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EUROZONE INFLATION: SHOOTS UP DRIVEN BY ONE-OFFS IN JANUARY

Berenberg Macro View

Biggest jump in 20-year history of Eurozone: Eurozone inflation shot up to 0.9% yoy in January from -0.3% in December. The 1.2ppt rise is the biggest since the start of the series in April 1999 by far. While national data over the past week – starting with Germany on 28 January, Spain on 29 January and France yesterday – had already pushed our (0.4%) and Bloomberg consensus (0.5%) expectations higher, today's Eurozone inflation print still surprised significantly to the upside. Core inflation, which strips off the more volatile food and energy components, also rose by 1.2ppt from 0.2% yoy in December to 1.4% yoy in January – the highest in five years. The 5-year-5-year forward inflation rate has also responded notably to the January prints. Is an inflation scare and thus a significant rise in nominal yields lurking around the corner? No and no.

One-offs drive the jump in January: The jump in the yoy headline and core inflation rate owes largely to one-offs including the return to (higher) normal VAT rates in some Eurozone countries, the introduction of an emissions-pricing scheme in Germany, changes to the composition of the basket of goods, a different winter sales period and energy price base effects. The energy component of the headline index was up 2.3% mom, bringing the yoy rate up from -6.9% in December to -4.1% in January. Besides higher oil prices and a smaller negative base effect, the 2021 start of the German emissions trading system – a fixed price of 25 euros per CO₂/tonne – translated into a price increase of around 5-10% for petrol and diesel alone. Pump prices were up 4.5% mom in January, lifting the yoy rate to -6.5% from -9.4% yoy in December. Non-energy industrial goods rose from -0.5% yoy in December to 1.4% in January. International supply chains hitting capacity constraints probably drove the price for durable goods such as cars, furniture and household appliances higher. Inflation of semi-durables goods such as clothing and footwear may have contributed even more. According to German state data (North Rhine-Westphalia), prices for clothing and footwear shot up to 1.7% yoy in January from -7% in December. The higher VAT largely explains the 3.5% mom increase in January. But the usual seasonal effect of discounts in January to sell the winter collection has apparently failed to materialise. Amid lockdowns, clothing retailers offered clearance sales prices already in December (-6.1% mom relative to November), which they seemingly did not reduce further in January. In addition, some retailers may be waiting to sell their inventories before giving discounts after the lockdown cut short the winter period. Services inflation was also up from 0.7% yoy in December to 1.4% in January.

Note: Amid tight lockdowns, the share of imputed goods prices and thus the margin of error of the inflation numbers are bigger than usual.

2021 inflation outlook – rising further: Some of these one-offs will support further gains in the inflation rate. The contribution from energy price base effects may only top in May. If Super 95 prices remain at their current levels, the yoy rate in pump prices would rise from -6.5% in January to 11.2% in May. The reduced VAT rates in H2 2020 drops out of the annual comparison in July 2021, triggering another temporary boost during H2 2021. Capacity constraints in international



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supply chains add to that. Pent-up demand can fuel price gains for (food, drink, hotel, travel, entertainment etc.) services from Q2 onwards as restrictions are eased. Before the publication of the January print we projected Eurozone inflation to rise from -0.3% in Q4 2020 to 1.2% yoy in Q2 2021 and to climb higher throughout H2 2021. The upside surprise of the January inflation creates further upside risks to that call of rising inflation.

