BERENBERG

PARTNERSHIP SINCE 1590

MACRO NEWS 04/04/18

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

EUROZONE UNDERLYING INFLATION PICK-UP IS TAKING ITS TIME

Berenberg Macro Flash

Eurozone inflation, March, in %, yoy

	Headline	Core
Actual:	1.4	1.0
Previous:	1.1	1.0
Consensus:	1.4	1.1
Berenberg	1.4	1.1

Price pressures are a far cry from 2%: Above-trend demand growth in the Eurozone continues to translate only very slowly into rising price pressures. While annual headline inflation rebounded from its 14-month low in February to the highest rate since late 2017, the core rate, a better measure of underlying inflation and slow-moving trends, remained unexpectedly (fairly) flat. Despite inflation having moved up – at a glacial pace, of course – and indicators of supply and demand suggesting anything but an end to this movement, inflation is yet to show a convincing, sustained upward trend towards the ECB's target of "below, but close to 2%". The ECB can, therefore, take it slow, let its net asset purchases run until the end of this year and wait for its first refi rate hike until summer 2019. Stay tuned.

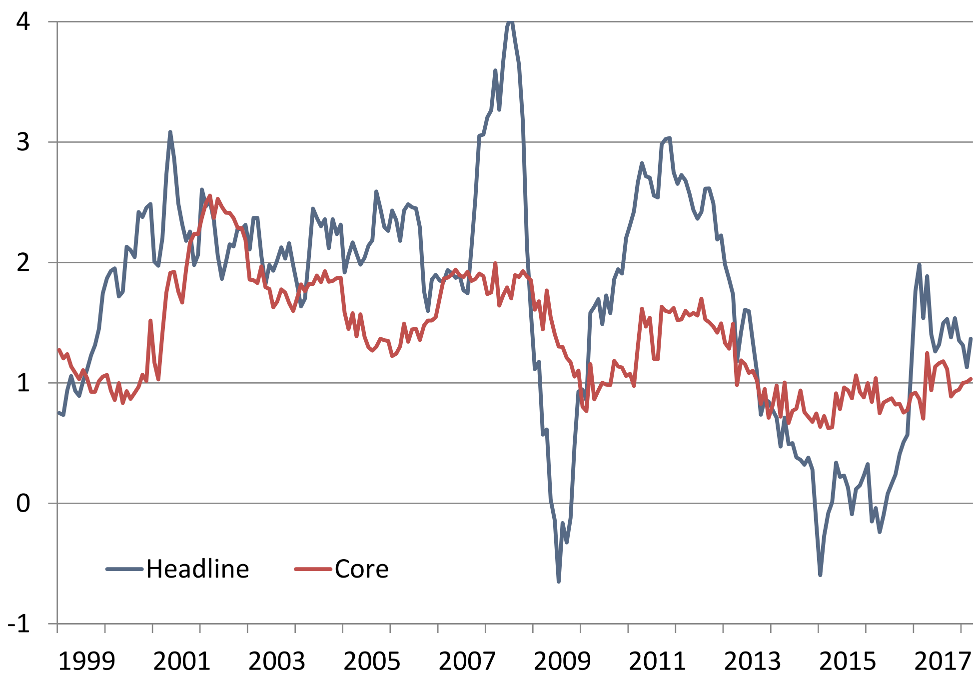
Headline rate rebounding: Headline inflation rose from 1.1% yoy in February (revised down from 1.2%) to 1.4% in March (see chart 1), mostly on the back of bigger price gains for food and services. Food prices increased by 2.2% yoy after 1.1% in February. In sum, the food components added about 0.25ppts more to the headline rate in March compared to February (see chart 2). The contribution of energy components to the headline rate remained stable at 0.2ppts, with prices rising by 2.0% yoy (after 2.1% in February). The Brent oil price in euro terms rose slightly by 1.8% mom, while pump prices fell 1.5% mom.

