

EURO AREA: INFLATION

A TEMPORARY BLOW IN MAY

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SUMMARY

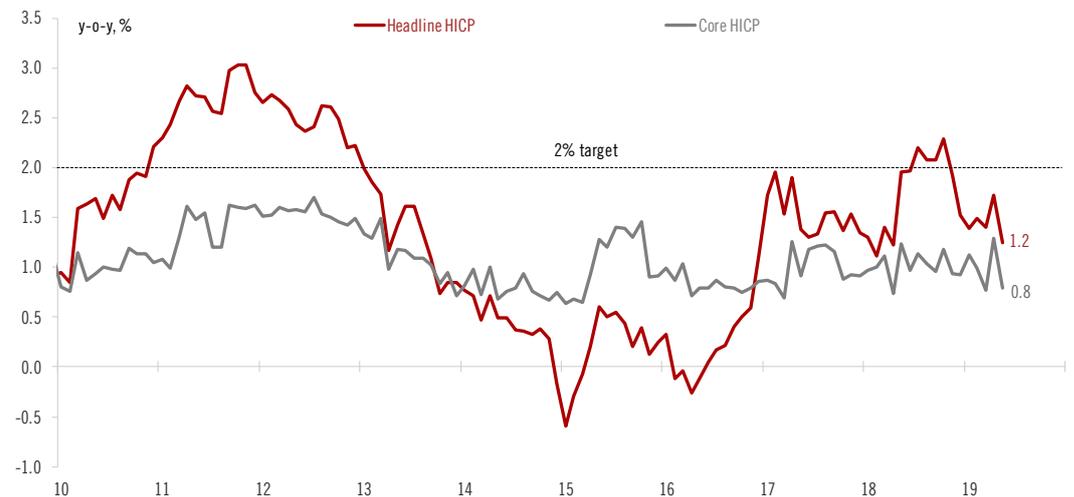
- Euro area flash HICP core inflation fell to 0.8% year on year (y-o-y) in May. The weakness in the core rate largely reflected post-Easter volatility in services prices.
- While we still expect strengthening wage growth to support a gradual recovery in core inflation, downside risks to our inflation outlook have increased.

A services payback in May

The euro area headline flash Harmonised Index of Consumer Prices (HICP) dropped to 1.2% y-o-y in May from 1.7% y-o-y in April. Core inflation fell by 50bp to 0.8% y-o-y, in line with our expectations. The details showed that the fall in core was due to a sharp decline in services inflation (1.1% y-o-y after 1.9%). This was not a surprise and was linked to the timing of Easter this year. Changes in the methodology used for package holidays in the German consumer price index (CPI) explain increased price volatility around this period.

Non-energy goods inflation rose in May to 0.3% y-o-y from 0.2% the previous month. Among the non-core components, energy prices were a slight drag on headline inflation (3.8% y-o-y after 5.3%), while the contribution from food, alcohol and tobacco was broadly flat (1.6% y-o-y after 1.5%).

CHART 1: EURO AREA - HICP INFLATION



Source: PWM - AA&MR, Eurostat, June 2019

Why is inflation so low in the euro area?

Beyond short-term volatility, the underlying inflation trend remains close to 1.0% y-o-y. The key question is: why are labour cost pressures not being reflected in rising prices? This remains a conundrum when it comes to the outlook for the euro area and the European Central Bank's (ECB) next monetary policy moves, especially as several measures show that wage growth started to pick up last year (see *Chart 2*).

