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EUROZONE INFLATION: HOT SUMMER DRIVES FOOD PRICES, CORE TAME

Berenberg Macro Flash

Eurozone inflation, September, in %, yoy

	Headline	Core
Actual:	**2.1**	**0.9**
Previous:	2.0	1.0
Consensus:	2.1	1.1
Berenberg	2.0	1.1

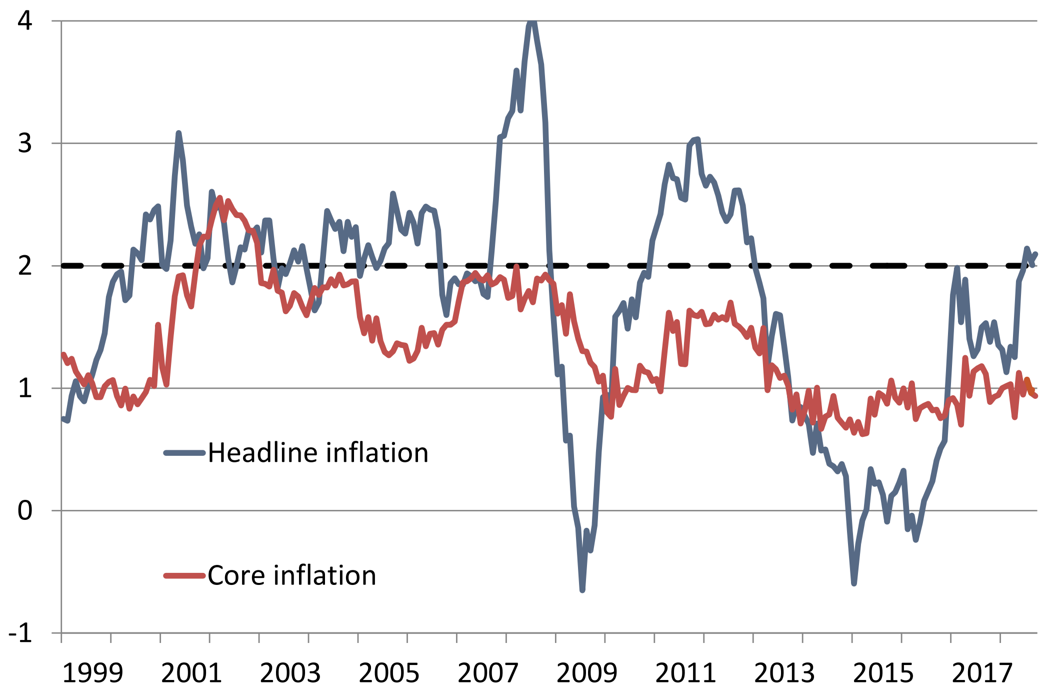
Headline inflation up, core surprises on the downside: Eurozone headline inflation has exceeded the ECB's target of "below, but close to, 2%" for four consecutive months. In September, a renewed pick-up in the Brent oil price beyond $80 per barrel and the rise in unprocessed food prices after a hot and dry summer pushed headline inflation to 2.1% yoy after 2.0% in August (see chart 1). The contribution from processed food was largely unchanged (see chart 2). Underlying price pressures remain muted, still lacking a clear uptrend. Core inflation even slipped from 1.0% (0.96%) yoy in August to 0.9% (0.94%), contrary to expectations of edging up to 1.1%. As price gains for non-energy industrial goods and services decelerated slightly, today's data shows that a "vigorous pick-up" in underlying inflation in the Eurozone is a long time coming. Rising input costs for material and labour translate only partly and slowly into higher charged prices so far. The ECB can and will, therefore, take it easy and stick to its guidance of keeping rates low "through the summer of 2019".

Is underlying inflation full of vim and vigour? ECB President Mario Draghi made the news when – in a hearing before the European Parliament on Monday – he spoke of "a relatively vigorous pick-up in underlying inflation". The next day, the ECB's chief economist Peter Praet quickly put the comments into perspective, denying any changes in the ECB's view of the inflation outlook. For the record, Draghi was alluding to the ECB's 2018-2020 inflation projections already published after the Governing Council's September meeting, not to the recent readings or the trend of the next few months. More precisely, he was stressing that, whereas headline inflation would remain stable at around 1.7% between 2018-2020, the stable projections would mask a decline in the energy contribution to headline inflation and a rise in core inflation from 1.1% in 2018 to 1.5% in 2019 and 1.8% in 2020 (see chart 3). That is, indeed, a vigorous pickup in core inflation projections.

Not quite yet, rather a long time coming. The ECB expects underlying inflation to increase because of a recently strengthening wage growth and a further tightening labour market driving sustained compensation gains. The ECB projects compensation growth to rise from 1.5% in 2017 and 2.1% in H1 2018 to 2.7% in 2020. It remains, however, to be seen to what extent wage growth translates into (price) inflation. Today's reading and the experience of the past five years, with core inflation sticky around 1%, suggest that the pick-up will happen only very gradually. We look for core inflation to edge up only to 1.4% in 2019 and 1.7% in 2020. Strong competition limits the extent to which businesses can pass on higher input costs and raise prices. As labour supply tightens, labour productivity growth usually rises and, as businesses invest in their facilities and equip their labour force with more machinery (think robots), total factor productivity growth edges up, too. Unit factor costs should therefore rise only gradually.