Core inflation broadly unchanged: The core rate remained fairly flat, rising from 1.01% yoy in February to 1.03% in March versus expectations of 1.1% and a 1999-2007 average of 1.6%. The steady core rate masks opposing movements. Services prices, the best gauge for domestically generated inflation as most services jobs are labour intensive and have do be done locally, rose by 1.5% yoy, after 1.3% in February and the 1999-2007 average of 2.3%. Rather than resulting from a strong pick-up in wages, this was likely due to a calendar effect with Easter this year much earlier than in 2017 and prices for package holidays distorting services prices upwards. We have to wait for the second reading published on 18 March for confirmation. Price increases for non-energy industrial goods (NEIG) were surprisingly weak, slowing from 0.6% yoy in February to 0.2% in March. This could owe to the rise in the euro's effective exchange rate on a trade-weighted basis by 6% yoy, even though over the recent past it seemed the exchange rate pass-through to prices had turned weaker.

Watch wage dynamics and labour productivity: March's reading of Eurozone inflation shows yet again that price pressures are building only very slowly despite above-trend demand growth – blame among other things a weaker responsiveness of inflation to slack and a greater uncertainty about the actual degree of slack. Going forward, the key is to watch 1) wage dynamics, i.e. stronger wage growth, and 2) the pass-through of wages into prices, i.e. stronger wages translating into higher unit labour cost (ULC) growth. Wages have trended up from the Q2-2016 trough of 1.1% yoy to 1.8% in Q4 2017. Labour productivity has also picked up, offsetting the stronger wage growth, so that ULC growth has remained around 0.6-0.9% yoy in 2017. Over the medium-term we expect wage growth to outpace productivity growth and higher ULC growth.

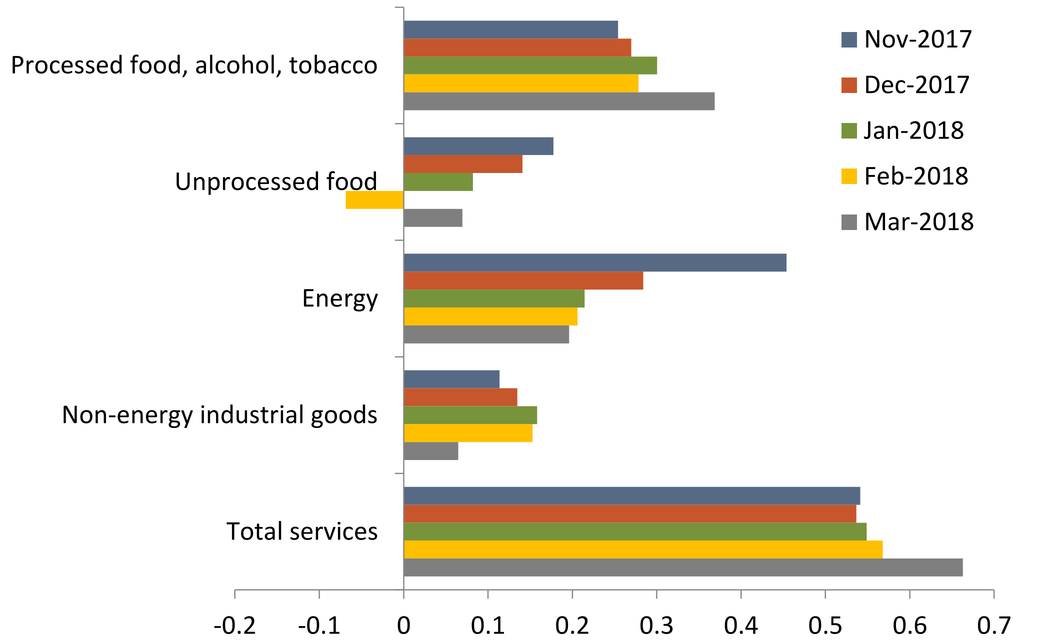
The ECB can go slowly: Going forward, we expect the ECB to adjust its guidance and its policy stance in a series of baby steps. If growth and inflation stay on track, the ECB will probably link its guidance on interest rates more closely to the inflation outlook and scale back the amount of monthly asset purchases from the current €30bn to €15bn net per month from October onwards until the end of December 2018. We expect the first refi rate by 25bp in June 2019, a second hike in December 2019, followed by roughly three further such steps in 2020. If core inflation fails to edge up over the course of the year or the current trade tensions escalate, the ECB may wait even longer before eventually tightening its policy. If growth continues to surprise on the upside while core inflation edges up, the ECB may raise its refi rate as soon as March 2019.

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