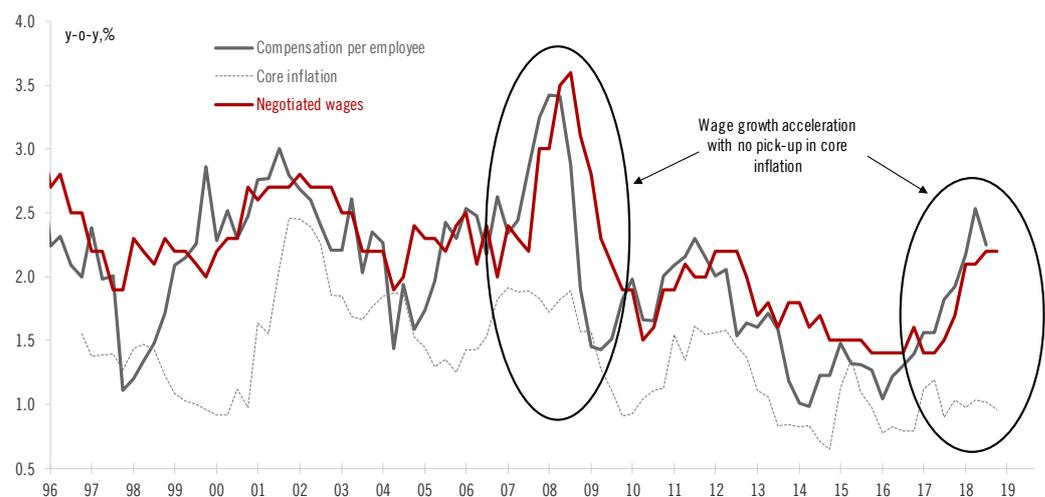
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Recent research by the ECB (see [here](#)) has found that what seems to be delaying the pass-through today is the fact that firms are absorbing labour cost increases by squeezing profit margins. This reflects two cyclical factors:

- 1) The euro area's emergence from a prolonged period of low inflation, which historically leads to a slower pass-through.
- 2) The softening of economic activity in 2018. Labour costs feed through more forcefully to prices when demand is strengthening. So, the fact that the euro area has recently experienced a negative demand shock is likely to have held firms back from raising prices.

Firms should be able to rebuild margins gradually if demand recovers and the downside risks (US auto tariffs, disorderly Brexit, intensification of the US-China trade dispute...) to our outlook do not materialise. However, those downside risks have increased significantly (see our previous Flash Note (see [here](#))).

CHART 2: EURO AREA COMPENSATION PER EMPLOYEE, NEGOTIATED WAGES AND HICP CORE INFLATION



Source: PWM - AA&MR, Eurostat, June 2019

Downside risks to our inflation outlook have increased

Overall, we expect May's fall in core inflation to prove temporary. We expect it to bounce back to 1.0% y-o-y in June. **We still think strengthening wage growth to support a gradual recovery in core inflation. However, downside risks to our inflation outlook have risen amid an uncertain growth outlook as external risks increase.** We forecast headline inflation to average 1.3% in 2019 and 1.4% in 2020, with core inflation at 1.2% and 1.4%, respectively.

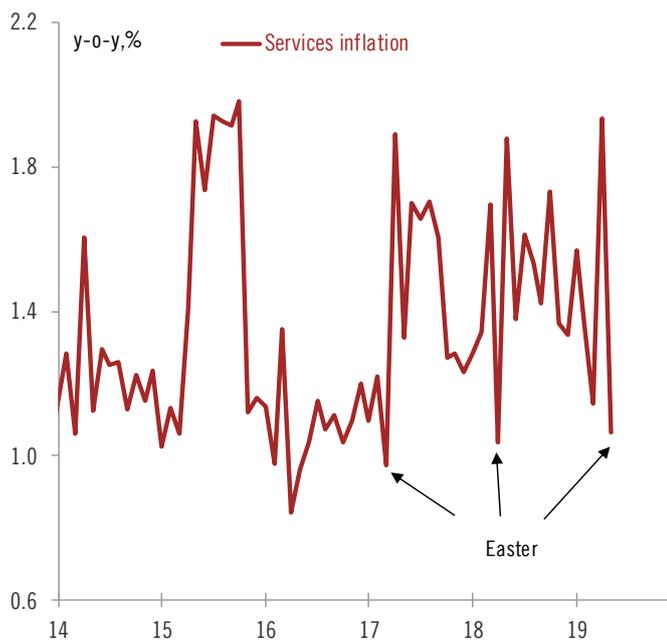
In this context, the ECB is likely to remain cautious. Amid growing external risks, potential 'insurance' rate cuts by the Federal Reserve (Fed) (see our Flash Note [here](#)) and renewed signs of inflation expectations de-anchoring, we have changed our ECB rate call. We now expect the ECB to stay on hold in 2020 (see our Flash note [here](#)).

