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OIL AND BASE EFFECTS DRIVE EUROZONE INFLATION HIGHER

Berenberg Macro Flash

Eurozone inflation, October, in %, yoy

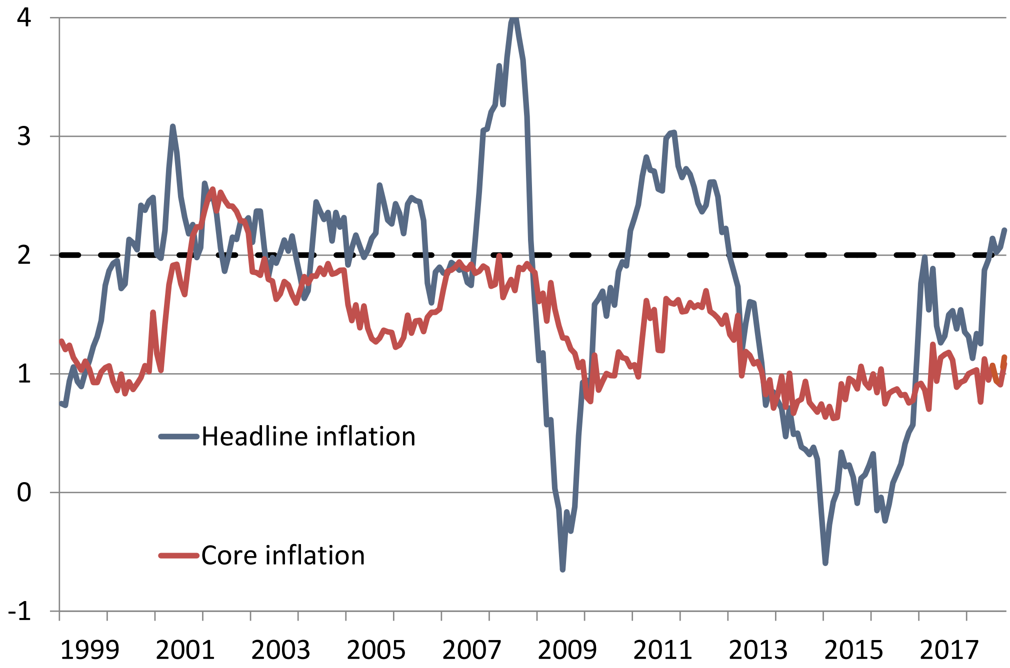
	Headline	Core
Actual:	**2.2**	**1.1**
Previous:	2.1	0.9
Consensus:	2.2	1.1
Berenberg	2.2	1.1

Headline and core up: A renewed pick-up in energy prices earlier this month and base effects pushed Eurozone inflation beyond the ECB's target of "below, but close to, 2%" for the fifth consecutive month. Headline inflation rose from 2.1% yoy in September to 2.2% in October (see chart 1). The base effects largely pertain to service prices (education and package holidays), therefore, driving also core inflation (1.1% yoy after 0.9%). Higher oil and pump prices forced the energy component's index up by 10.6% yoy this month after 9.5% previously (see chart 2). Price gains for core (non-energy industrial) goods and processed food edged higher (0.4% after 0.3% and 2.3% after 2.2%, respectively), while unprocessed food inflation slowed (2.1% after 3.2%) as the effects of a hot and dry summer were fading.

Impact from slowdown on labour market: Looking through the monthly swings, the ground for underlying inflation to rise is fertile. A tightening labour market is driving a pick-up in wage growth – the scolded Philips curve is not dead. While the Eurozone's upswing has moderated significantly throughout this year, employment gains have held up: like in 2017 600k new jobs were created on average each quarter. This is unlikely to continue. The third consecutive stable reading of the unemployment rate at 8.1% in September and still high but slipping indicators of labour shortage (see chart 3) are the latest signs that the pace at which labour demand and supply rebalance slows. Wage growth is, therefore, likely to climb slower over the next 12 months than over the previous ones. Meanwhile, as productivity gains look set to accelerate and many businesses continue to face heavy competition, rising input costs for material and labour will translate only slowly into higher charged prices. With all eyes – and hope at the ECB – on wage growth to drive price inflation higher, the risks to the ECB's projection of a "relatively vigorous" rise in core inflation from 1.1% in 2018 to 1.5% in 2019 and 1.8% in 2020 are on the downside (see chart 4). We look for only 1.4% in 2019 and 1.7% in 2020.

