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EUROZONE INFLATION ABOUT TO TURN NEGATIVE

Berenberg Macro Flash

Heading down further: Under the impact of low oil prices, headline inflation in the Eurozone fell to 0.1% yoy in May from 0.3% in April, core inflation rose slightly to 0.9% after 0.85% in the previous month (see Chart 1). Eurostat thus confirmed the preliminary estimates. Despite the marginal uptick in May, even core inflation remains well below the pre-pandemic average of 1.15% for January and February. For the remainder of 2020, we expect inflation to head down further amid continuing disinflationary forces stemming from the Covid-19 recession. The soft inflation outlook supports the case for continued aggressive ECB stimulus.

Three insights from the May inflation data:

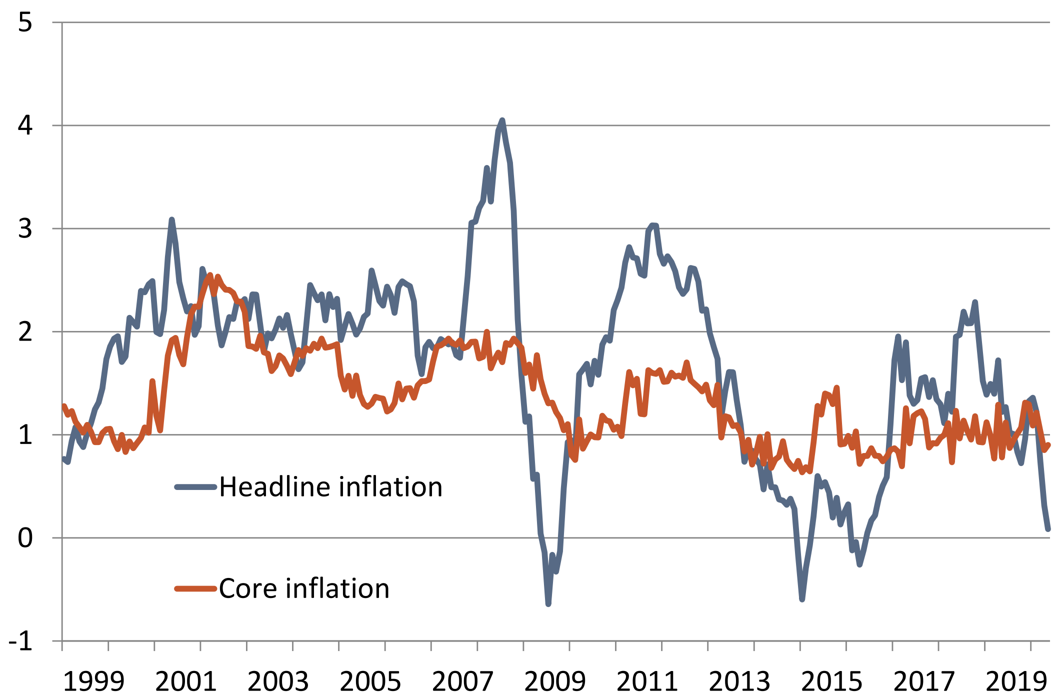
- A 12% yoy collapse in the energy component shaved off 1.2ppt from the headline inflation rate in May (see Chart 2). While oil prices have increased significantly from their lows in mid-February, they remain markedly lower than in 2019. Oil supply has not been cut as much as demand has plummeted. A stronger euro has added to the oil price effect over the past few months. However, the recent rebound in oil prices may add c0.3ppt to headline inflation in the next two months.
- The drag from energy inflation has offset the rising contribution from higher processed and unprocessed food prices we have seen in 2020 so far (see Chart 2) as households stocked up food amid stay-at-home orders and weak crops amid a dry season. This was still the case in May.
- Services inflation as the key component of core inflation rose a little from 1.2% in April to 1.3% in May, mostly because of a 0.05ppt bigger contribution from higher prices for transport services (see Chart 3). However, this merely corrects part of the unusual decline in transport price inflation in April and does not seem to be the start of a genuine uptrend.

H2 2020 – falling further: Low oil prices will continue to be a drag for inflation, although by less than in May. We expect the contribution from stronger food prices to largely wane as Eurozone governments continue to ease restrictions. Services inflation, a good proxy for underlying price pressures, can head modestly lower as weak demand by households and businesses more than offsets the rise in costs for many services caused by social distancing rules. The temporary German VAT cut during H2 will also weigh on Eurozone inflation, probably subtracting 0.3ppt from the Eurozone core and headline inflation rates. Taken together, we expect headline inflation to fall to around -0.3% yoy on average during H2.

From 2021 onwards, disinflationary forces to wane slowly: In early 2021, the drag to headline inflation from low energy prices will vanish as base effects move out of the yoy comparison. If oil prices remain at, or rise beyond, current levels, the energy component will provide a little positive contribution to headline inflation in mid 2021. As demand regains ground relative to supply on the back of a strong, continued monetary and fiscal stimulus, underlying inflation can rise eventually from Q2 2021 onwards. However, we expect price pressures to build only very slowly. Unemployment will remain elevated and consumers may remain more cautious than they were before the pandemic for years to come. As a result, underlying inflation may not return to (the already subdued) pre-crisis level before 2022. Risks remain on the downside.

