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EUROZONE HEADLINE AND CORE INFLATION CONVERGENCE TO COME

Berenberg Macro Flash

Eurozone inflation, August, in %, yoy

	Headline	Core
Actual:	**2.0**	**1.0**
Previous:	2.1	1.1
Consensus:	2.1	1.1
Berenberg	2.1	1.1

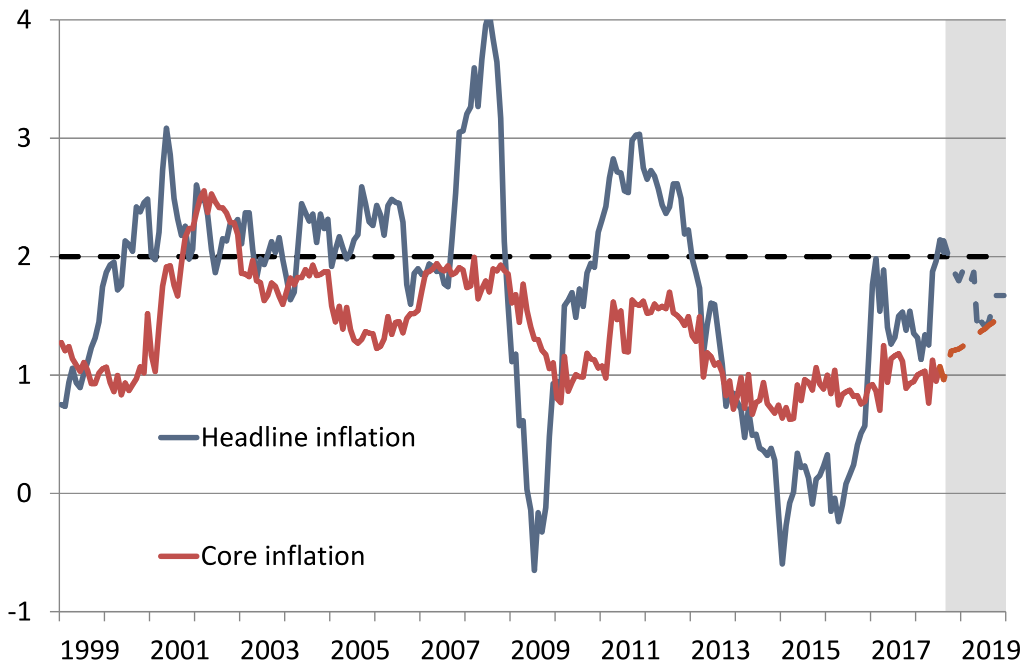
Beyond the peak in headline inflation: Both headline and core inflation edged lower in August with weaker price gains among services and non-energy industrial goods adding to the fading oil price effect. Going forward, headline and core should converge gradually. Oil prices are unlikely to surge much higher from their current levels. At the same time, the underlying forces of demand and supply in the Eurozone are likely to push domestic prices up at a slightly faster pace. Stronger wage gains reflecting emerging labour shortages will increasingly feed through to higher price inflation. The stickiness of core inflation around 1% for the last five years, demonstrated once again by the August print, suggests that this process will take time. Amid risks to the economic outlook stemming from a challenging external environment, the ECB can, therefore, stick to its guidance of normalising its monetary stance only slowly.

The trend is down for headline as oil price base effect fades: Headline inflation in the Eurozone slowed down from 2.1% yoy in July to 2.0% in August (see chart 1). Drivers were lower price gains across the board, including core components (see chart 2) which caused also core inflation to edge lower from 1.1% yoy in July to 1.0% in August. Unless oil prices surge again, headline inflation should recede gradually to levels closer to 1.8% yoy at the end of this year and 1.5-1.6% in summer 2019 as the oil price base effect drops out of the yoy comparison. At the same time, the lower contributions from the energy component should be offset partly by the core components, especially services, contributing ever more to the headline rate (see chart 3). We expect core inflation to reach 1.2% yoy in Q4 2018 and 1.5% in Q4 2019. Higher food prices in the wake of un unusually hot and dry summer will likely show up in headline inflation soon. However, the fading oil effect looks set to dominate, keeping headline inflation on a downward trajectory for the remainder of 2018.

Stronger wage growth should slowly drive services and core inflation higher: 21 consecutive quarters of demand growth are leaving their mark on the Eurozone economy. This applies, in particular, to the labour market. The Eurozone has created more than 8.5 million new jobs over the past five years. This has pushed the unemployment rate down from 12.1% in summer 2013 to 8.2% in June and July 2018, the lowest level since November 2008. As businesses compete more for employees, labour turns short in supply and employees' bargaining power improves. This translates into somewhat stronger wage growth over time. While the growth in total compensation has advanced from the lows of 1.1% yoy in Q2 2016 to 2% in Q1 2018 (see chart 4), much of this owed to wage drift. Instead of settling for stronger gains in negotiated wages, businesses were paying higher bonuses and for overtime hours. More recently, stronger growth in negotiated wages from 1.5% yoy in Q4 2017 to 2.2% in Q2 2018 suggests that the pick-up in compensation could be sustained. Some of the increase in negotiated wages stems from German one-off effects, though.

