

EURO AREA: HICP INFLATION

BOTTLENECKS AND COMMODITY PRICES ARE DRIVING INFLATION UP

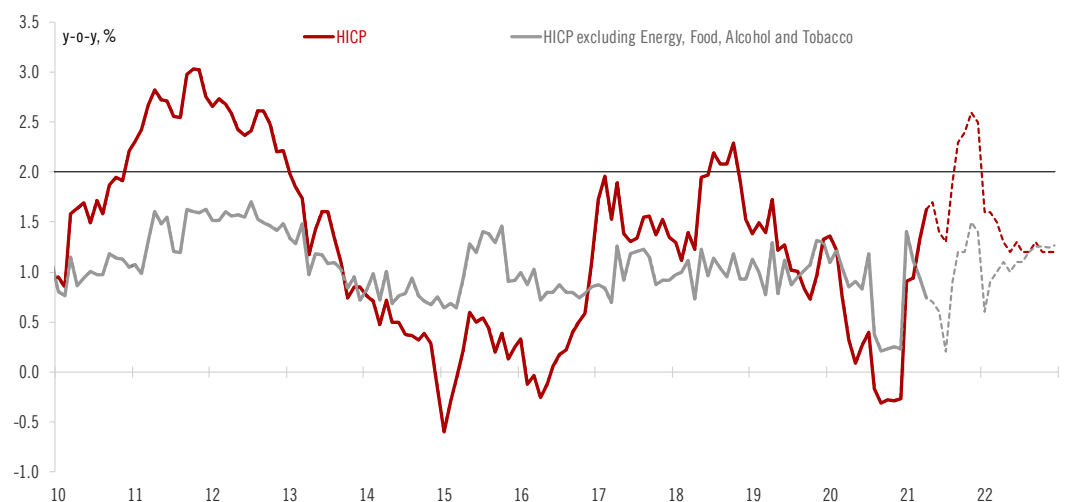
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SUMMARY

- Price pressures are building across advanced economies and the euro area is no exception. Several drivers are pushing inflation up. These include the recovery in prices depressed by the pandemic, supply bottlenecks and higher commodity prices. The reversal of VAT cuts and higher carbon prices in Germany as well as changes in weightings in Eurostat's price indexes may also be factors.
- We have revised up our euro area headline inflation forecasts to reflect the stronger commodity prices and supply bottlenecks. We see headline inflation averaging 1.7% in 2021 (up from our previous forecast of 1.4%). As base effects fade, we expect headline inflation falling back to 1.3% on average in 2022.
- We expect core inflation to be extremely erratic this year due to several technical factors. We have marginally raised our core inflation forecast to 1.0% in 2021 (from 0.9% previously) and again in 2022.
- Mainly because of supply-chain issues, risks to inflation in the coming quarters remain tilted to the upside. We believe the hike in inflation in H2 will prove transitory.
- To change our view on the transitory nature of the inflation spike, we would need to see signs of increasing tightness in the labour market. So far, wage growth has remained subdued in the euro area.
- The ECB is likely to look through temporarily higher inflation and maintain its highly accommodative monetary policy given the subdued medium-term inflation outlook.

CHART 1: EURO AREA HICP INFLATION WITH FORECASTS



Source: PWM - AA&MR, Eurostat, 03 June 2021 (Forecast assumptions: EUR/USD= 1.21; Brent USD/bbl= 69)

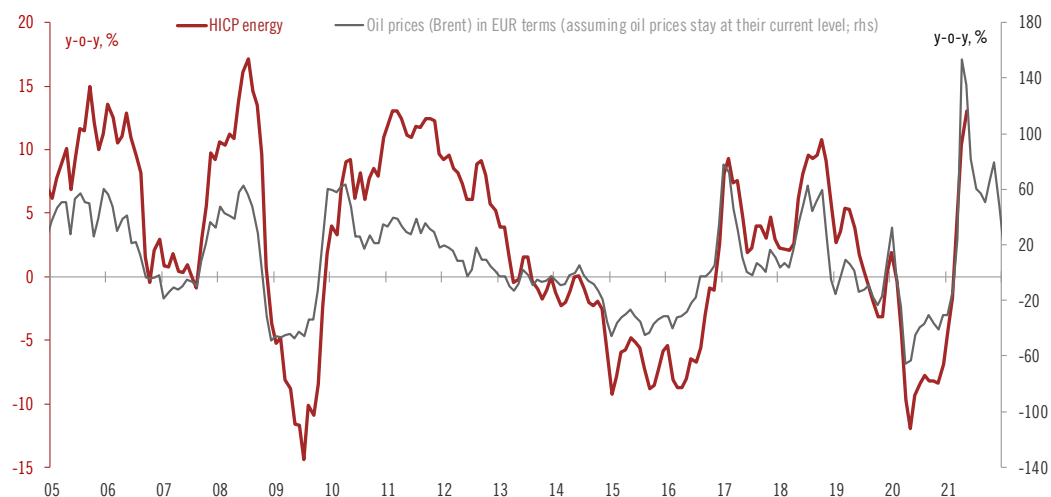
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Headline inflation climbs to 2.0% y-o-y, the highest level since October 2018