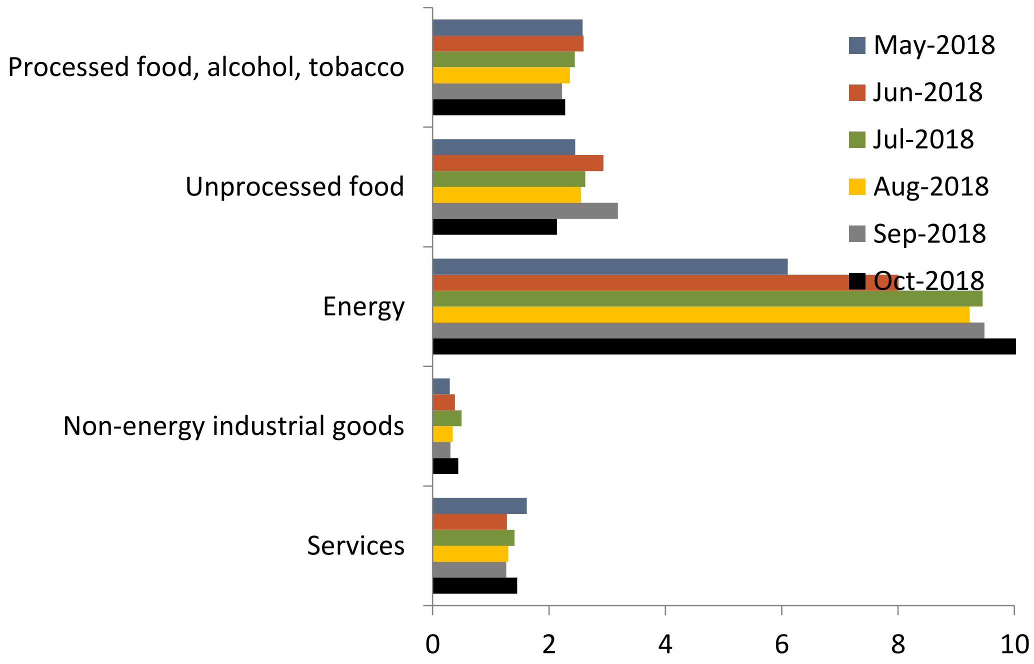
Wait for an interesting ECB December meeting: That inflation did not surprise on the downside will cause somewhat a sigh of relief in Frankfurt following yesterday's disappointing Q3 GDP print and the unusually strong cocktail of risks. The ECB may feel vindicated in largely looking through the weak economic data and ending its contentious asset purchase programme this year with no major changes to the inflation outlook as of now. Still, softer growth will cause the ECB to revise its projection of 1.8% real GDP growth for 2019 GDP growth down at its meeting on 13 December and likely trigger a debate whether the guarantee to keep interest rates at their current record-low levels should be extended beyond the summer of 2019. The ECB need not take a decision on a potential tweak to its rate guidance in December already. It has plenty of time to watch the data. If growth rebounds from its 2H 2018 dip to an annualised rate at or above the 1.5% trend over the course of 2019, as we expect, the ECB will probably still start to raise rates very gradually next autumn.