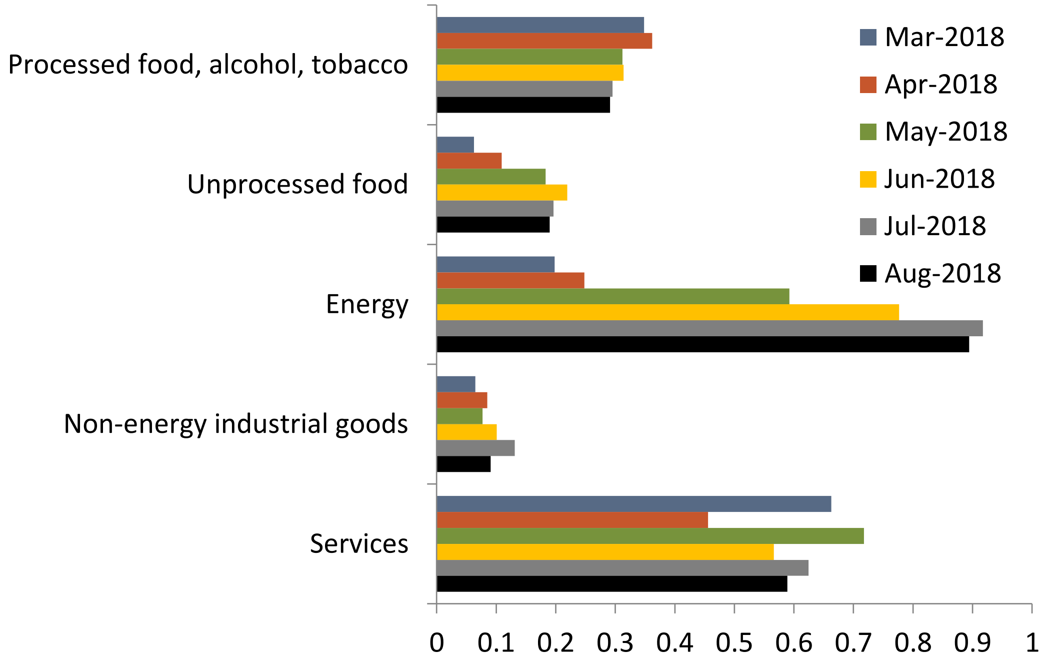
The ECB can take it easy: While it is not clear to what extent the stronger wage gains will translate into inflation, unit labour cost increases will likely continue to edge up from their Q3 2017 low of 0.4% yoy (see chart 5). But some of the wage gains will be offset by a pick-up in productivity growth. Continued uncertainty about the outlook may also weigh on demand growth. We thus expect unit labour costs and core inflation to edge up only gradually. Slowly upward trending underlying inflation will be sufficient for the ECB to end its asset purchases in December 2018 and hike rates in September 2019.

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



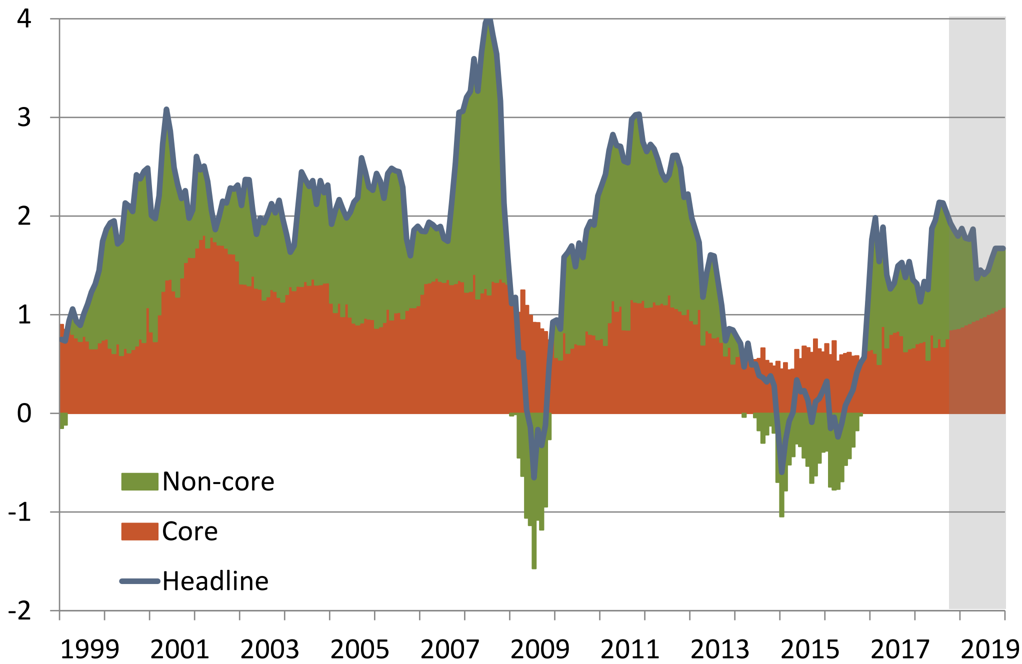
Sources: Eurostat, Berenberg calculations

