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

# EUROZONE UNDERLYING INFLATION EDGING UP

## Berenberg Macro Flash

**Eurozone inflation, February, in %, yoy**

| | Headline | Core |
|---|---|---|
| **Actual:** | **1.2** | **1.0** |
| Previous: | 1.3 | 1.0 |
| Consensus: | 1.2 | 1.0 |
| Berenberg | 1.3 | 1.1 |

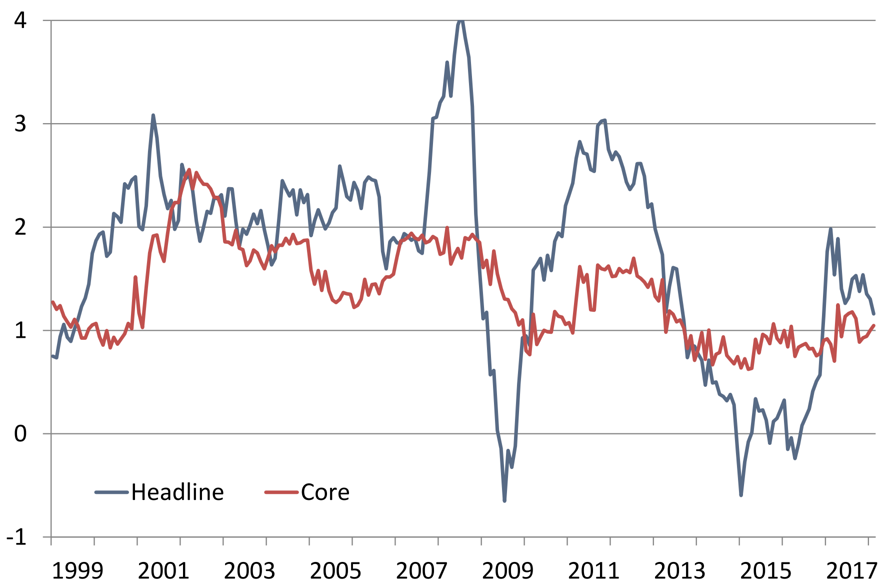
**Low Eurozone inflation gives the ECB space to go slow, or even slower:** With Eurozone prices rising by only 1.2% yoy, the ECB remains far away from its inflation target of below, but close to 2%. Although inflation edged up for some core components for the fourth month in a row, this was more than offset by the drag from the more volatile components of headline inflation such as food and energy. ECB and markets' expectations of higher inflation are yet to materialise, the ECB's growing confidence has yet to turn into certainty. Ample monetary support for aggregate demand thus continues to be warranted in ECB parlance. Today's inflation reading may tilt the ECB to wait for more signs of price pressures building over the next months before adjusting its guidance significantly. At its 8 March meeting, the ECB Governing Council may possibly still maintain its QE easing bias, namely the notion that asset purchases could be scaled up if required.

**Headline rate sagging, core edging higher:** Headline inflation moderated for the third month in a row from 1.3% yoy in January to 1.2% in February, the weakest since December 2016, partly on the back of smaller price gains for food and energy. Food price inflation slowed to 1.1% after 1.9% in the previous month. This was largely caused by a base effect. Prices for unprocessed food had surged in February 2017 (5.3% yoy) due to a shortage of vegetables in Germany and France. Over the last 12 months, those prices have actually dropped by 0.9%. In sum, the food components shaved about 0.15ppts off the headline rate. Energy prices dropped roughly 4% mom in February in euro terms, with the oil price up only by 2.9% yoy after 8.2% in January. While failing to offset those drags, prices of the core components edged up modestly further, raising the core rate from 1.000% in January to 1.047% in February, just shy of 1.1%. Price increases for both non-energy industrial goods (NEIG) and services were stronger. While accelerating only from 0.6% to 0.7% (NEIG) and 1.2% to 1.3% (services), this is the kind of glacial pace we should expect with cyclical factors pointing to somewhat higher inflation while structural and other forces keep price increases limited. From March onwards, both headline and core inflation are likely to edge up.

**Cyclical, structural and other factors fight it out:** Capacity constraints of both labour and capital are replacing lack of demand as the limiting factor to expand business ever more. Capacity utilisation is at a post-crisis high according to surveys of the European Commission. Narrow and broader measures of unemployment have fallen to levels last seen at the beginning of the financial crisis. As a consequence, wage growth in the Eurozone could increase further to 2% yoy by the end of 2018 from 1.7% in Q3 2017 and 1.4% in Q4 2016. But despite signs that wage growth will gain a little momentum, it will take time. First, while a wage deal in Germany raises wage costs in the metal and engineering industry by roughly 3.5% 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, the structural disinflationary factors (globalisation, technological change, preferences shift towards job security and work-life balance) will continue to be present. As a result, the uptick in underlying inflation will likely be modest (from 0.9% yoy in Q4 2017 to 1.3% in Q4 2018).

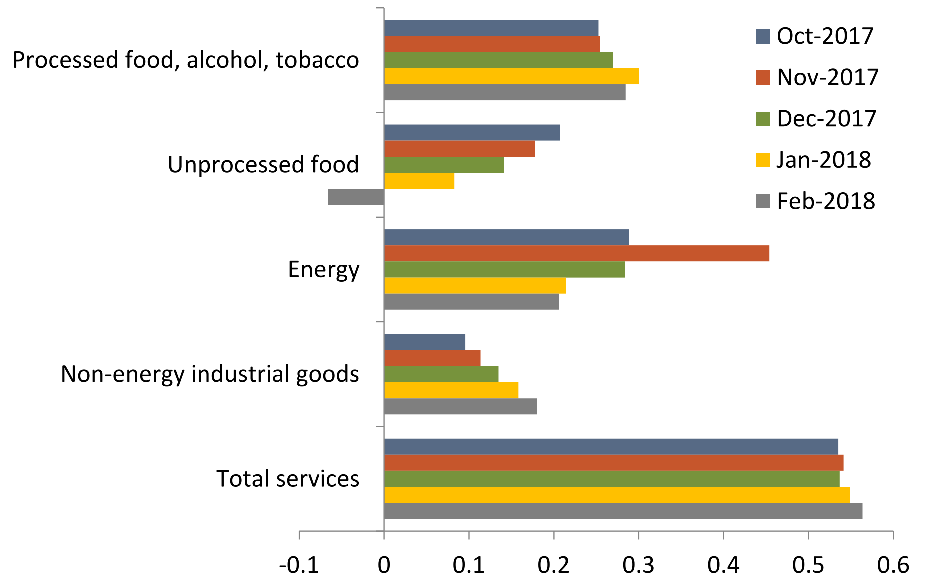
**The ECB will be patient and persistent:** That some components of core inflation has been edging up for four months in a row is providing ECB policymakers with confidence that the strong momentum of the Eurozone economy will eventually raise inflation towards the target rate of below, but close to 2%. As price pressures will build up only very slowly, patience and persistence are still necessary. In other words the ECB will adjust its stance only very gradually. We expect changes over the next months. Initially, the ECB may just tone down the notion that QE could be extended and scaled up if need be. The ECB may also de-emphasise the link between asset purchases and inflation. This summer, we expect the ECB to announce the end of purchases and provide more specific guidance towards the start of the rate hike. We look for the first refi rate hike in June 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.

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




*Source: Eurostat*

**Chart 2: Contribution to headline inflation by components (yoy, in % points)**




*Source: Eurostat*



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