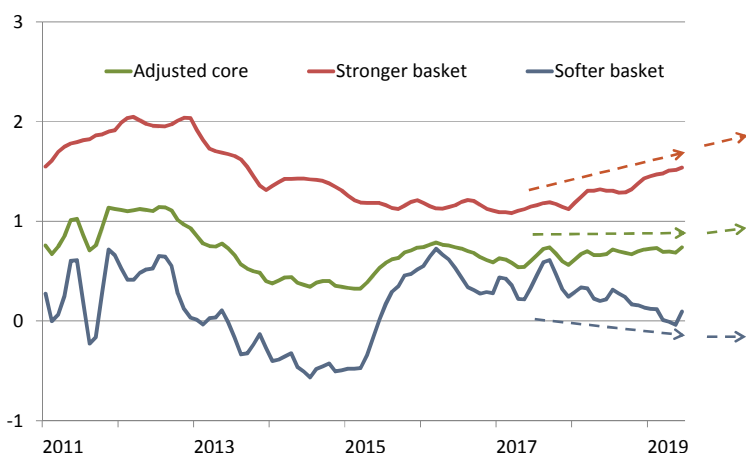


19 July 2019

Eurozone inflation: making sense of the stable core

Eurozone inflation: softer basket offsets gains in the stronger basket



YoY change in %. Adjusted core: core consumer price index ex package holidays and transport services. Stronger basket: non-durables, housing services, recreation and personal care (ex package holidays and accommodation); and miscellaneous services. Softer basket: durables and semi-durables, communication and accommodation services. Source: Eurostat, Berenberg

- Stable core:** Despite tightening labour markets, inflation pressures remain subdued across the western world. In the Eurozone, unemployment has fallen from a peak of 12.1% in 2013 to 7.5% in May 2019, within striking distance of the post-1991 low of 7.3% (late 2007/early 2008). Wage growth has picked up from a mere 1.2% in 2016 to 2.2% in Q1 2019. Nonetheless, core inflation has hovered around 1% yoy since 2013.
- Dissecting the core:** To focus on the underlying dynamics, we take two items out of the core inflation basket: volatile package tours and the partly oil-price driven transportation services. We then split this adjusted core into two baskets with major components that typically show either higher or lower rates of inflation than the average; we call these “stronger” and “softer” core respectively.
- Stronger core to the fore:** The stronger basket largely contains non-durable goods, many services including most parts of recreation services as well as housing costs. Many of these items are comparatively labour-intensive and/or closely tied to domestic demand. Roughly in line with a tighter labour market and more robust private consumption, inflation pressures have edged up in this segment since 2017. Until 2016, subdued rises in cost for housing services had kept the overall rate low, largely as a legacy of the euro crisis. Since late 2016, housing inflation has been edging up.
- Watch the softer basket:** Durable and semi-durable goods as well as communication costs and accommodation services dominate the softer basket. Communication costs have been brought down by rapid technological progress and a series of pro-consumer changes in regulations, such as caps on roaming charges in the EU. Durables and semi-durables are subject to intense global competition. The shift from a modestly undervalued euro exchange rate in 2013-2014 to an overvaluation in 2015 boosted prices for durables and semi-durables. After this effect had been digested, the gradual decline in price increases in the softer basket since early 2016 has offset the modest increase in price pressures for the stronger basket. This has kept the overall core rate flat (see chart).
- Gradual updrift ahead:** We expect price pressures in the stronger basket to edge up further. With trade troubles gradually spilling over into the domestic economy, this updrift is likely to be very gradual, though. Price increases for the weaker basket could stabilise around zero soon. We do not look for a major change in the exchange rate to dampen inflation. A likely rebound in some emerging market currencies should offset a potential rise in the euro versus the US dollar. The big waves of regulation changes in communications are probably over. As a result, the softer basket should no longer offset further gains in the strong basket. Core inflation should thus rise in the next few years. The process is likely to be slow and not constrain the ability of the European Central Bank to [easy policy shortly](#).

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