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OIL PUSHES EUROZONE INFLATION TO 2%, UNDERLYING PRESSURES SUBDUED

Berenberg Macro Flash

Eurozone inflation, June, in %, yoy

	Headline	Core
Actual:	**2.0**	**1.0**
Previous:	1.9	1.1
Consensus:	2.0	1.0
Berenberg	2.0	1.0

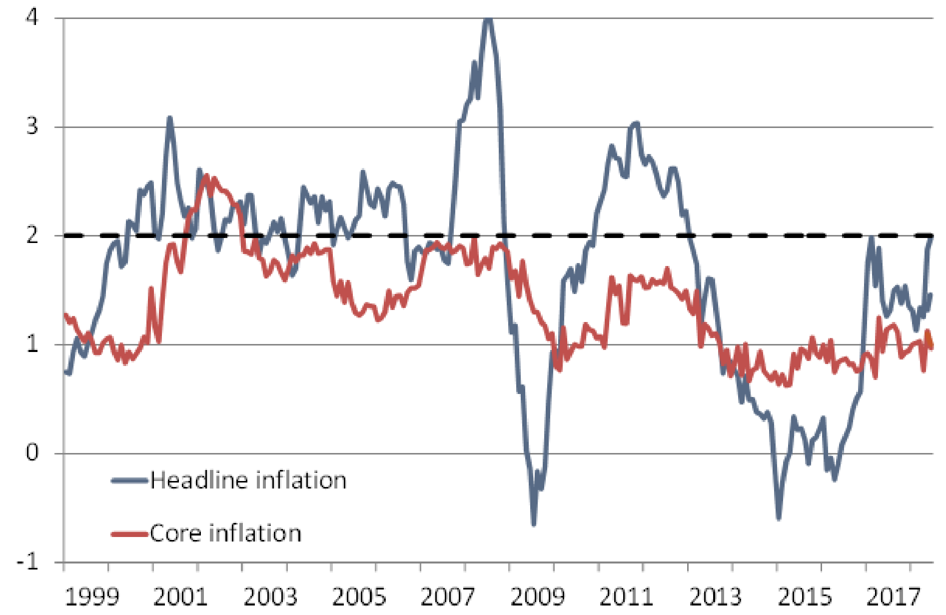
Oil makes the difference: Headline inflation continued to edge higher in June while core inflation eased (see chart 1). The 1ppt gap between headline and core inflation is the biggest since February 2017. The recent rise in oil prices is driving up the energy component of the headline rate. Underlying price pressures, for which the core rate is a better gauge, remain a far cry away from the ECB's 2% target. While the gap will not close by much over the next two months, it will likely do so over the medium-term as long as oil prices do not rise much further. We expect underlying price pressures to build only very gradually. The ECB has no need to speed up its slow policy normalisation process.

Pump prices push headline higher, lower services inflation weighs on core: Headline inflation in the Eurozone accelerated from 1.9% yoy in May to 2.0% in June in line with expectations. Higher prices for both processed and unprocessed food and energy (after falling by 0.9% mom in June 2017, energy prices rose by the same rate in June this year) all provided bigger contributions to the headline rate in June (see chart 2). The core rate receded because services inflation declined from 1.6% yoy in May to 1.3% in June. After the early Pentecost holiday had caused a surge in prices for package tours in May, the effect reversed in June. Slightly stronger price increases for non-energy industrial goods (NEIG) – up from 0.3% yoy in May to 0.4% in June – did not offset that. Core inflation, which consists only of the services and NEIG components of the goods' basket, fell as a result to 1% yoy in June from 1.1% in May.

Convergence over the medium-term: The oil effect may raise headline inflation slightly further in July and August. Thereafter, inflation should recede gradually to levels closer to 1.5% in summer 2019 as the effect of higher energy prices drops out of the yoy comparison. At the same time, the lower contributions from the energy component should be offset partly by core inflation which will gradually edge up as capacity constraints become more binding. 20 consecutive quarters of demand growth are starting to leave their mark on the Eurozone economy. This applies, in particular, to the labour market. 8.5 million new jobs have been created in the Eurozone over the past five years. Among manufacturers, labour shortage is almost on par with demand as a limiting factor to production for the first time of the series' history since 1985 (see chart 3). We expect the tightening labour market to lead to stronger growth in both wages and unit labour costs.

