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EUROZONE INFLATION DIP ADDS TO ECB HEADACHE

Berenberg Macro Flash

Eurozone inflation, March, in %, yoy

	Headline	Core
Actual:	**1.4**	**0.8**
Previous:	1.5	1.0
Consensus:	1.5	0.9
Berenberg	1.5	1.0

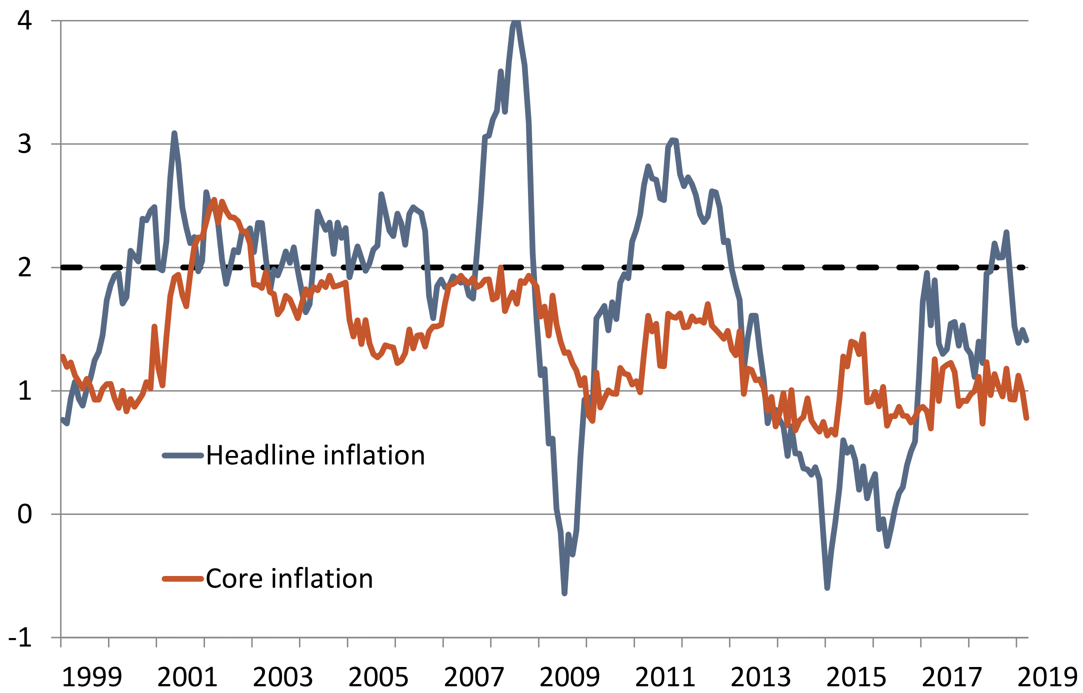
Waiting for Godot? Judging by the weak March inflation print it is a stretch to argue that the convergence of inflation towards the 2% target is "delayed rather than derailed" – as ECB President Mario Draghi has put it recently. Watching the monthly inflation figures feels more like waiting for something which is not going to come. Still, there are reasons to think that inflation is not Godot and (its pick-up) will come eventually. While headline inflation dipped in March, we note that base effects likely distorted the March inflation to the downside.

Lower inflation across all components except energy: Headline inflation fell from 1.5% yoy to 1.4% in March according to a first Eurostat estimate (see Chart 1). A jump in oil prices by 9.4% yoy and by 4.3% mom drove the energy component higher (from 3.6% yoy in February to 5.3% in March, see Chart 2). But the push was more than offset by weaker inflationary pressures across the remaining components. Food prices fell from 2.3% yoy to 1.8%. Lower duties for alcohol and tobacco in France may have been partly to blame. Also, the core components softened and drove core inflation from 1.0% yoy to 0.8%. Non-energy industrial goods inflation was down from 0.4% yoy to 0.2% and services inflation fell from 1.4% yoy to 1.1%, the weakest rate since April 2018. A later Easter this year than in 2018 (21 April vs. 1 April) meant less spending than usual on expensive package holidays – as suggested by last week's German data. The Easter base effect likely weighed on both headline and core inflation in March. Conversely, in April it may distort the number slightly to the upside.

