour shortages may soon surpass demand as the number one limiting factor to production for the first time of the series' history since 1985 (see chart 3). As a consequence, wage growth in the Eurozone could accelerate further to 2% yoy by the end of 2018 from 1.7% in Q3 2017 and 1.4% in Q4 2016.

Other forces will keep price pressures building only slowly: Indicators of demand and supply point to building wage pressure. Yet, this has been the case for some time, without having an effect on core inflation. The question is when or even if the Phillips curve will reassert itself? It is still early on. Despite the strong signs that wage growth will gain momentum, it will take time. First, while a deal in Germany may well raise wage costs in the metal and engineering industry by roughly 3% this year, workers in the services industries and in the rest of the Eurozone will get smaller pay rises. Second, higher productivity growth this year can offset some pick-up in wage gains – unit labour costs will rise by less than the higher wages suggest. Third, while the cyclical factors (more slack in the labour market, backward-looking wage setting) are starting to weigh less on wage inflation, the structural disinflationary factors (globalisation, technological change, preferences shift towards job security and work-life balance) will continue to be present. This means the uptick in underlying inflation will likely be modest (from 0.9% yoy in Q4 2017 to 1.3% in Q4 2018).

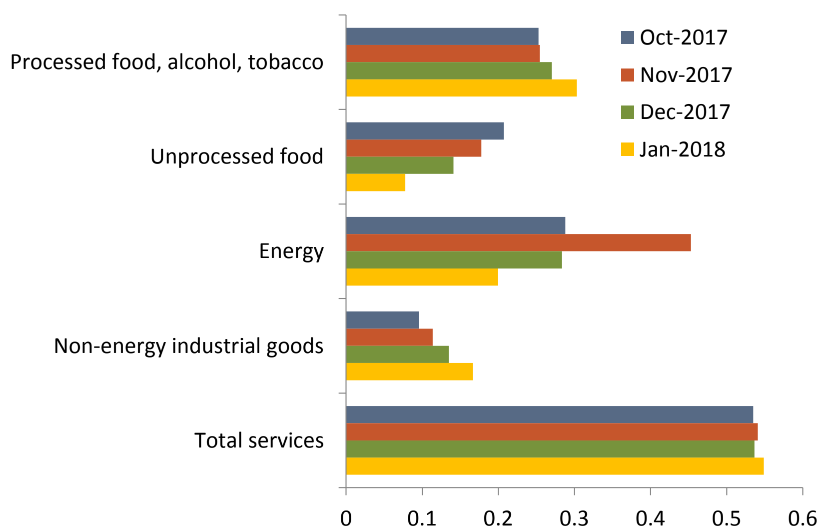
The ECB should and will likely stop asset purchases after September: Becoming ever more confident in the convergence of inflation towards its target, means the ECB can adjust its forward guidance and policy throughout the year. As underlying inflation remains subdued and in order to not trigger an unwarranted appreciation of the euro, the ECB will, however, do that gradually. 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), June (announcing the end of purchases in September) and the start of the rate hike cycle in Q1 2019. If core inflation fails to edge up over the course of the year and/or if the euro strengthens to such an extent that it would dampen the outlook for growth and inflation significantly, the ECB may wait a little longer before eventually reducing its monetary stimulus. In particular, if the euro continues to rise in coming weeks, the ECB may well delay any significant change in its formal guidance until after its 8 March meeting.

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



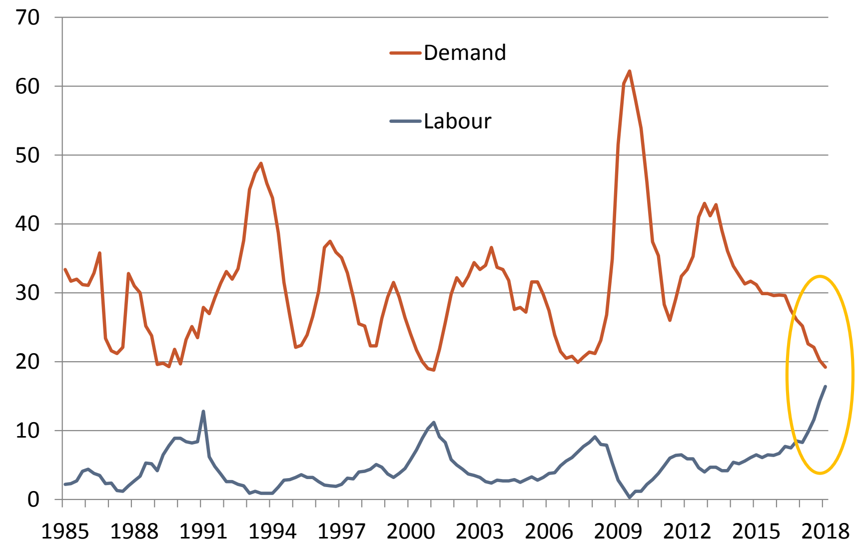
Source: Eurostat

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



Source: Eurostat

Chart 3: Limiting factors to production



The answers "labour" and "demand" refer to the European Commission's economic sentiment survey's question of what limits the production of manufacturing companies. Source: European Commission

Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7859
www.berenberg.com
florian.hense@berenberg.com