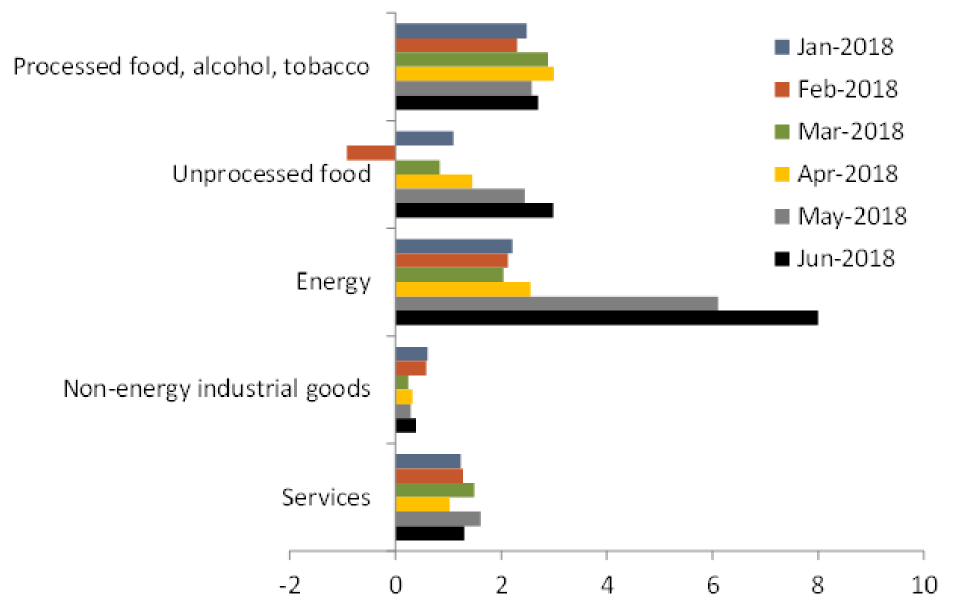
No need to hurry for the ECB: Compensation per employee growth has accelerated from the trough of 1.1% yoy in summer 2016 to 1.9% in Q1 2018. But thanks to stronger productivity gains, unit labour cost growth increased only marginally from 0.7% to 0.8% (see chart 4) and core inflation from 0.8% to 1.0% in the same period. The ECB has won its fight against deflation and no longer needs its tool to combat deflation risks, the monthly net asset purchases. After asset purchases end in December 2018, the ECB can keep rates at its current level through the summer of 2019. In line with the ECB's guidance, we expect a first rate hike in September 2019.

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



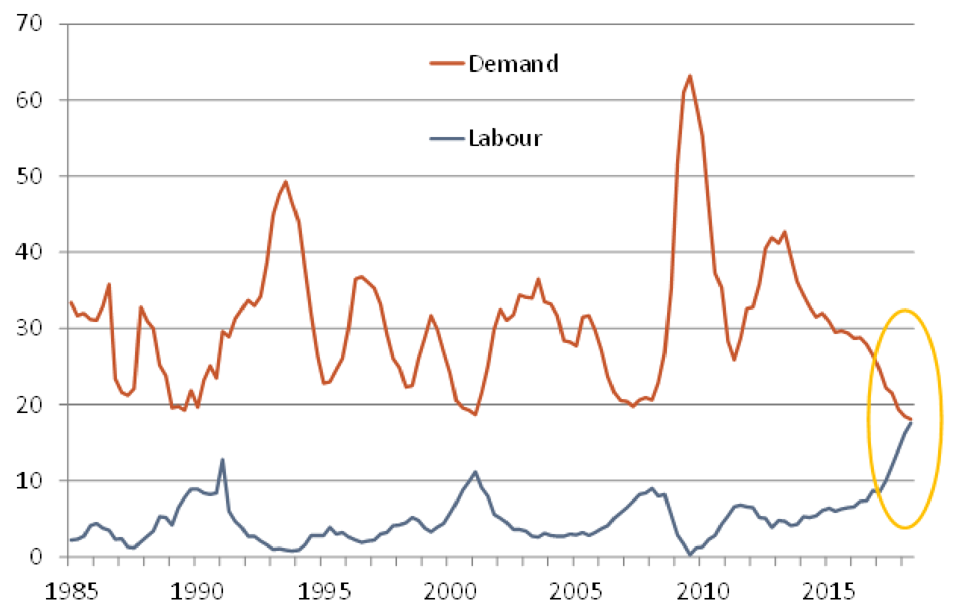
Sources: Eurostat, Berenberg calculations

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



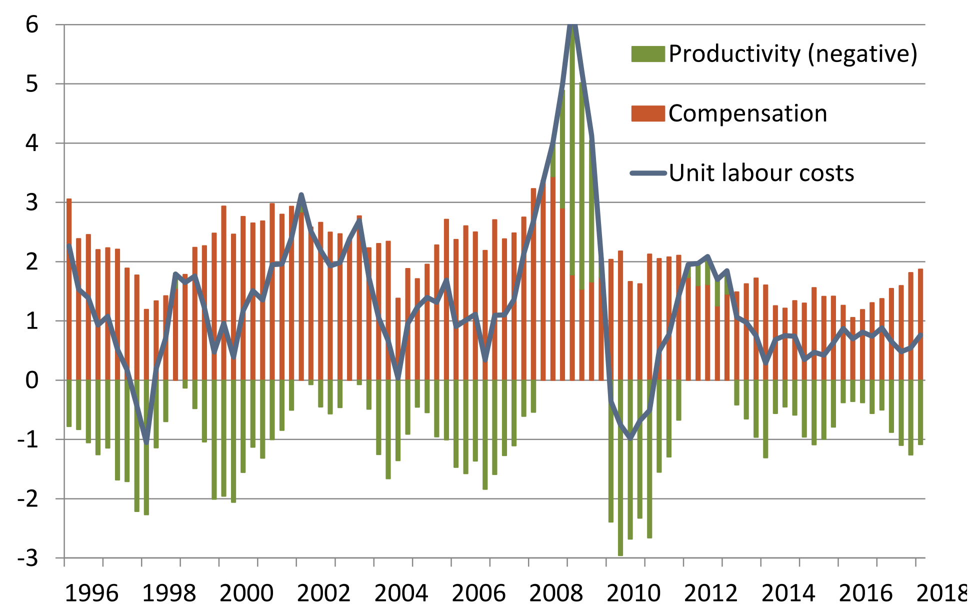
Contributions to yoy headline inflation rate in % points. Source: Eurostat

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 for Q2 2018.
Source: European Commission

Chart 4: Compensation, productivity and unit labour costs (yoy, in %)



Source: ECB

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