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EUROZONE INFLATION: EASTER TIMING OBSCURES SLOW UPWARD TREND

Berenberg Macro Flash

Headline, core and services inflation all softened in April by more than expected. Taking the weaker than expected April rates (headline at 1.2%, core at 0.7% and services at 1.0%) at face value, the ECB's projection that inflation will rise gradually is still more wishful thinking than reality. However, the April decline in inflation owes largely to the timing of Easter and should correct itself next month. The ECB will look through the volatility in the current inflation data. An oil-driven spike in headline inflation up to 1.7% or even 1.8% in the summer months may possibly scare some observers. But beyond a temporary oil effect this year, the medium-term outlook remains benign. Underlying inflation looks set to firm very gradually, allowing the ECB to stick to its schedule of reducing its monetary stimulus cautiously.

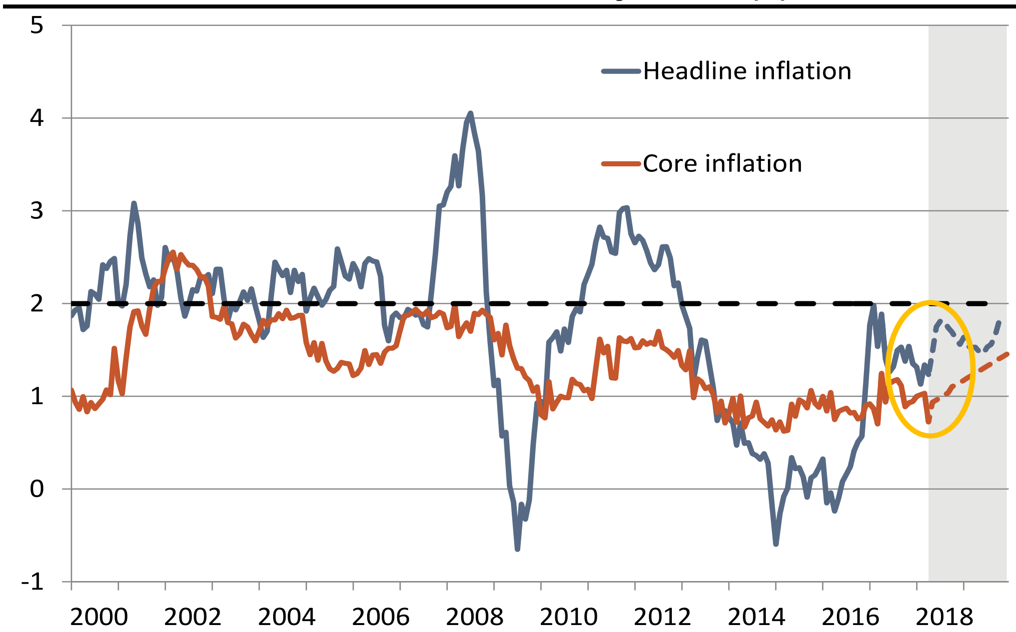
Collapse in services inflation: Headline inflation in the Eurozone decelerated from 1.4% yoy in March and consensus of 1.3% to 1.2% in April (see chart 1). Higher prices for both processed and unprocessed food and for energy all provided bigger contributions to the headline rate than in March. The lower headline rate was driven by a drop in services inflation, which declined from 1.5% yoy in March to 1.0% in April (see chart 2). Slightly stronger price increases for non-energy industrial goods (NEIG) – up from 0.2% yoy in March to 0.3% in April – did not offset that. Core inflation, which consists only of the services and NEIG components of the goods' basket, fell as a result to 0.7% yoy in April, the weakest in 13 months, from 1.0% in the three months before and 0.9% expected (see chart).

Easter base effect weighs on services inflation: Core and services inflation are usually relatively good gauges of underlying price pressures and attractors for the headline rate over the medium-term. This is why we pay particular attention to their ups and downs, also to make out a possible change in the direction of a trend. The drops in April do not signal a change in the trend. Core and services inflation were distorted by exceptional factors. The early Easter holidays created a base effect. The Easter holidays fell on 1 April in 2018 and 16 April in 2017. While higher costs for holiday spending were fully captured during April in 2017 (prices are collected in the middle of the month), this was not the case in 2018. Consequently, the services category (which includes restaurants, hotels and airlines in the holidays business) drove headline and core inflation lower in April after giving it a boost in March.