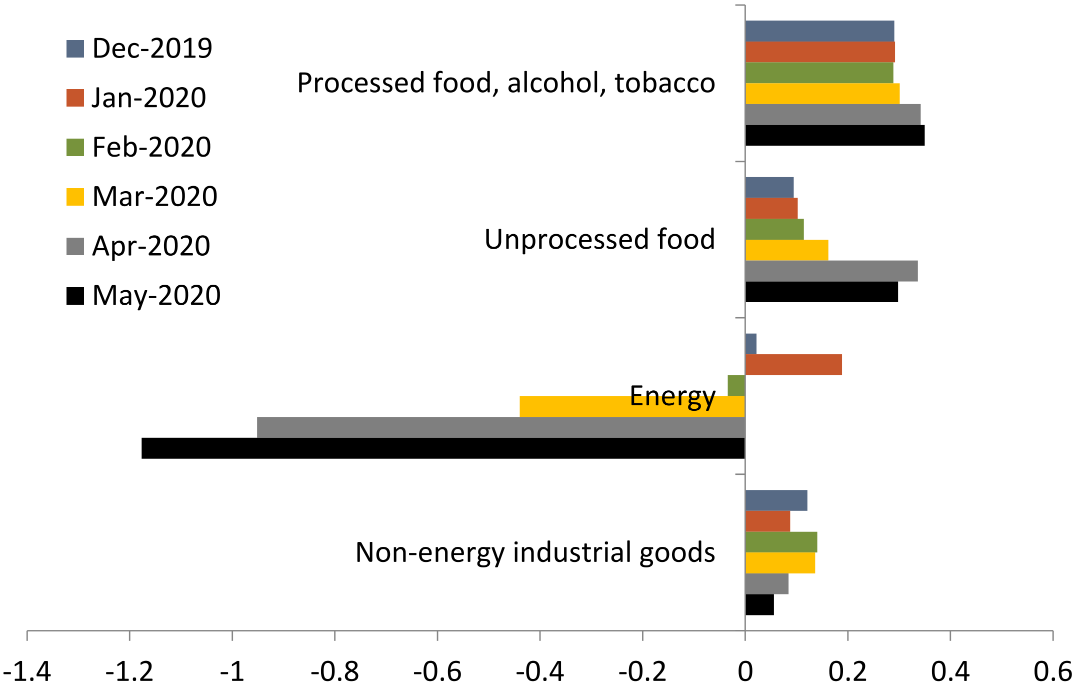
Low energy prices – a helpful shock absorber: The immediate negative impact of sharply lower oil prices on energy sector investment and corporate bond spreads added to the adverse market reactions in the early stages of the pandemic in March. However, as in previous periods, the positive impact on real households' incomes is gradually starting to become more powerful, at least in the oil importing Eurozone. In addition, lower oil prices have given the ECB even more room in the last few months to provide a massive monetary impulse.

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



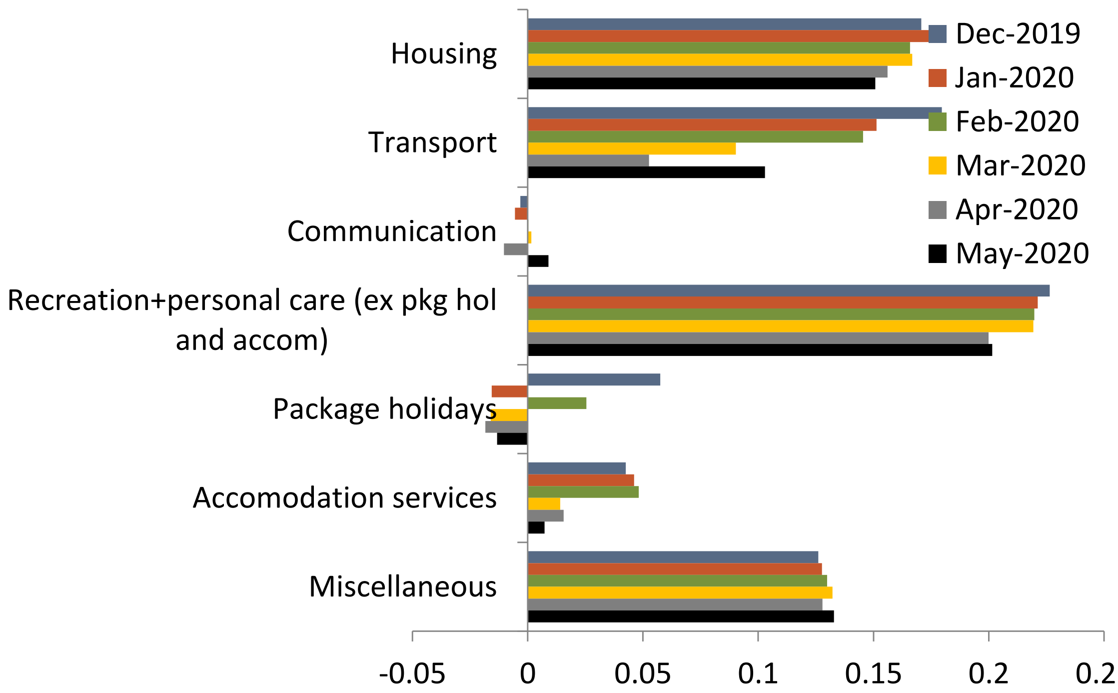
Source: Eurostat, Berenberg

Chart 2: Contribution to yoy inflation by goods' component (in ppt)



Source: Eurostat, Berenberg

Chart 3: Contribution to yoy inflation by services' component (in ppt)



Source: Eurostat, Berenberg

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