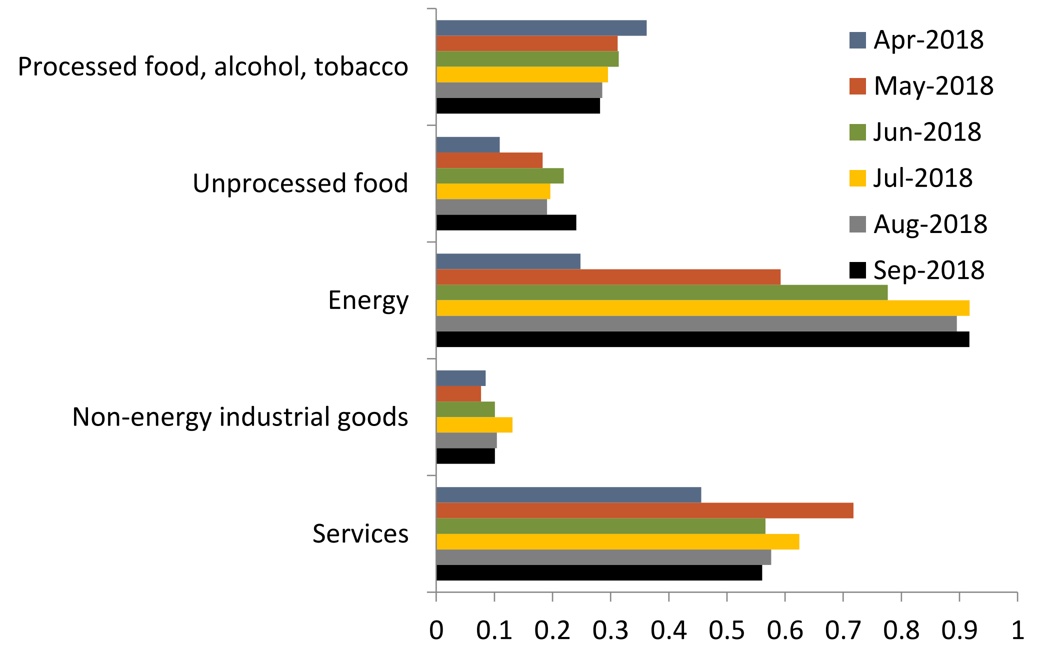
We maintain our ECB calls: The ECB is in no hurry. Following the cut in net asset purchases from €30bn to €15bn in October, the ECB will end its purchases on schedule at the end of December. After holding rates steady "through the summer of 2019", we look for the ECB to raise rates in two small steps in late 2019. In September 2019, the ECB may return to a symmetrical rate corridor by raising its deposit rate from -0.4% to -0.15% while lifting the main refi rate and the marginal lending rate by 10bp each from 0.0% to 0.1% and from 0.25% to 0.35%, respectively. In December, the ECB may then lift all rates by 15bp, putting an end to a negative deposit rate and reaching a refi rate of 0.25%.

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



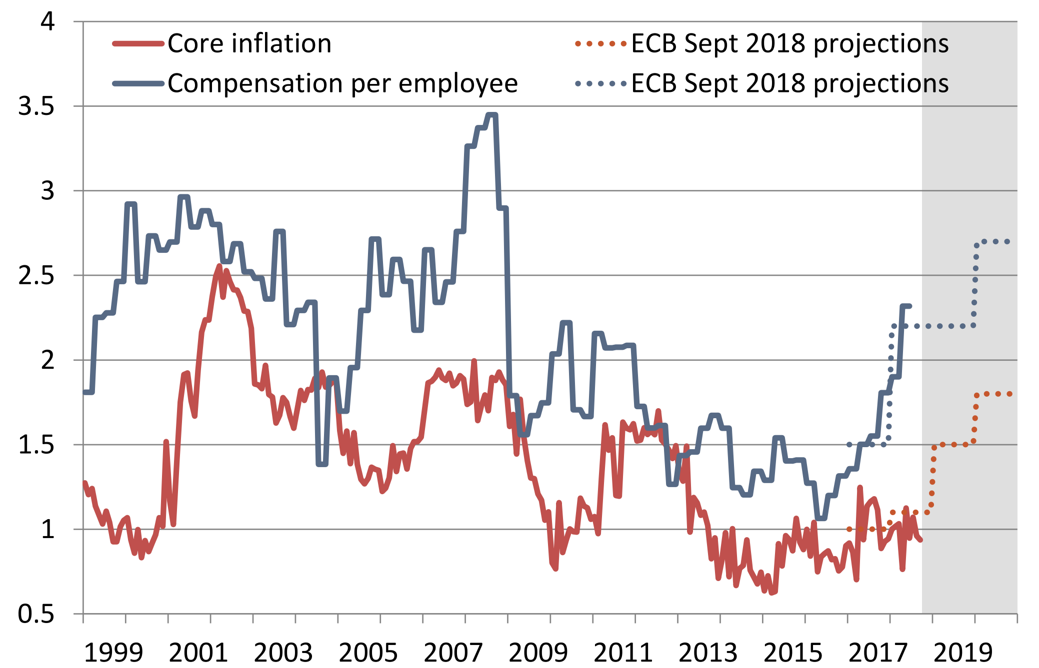
Sources: Eurostat, Berenberg calculations

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



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

Chart 3: Core inflation and compensation per employee (yoy, in %)



Sources: Eurostat, ECB

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