Watch wage dynamics and labour productivity: For a more telling gauge of where price pressures stand and are heading towards, wait for the next months' readings. For May, we forecast an increase of the headline rate to 1.5% yoy. Driven by higher oil prices, the rate could rise to 1.7% or even 1.8% during the summer months before falling back to levels of around 1.5% as the energy base effect fades out of the yoy comparison. We also expect the core rate to rebound in May to 0.9% and reach 1.2-3% by year end (see chart 1). Going forward, the key issues to watch are 1) the wage dynamics and 2) the pass-through of wages into prices. A tightening labour market has driven wage growth higher to 1.8% in Q4 2017 from 1.1% in Q2 2016. Further strong employment gains will raise wage inflation by more than can be offset by concurrent gains in productivity growth, putting unit labour costs on an upwards trajectory. The risks to our inflation forecasts are tilted modestly to the downside.

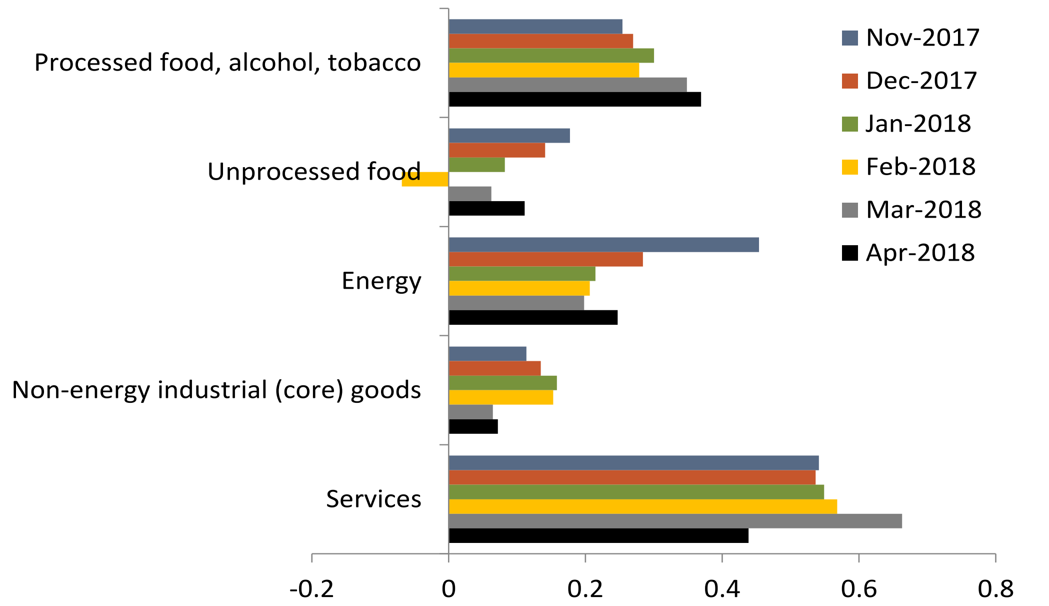
The ECB can keep calm: Going forward, we expect the ECB to adjust its guidance and its policy stance in a series of baby steps. If the trade tensions are largely resolved over the next six weeks, the Eurozone economy can rebound in the summer from its current dent to growth. With core inflation like to rise gradually, the ECB will probably scale back the amount of monthly asset purchases from the current €30bn to €10-15bn 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 the trade tensions escalate much further for much longer, the economy suffers worst than just a temporary slowdown and core inflation fails to edge up over the course of the year, the ECB may delay the end of its asset purchases and the first rate hike by 3-6 months.

Chart 1: Headline inflation, core inflation and Berenberg forecasts (yoy, in %)



Yoy inflation rate, in %. Sources: Eurostat, Berenberg calculations

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



Contributions to yoy headline inflation rate in % points. Source: Eurostat

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