Encouraging drop in eurozone inflation in September but concerns remain

Inflation fell more than expected from 5.2 to 4.3% in September, an encouraging sign. Weak demand and base effects are currently impacting inflation favourably, but higher energy and wage costs do keep the risk alive that inflation could remain above target for longer than hoped

As expected, inflation fell in September - not just the headline rate but the core as well, which saw a strong decline from 5.3 to 4.5%. Base effects from government support last year ended, which was the main reason for the fall, but the good news is that the sharp decline was more than anticipated, as current price developments have become more benign. Using our own seasonal adjustment, non-energy industrial goods inflation was negative month-on-month in September. Services inflation may have ticked up MoM and remains elevated although businesses in the service sector do indicate that pricing power is diminishing as demand for services weakens.

There are big differences between countries at the moment in large part driven by how energy translates to consumer prices, but also by differences in wage growth and economic performance. Spain saw inflation increase from a low base on the back of the increasing energy prices, while Germany, Netherlands and Belgium experienced sharp drops.

Still, inflation worries cannot be buried just yet

Higher oil prices are a concern for the inflation outlook. Energy prices did not fall as much as expected in recent months and are now set to contribute positively again to inflation as the oil price has risen above US$90 per barrel. We expect that this will mainly push eurozone inflation higher at the start of next year, and a contribution of one percentage point to headline inflation is not unimaginable. This is well below last year's impact, but still sizable enough to prevent headline inflation from hitting the European Central Bank's 2% target as soon as forecast.

A big question is if this will again spark significant second-round effects. In the current, much weaker economic environment, businesses are indicating that pricing power is weakening. This seems to limit any significant resurgence of inflation. Still, higher energy costs and high wage growth – in combination with current weak productivity – should continue to put upward pressure on inflation in 2024. With demand currently alleviating pressures, we do expect inflation to continue to gradually trend down. But as uncertainty about the pace of the normalisation of inflation will persist for some time, higher-for-longer interest rates from the ECB are definitely a realistic scenario despite September's very promising drop in inflation.

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