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Disappointing eurozone inflation makes September rate cut a close call

Preliminary figures for both headline and core inflation came in slightly higher than expected in the eurozone. While we believe that the downtrend remains intact, today's figures make a September rate cut from the ECB a very close call

A supermarket in Barcelona

July inflation higher than expected

The year-on-year increase in eurozone HICP rose to 2.6% in July from 2.5% in June, according to the flash estimate. Consensus had pencilled in 2.5%. Core inflation remained stable at 2.9%, also above the consensus expectation. Looking at the different components, energy inflation rose to 1.3%. In the first quarter, the energy contribution to inflation was still negative. On this front, base effects will continue to have a volatile impact in the second half of the year. Non-energy industrial goods inflation remains low at 0.8%, while unprocessed food inflation declined to 1.0%.

The component the European Central Bank is probably scrutinising the most is services inflation, since it is the most “domestic” component and also very sensitive to wage increases. Services inflation did come down – but only marginally, to 4.0% from 4.1% in June.

September rate cut remains a close call

Where do we go from here? Bear in mind that in the ECB's June staff forecasts, headline inflation is estimated at 2.3% in the third quarter and 2.5% in the fourth. But as mentioned, base effects for energy prices remain an important driver of this forecast, which makes headline inflation a bit more volatile. For underlying inflation – likely the more important metric in the central bank's assessment – ECB staff are banking on 2.7% in the third quarter and 2.6% in the fourth. Looking at today's data, we would definitely need better inflation figures in August and September to remain on course. This is still possible, since in both the PMI survey and the European Commission's business and consumer survey, it appears that businesses' pricing power has started to weaken, now also in services.

The latest data has not given the ECB the certainty it needs to confirm that the inflation battle has been won. That said, survey data still suggests that the downward trend in inflation is likely to continue. And keep in mind that, at the current level, interest rates still imply restrictive monetary policy. Today's figures have slightly reduced the probability of a rate cut in September, but there's still six weeks of data to be seen before the ECB has to make a decision.

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