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EUROZONE INFLATION HITS 2%, UNDERLYING PRESSURES REMAIN SUBDUED

Berenberg Macro Flash

Eurozone inflation, February, in %

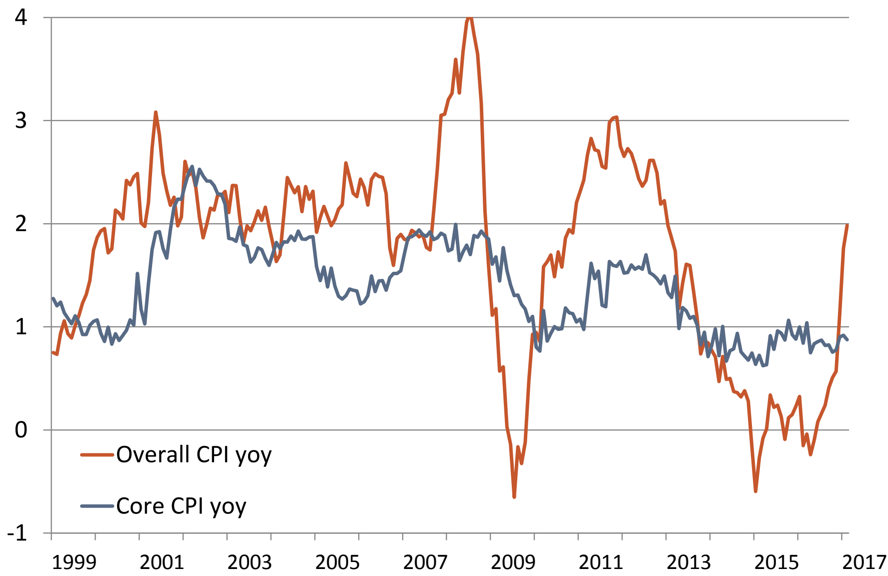
	Headline	Core
Actual:	**2.0**	**0.9**
Previous:	1.8	0.9
Consensus:	2.0	0.9
Berenberg:	2.0	0.9

Mind the gap. Headline inflation accelerated to 2% yoy in February, its fastest pace since January 2013, after 1.8% in January (see **chart 1**) – and thereby slightly even surpassed the ECB's target of "close, but below 2%". An oil price base effect (Brent went up by more than 70% since February 2016, from 30 EUR/barrel to 53 EUR/barrel) and higher food prices were the main drivers. Headline inflation is poised to drop to a level of around 1.5% during the rest of the year. Underlying price pressures remain subdued. Core inflation, excluding energy and food, was unchanged at 0.9%, as it has been for the last three years. We do not expect underlying forces of demand and supply to generate a rise in core inflation to the ECB's target for at least 18 months (no more than 0.4ppt per year, with a good chance it could be less). This is broadly implied by the ECB's asset purchase programme. Until inflation converges in a durable and self-sustained fashion towards 2% across the whole Eurozone over the medium-term, the ECB will not change materially its current accommodative stance.

It's the labour market, stupid. Core inflation will edge higher as the labour market further tightens. Unemployment, despite major improvements since its peak in 2013 at 12.1%, remains elevated at 9.6% (unchanged from January). At the current level, unemployment in the Eurozone remains roughly twice as high as in the US and the UK and progress needs to continue for unemployment to return to its average pre-Lehman recession level of below 8% (see **chart 2**). Wage growth has been moderate – and a recent weak wage deal for the public sector in Germany despite its record high level of employment suggests that this is not going to change materially, let alone in those countries that continue to suffer from slack in their labour market. Therefore, second round effects, important for inflation expectations, seem to remain modest for now.

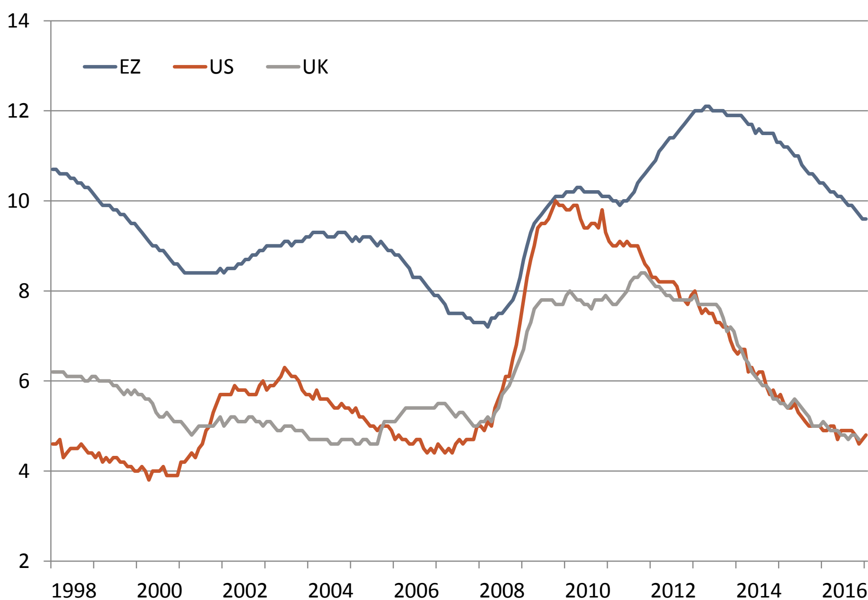
The ECB will not have to rethink the thrust of its policies. The ECB will be very cautious not to make the same mistake it did in 2011 when it ended up hiking rates in April and July, just a few months before the Euro crisis erupted. The ECB will have little need to revise its staff projections for growth (1.7% for 2017 and 1.6% for 2018), but may edge up its inflation forecasts (currently 1.3% for 2017 and 1.5% for 2018) due to higher than expected base effects from oil prices change. Deutsche Bundesbank President Weidman hinted at an upgrade earlier this week. If bank lending continues to edge up (2.4% yoy in January, up from 1.1% in Q1 2016), the ECB may see less need to penalise banks for parking liquidity at the ECB. If so, the ECB could consider easing the penalty rate on such bank deposits from -0.4% gradually to -0.25% as early as from June this year, that is once the French elections and the risks associated with the elections are out of the way. We look for the ECB to drop its dovish guidance ("risks tilted to the downside") in mid-2017 and announce in autumn 2017 a gradual reduction of asset purchases starting in January 2018. After the likely end of such purchases in the autumn of 2018, the first ECB hike in the refinancing rate may follow in September 2019, that is shortly before Draghi's eight-year term ends in late October 2019.

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



Source: Eurostat

Chart 2: Unemployment rate – Eurozone, US and UK (in %)



Harmonised unemployment rate in %. Source: Eurostat

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