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



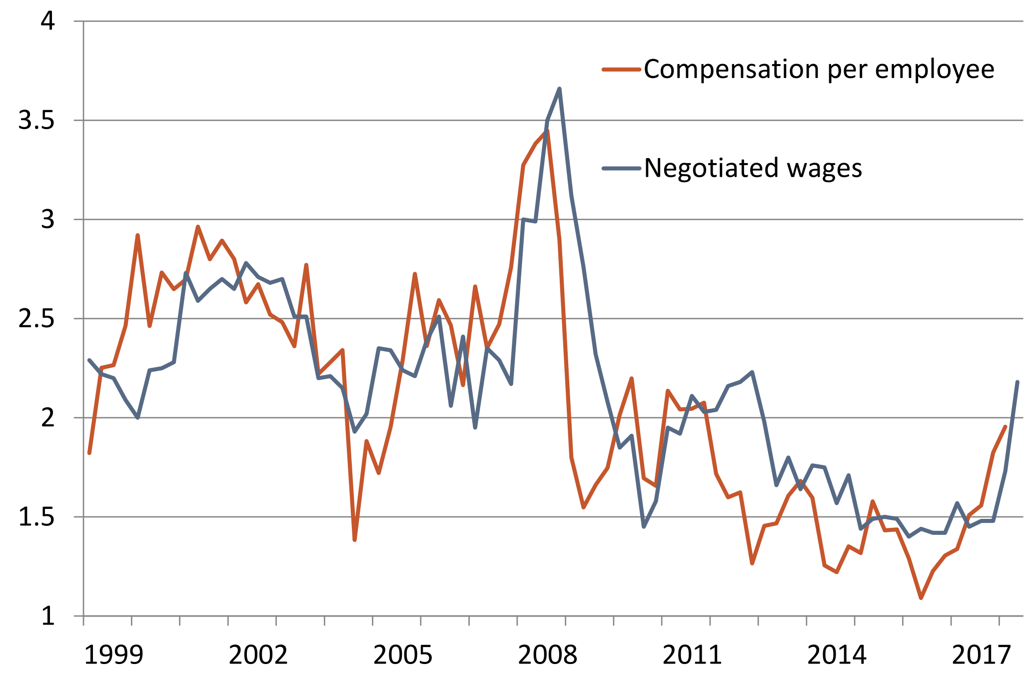
Contributions to yoy headline inflation rate in % points. Source: Eurostat

Chart 3: Core and non-core components' contribution to headline inflation (yoy, in % points)



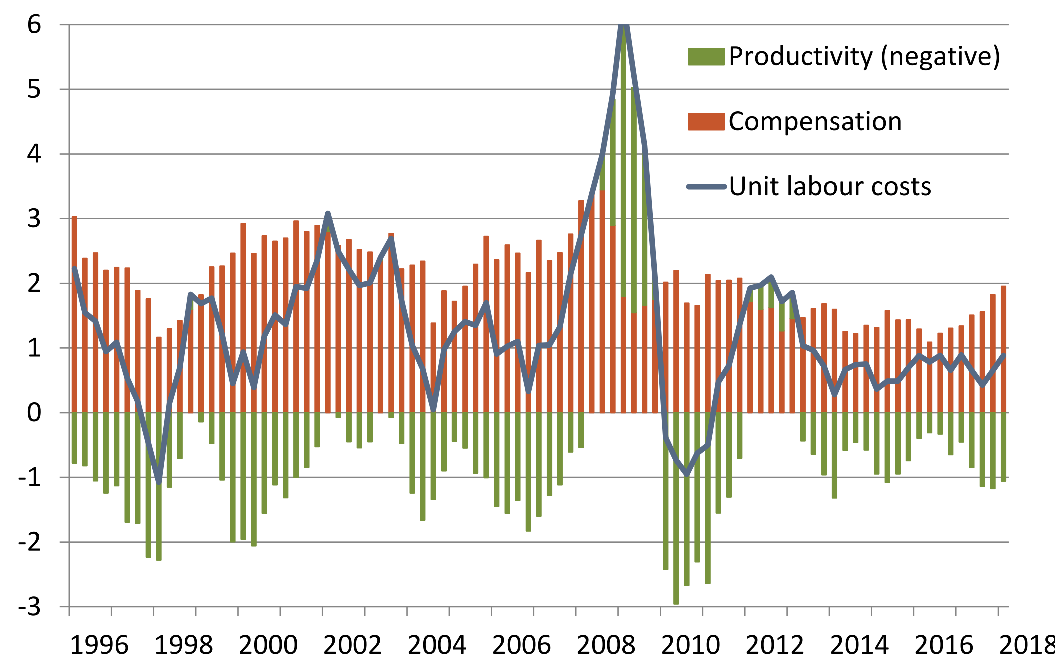
Headline inflation in %, core and non-core contribution in % points. Berenberg forecasts for September 2018 onwards. Sources: Eurostat, Berenberg calculations

Chart 4: Compensation per employee and negotiated wages (yoy, in %)



Source: ECB

Chart 5: Compensation, productivity and unit labour costs (yoy, in %)



Source: ECB

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