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



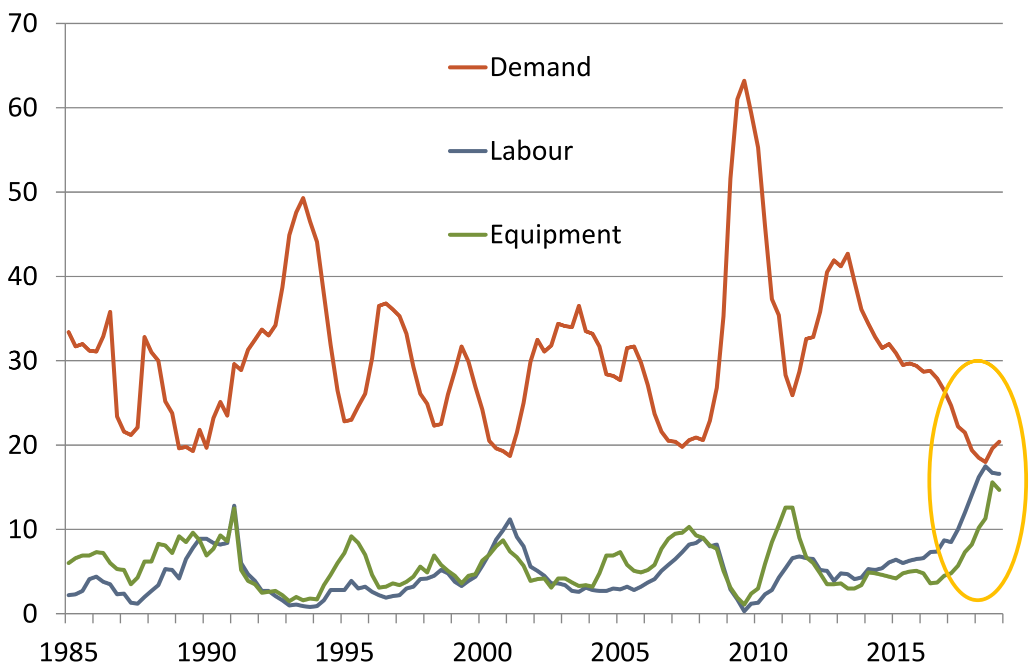
Sources: Eurostat, Berenberg calculations

Chart 2: Inflation by component (yoy, in %)



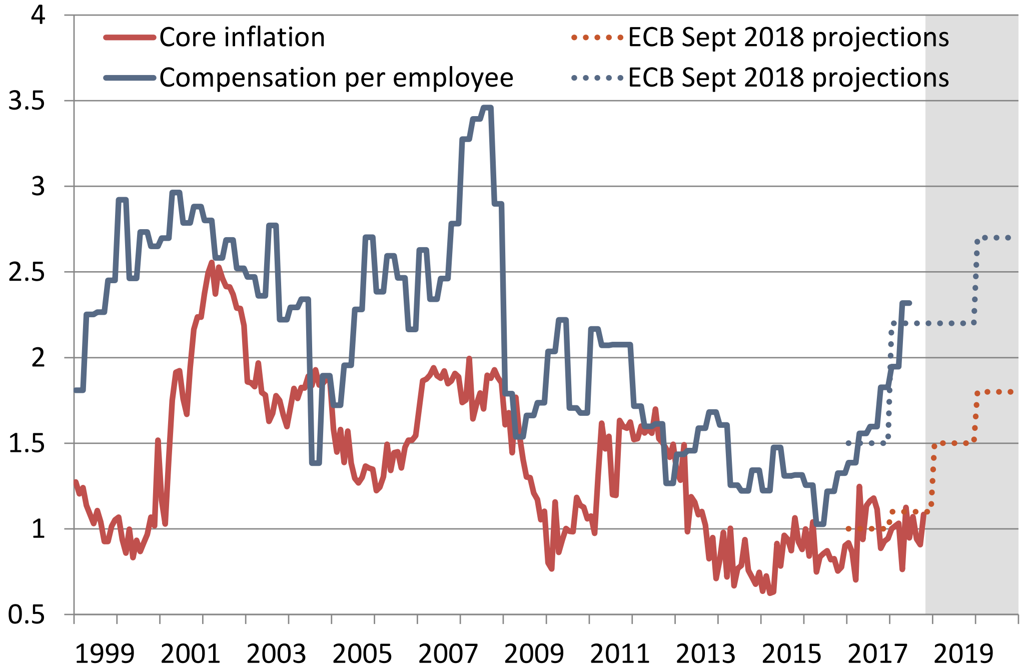
Yoy change in %. Source: Eurostat

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 Q4 2018. Source: European Commission

Chart 4: Core inflation and compensation per employee (yoy, in %)



Sources: Eurostat, ECB

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