Underlying prices pressures at odds with wage growth: Despite the short-term base effect driven volatility, the weak services price pressures are counterintuitive. Wage growth has been picking up for a while. Compensation per employee is growing by 2.2% yoy (see Chart 3). And that is not just for one-off payments (bonus, overtime etc.). Negotiated wages are also up by 2.2% yoy. The labour market has remained robust despite the slowdown in the rate of real GDP growth – employment growth has slowed down only mildly from 1.6% yoy in Q2 2018 to 1.3% in Q4. Unemployment stood at 7.8% in February, the lowest level since September 2008. Going forward, a solid labour market should support wage gains.

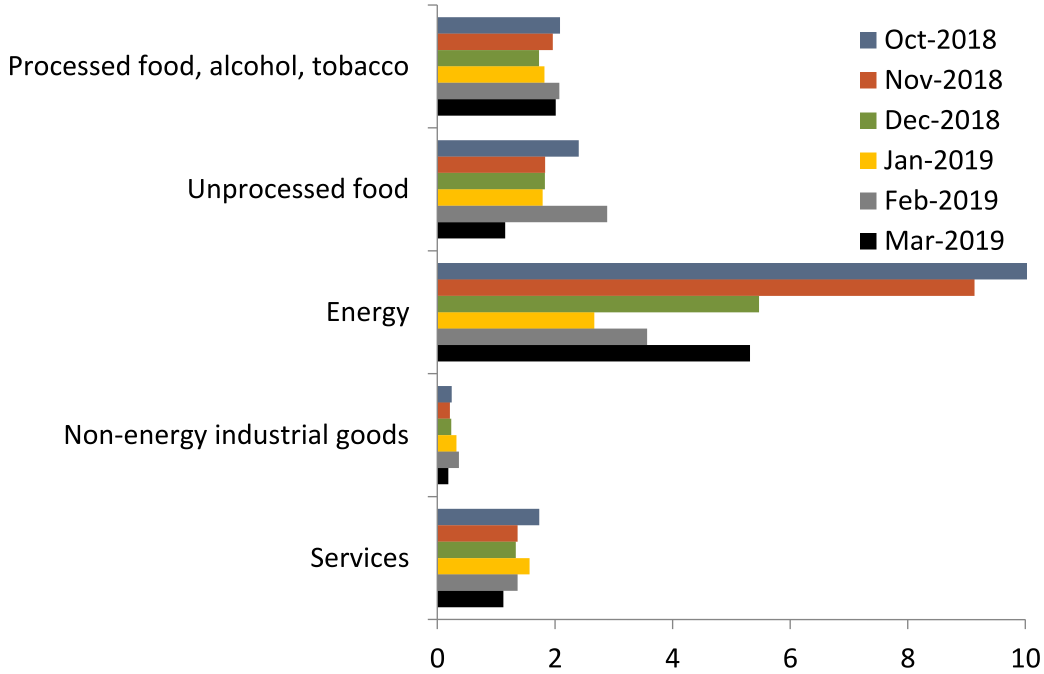
Weak pass-through from wages to prices: There are a number of reasons why stronger wage gains are not yet translating into higher price inflation. After a long period of low inflation, businesses are wary to increase prices amid fears it could result in a loss of market share. The wariness is particularly pronounced in times of soft demand. Another reason could be that the impact from a strengthening euro from mid 2017 to mid 2018 which drives imported inflation lower has come with a longer-than-normal lag. Unlike core inflation, the growth rate of the GDP price deflator, a better gauge for domestically generated inflation, has accelerated from 0.6% in Q4 2016 to 1.5% in Q4 2018 (see Chart 4). In sum, if and when Eurozone growth returns to trend throughout the second half of 2019, price pressures could build again