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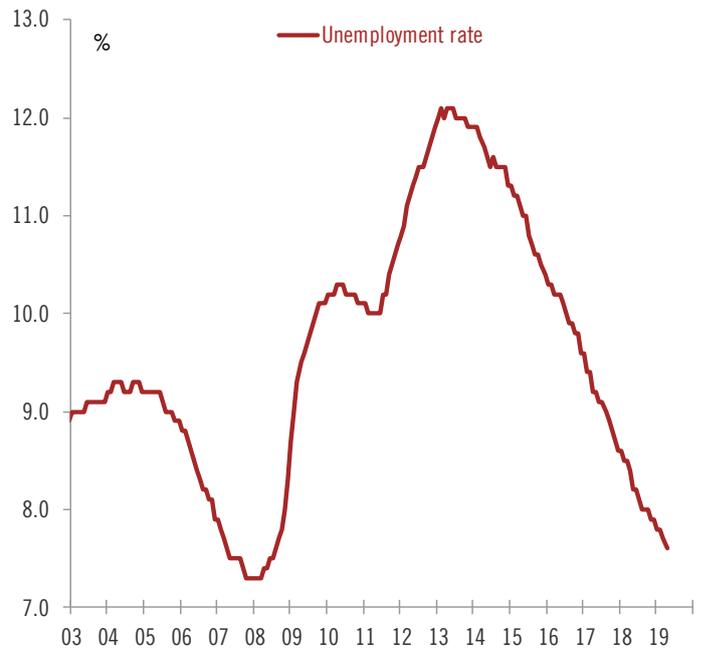
Appendix: some key charts

RECENT VOLATILITY IN CORE INFLATION WAS PARTLY DUE TO EASTER



Source: PWM - AA&MR, Eurostat

LABOUR MARKET CONTINUES TO TIGHTEN



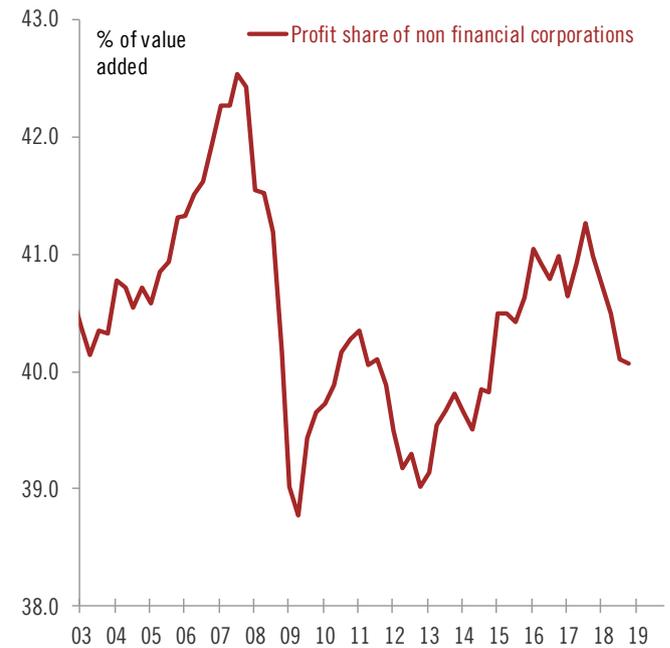
Source: PWM - AA&MR, Eurostat

OTHER MEASURES OF CORE INFLATION CONTINUE TO RISE



Source: PWM - AA&MR, Bloomberg

SQUEEZE IN MARGINS SUGGESTS FIRMS HAVE BEEN UNABLE TO PASS COSTS



Source: PWM - AA&MR, Eurostat

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