Euro area HICP headline inflation (flash estimate) picked up to 2.0% y-o-y in May from 1.6% in April, the highest level since October 2018, while the core rate rose to 0.9% y-o-y from 0.7%. Both figures were slightly above our expectations. **The increase in headline inflation was mainly driven by rising energy inflation**, which rose 2.7pp to 13.1% y-o-y, while food, alcohol and tobacco inflation remained unchanged at 0.6% y-o-y. Both services and non-energy industrial goods inflation rose by two-tenths of a percentage point to 1.1% y-o-y and 0.7% y-o-y, respectively. Eurostat will publish the final HICP release with a component breakdown on Thursday, June 17.

CHART 2: EURO AREA HICP ENERGY AND OIL PRICES



Source: PWM - AA&MR, Eurostat, 03 June 2021

Inflationary pressures are building

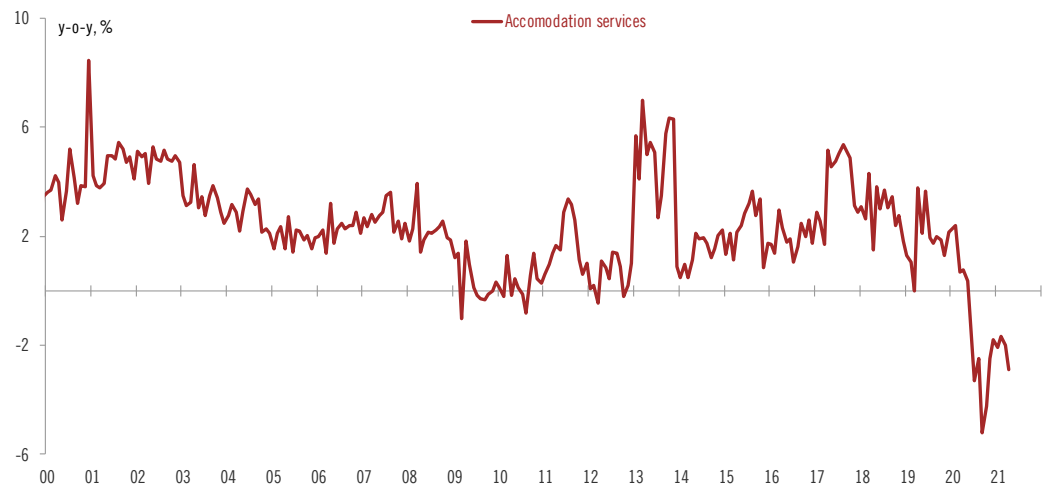
There are several drivers pushing inflation up beyond base effects. They include, **supply bottlenecks, input shortages in manufacturing, higher commodity prices and price normalisation after the disruption caused by the pandemic**. Hospitality, travel and leisure services (see *chart 3*) were particularly affected by the drift of demand in 2020. As economies reopen, prices will gradually normalise.

There are also some euro area specific factors such the reversal in the VAT cut and increases in carbon prices in Germany. The changes in the weightings of certain items in Eurostat's price indexes to take into account the drastic change in the consumption pattern triggered by the pandemic has also increased volatility in the data. The weights of airlines, package holidays, hotels and restaurants have been significantly reduced, while the weights of food, housing-related durable good and housing services have been increased.

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CHART 3: EURO AREA ACCOMODATION SERVICES INFLATION



Source: PWM - AA&MR, Eurostat, 03 June 2021

Ready for high inflation in Q3-Q4?