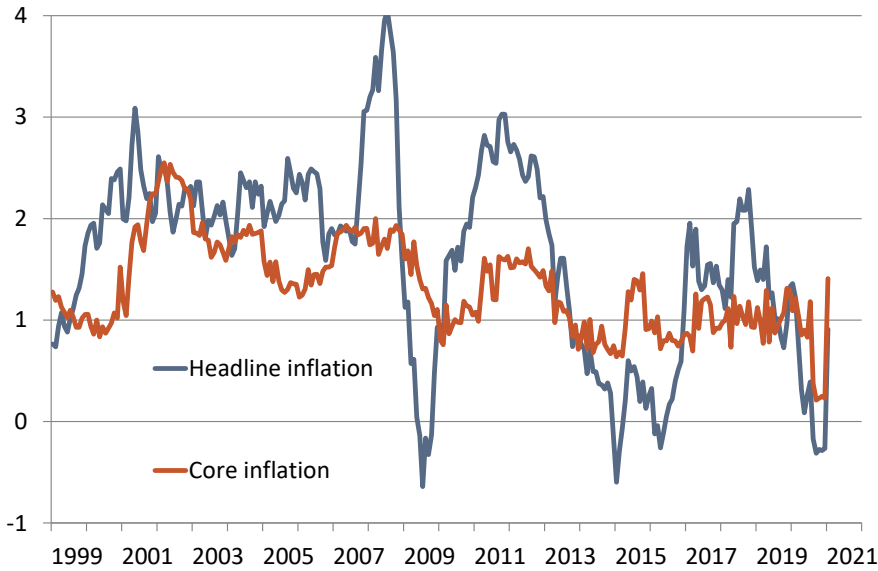
Medium-term outlook – underlying price pressures rising only slowly: The one-off driven snapback in inflation in 2021 should not be mistaken for a rapid rise in underlying price pressures. Underlying inflation will increase only gradually over the medium-term. In 2022, inflation will – if anything – rise much more slowly and possibly even fall at the start of the year as positive base effects fade. More fundamentally, capacity utilisation will take time to return to pre-pandemic levels despite strong demand growth. Unemployment and insolvencies will likely first rise before they fall, keeping a lid on wage and price growth. A strengthening euro could also contain price gains throughout the next two years. By the end of 2022, inflation will likely be still well short of the ECB’s “below, but close to, 2%” target.

ECB – limiting rise in nominal bond yields: Besides pointing out that this year’s strong rise in inflation should not be extrapolated and inflation will rise only gradually over the medium-term, we expect the ECB this year over and over again to bring home the message that a gradual rise in inflation towards target is positive and monetary policy will remain supportive even when inflation hits its target. If the economy recovers – as spring brings better weather and effective mass vaccination progresses – and inflation expectations rise notably, the ECB will be under pressure to raise its asset purchases to contain the rise in nominal bond yields. Some Governing Council members will likely welcome this, others may question the logic of such a step amid a recovery in economic activity, actual inflation and inflation expectations. Still, we expect a majority of Governing Council members to stay the course – with very supportive monetary policy probably until the labour market has recovered and even if inflation has hit the ECB’s target by then. Nevertheless, as we pointed out [here](#), the ECB faces two challenges: communication and unity.



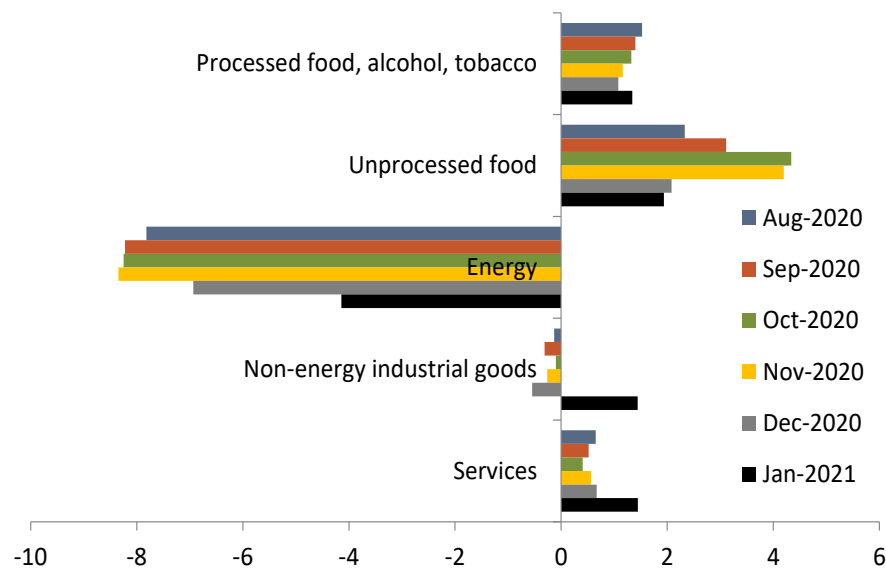
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Chart 1: Headline and core inflation since 1999 (yoy, in %)



Source: Eurostat, Berenberg

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



Source: Eurostat, Berenberg



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