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



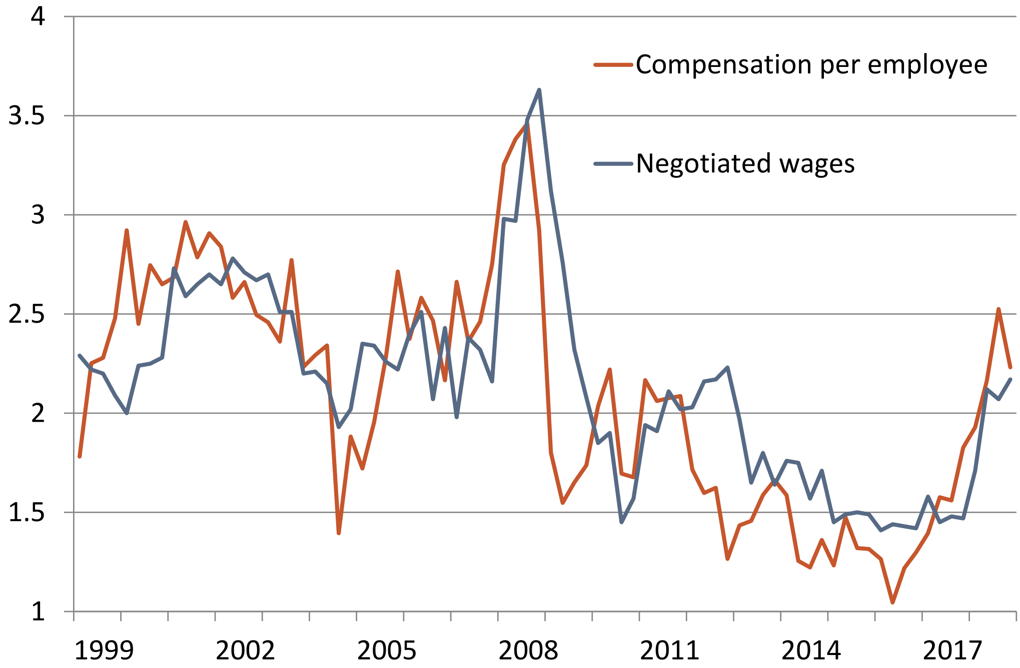
Sources: Eurostat, Berenberg calculations

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



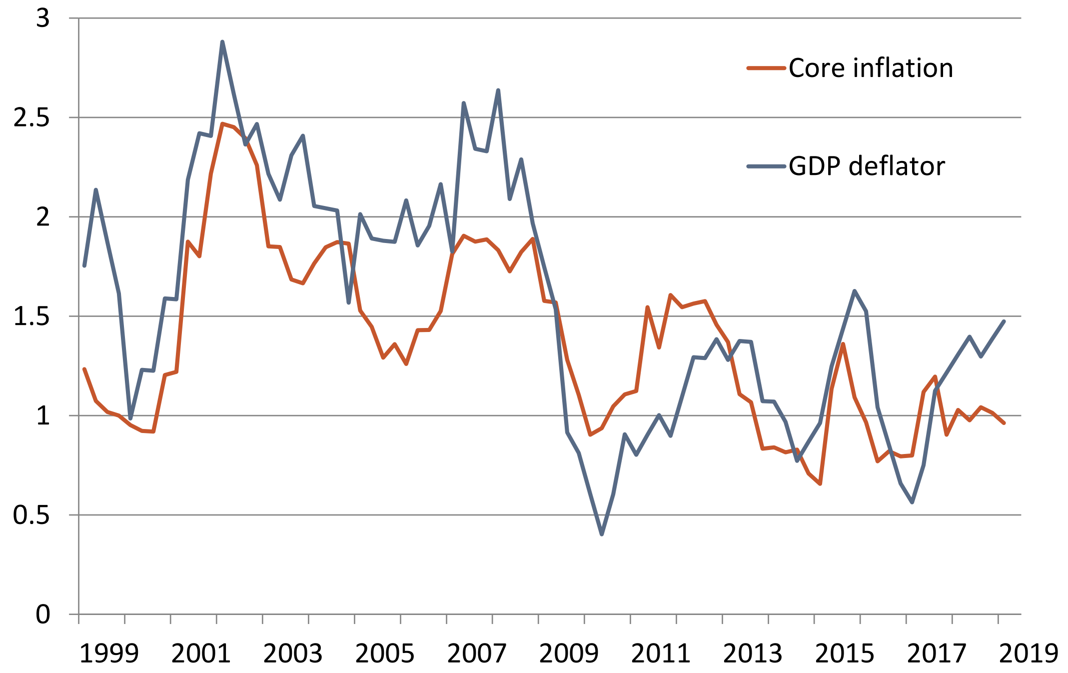
Source: Eurostat

Chart 3: Compensation and wage growth (yoy, in %)



Source: ECB

Chart 4: Core inflation versus GDP price deflator (yoy, in %)



Sources: Eurostat

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