We have revised up our headline inflation forecasts to reflect stronger commodity prices and supply bottlenecks. In contrast to the US, the spike in headline inflation in the euro area will occur in the second half of the year. **We see headline inflation averaging 1.7% in 2021** (up from our previous forecast of 1.4%). As base effects fade, headline inflation is expected to fall back to **1.3% on average in 2022** (see *chart 1*)

We still expect core inflation to be extremely erratic this year due to a myriad of technical factors. **We have marginally raised our core inflation forecast to 1.0% in 2021** (from 0.9% previously) **and 2022**. Risks to inflation in the coming quarters remain tilted to the upside, principally because of supply-chain bottlenecks. How long these inflationary pressures persist will depend on how quickly supply comes back in line with demand. Pent-up demand also poses upside risk to inflation.

Country wise, the temporary rise in inflation will be particularly apparent in Germany due to the reversal of 2020 VAT cuts and increases in carbon taxes.

A more permanent inflation shock? Look at the labour market

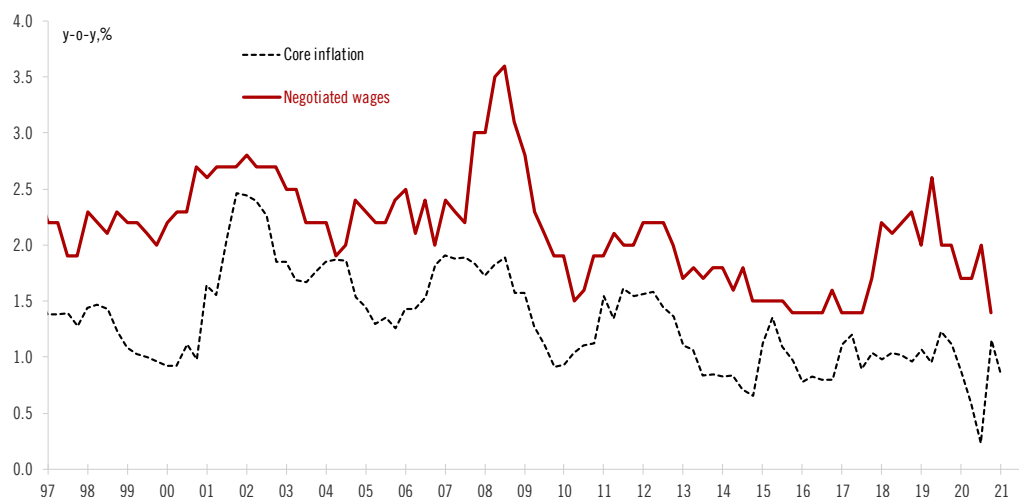
The key question for markets is how persistent the rebound in prices will prove going into 2022. As mentioned, we believe the hike in inflation in H2 will prove transitory, although there are some upside risks. **Developments in the labour market will be important to monitor.** Signs of increasing tightness in labour markets could determine whether the temporary rise in prices turns into something more permanent. Traditionally, wage growth has been an important factor in driving core inflation, but so far, there is little evidence of wage pressure in the euro area. In Germany, annual wage negotiations have suggested that job preservation considerations are outweighing wage increases.

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While we expect prices in the sectors worst hit by the pandemic to gradually adjust to economic re-opening, it will be important to closely monitor the inflation rate in sectors that have been little affected by the pandemic as well.

CHART 4: EURO AREA NEGOTIATED WAGES AND CORE INFLATION



Source: PWM - AA&MR, Eurostat, 03 June 2021

ECB to look through the noise

The ECB will look through strong HICP prints in the coming months. Nevertheless, the battle between the bank's hawks and doves is bound to intensify as economic fundamentals improve. The ECB faces a delicate decision over the pace of its Pandemic Emergency Purchase Programme (PEPP) buying at its 10 June meeting. We expect the Governing Council to strike a compromise between the hawks and the doves by maintaining the "higher" pace of PEPP purchases it announced in March during Q3 but hinting at a modest slowdown from Q2 that would leave monthly purchases above their historical average (see our ECB preview "it is urgent to do nothing" for further details).

Ultimately, the ECB's broader policy stance is the more important issue. **Given the subdued medium-term inflation outlook for the euro area, we expect highly accommodative monetary policies to continue beyond the recovery.**

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