

Eurozone inflation surprisingly increased in April

Headline inflation was slightly up while core inflation was slightly down. This makes April inflation in the eurozone sticky and underlines the need for further rate hikes, albeit at a slower pace and smaller magnitude than before



Eurozone inflation surprised to the upside and came in at 7.0% year-on-year in April, from 6.90% YoY in March. Core inflation dropped marginally to 5.6%, from 5.7% in March. The unexpected increase is the result of a bounce back in energy price inflation, after the strong negative base effect in March, and slightly higher service price inflation. As with GDP growth last week, inflation divergence across the monetary union is high, reflecting different government energy price caps, subsidies and pass-throughs from wholesale to retail energy prices. In April, headline inflation ranged from 2.7% YoY in Luxembourg to 15% YoY in Latvia.

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Looking ahead, inflation developments in the eurozone will be determined by two rather opposing forces: on the one hand, negative base effects on energy and food prices as well as dropping selling price expectations in industry argue for a further drop in headline inflation. On the other hand, still high selling price expectations in services as well as wage increases are likely to fuel underlying inflationary pressures. As a consequence, we expect headline inflation to continue falling, while core inflation will remain sticky. As ECB Executive Board member Isabel Schnabel said recently: "I would not overemphasise the peak [in core inflation] as such, because what really matters is that inflation is returning to our two percent target over the medium term. We need to see a sustained decline in core inflation that gives us confidence that our measures are starting to work".

Today's data strengthen our call of a 25bp rate hike on Thursday

Over the last year, inflation in the eurozone, which started as a supply-side issue, has become a demand-side issue. This is a clear invitation for the ECB to continue hiking interest rates. While there is very little a central bank can do to lower oil prices or to stop a war, there's a lot a central bank can do to stop too much money chasing too few goods: bring down demand. And this is exactly what the ECB will continue doing on Thursday. Even if headline inflation has come down and will come down further, this is not yet the moment of relief. The ECB doesn't want to repeat the previous mistake of underestimating inflation and will therefore be willing to go too far, even if this eventually turns out to be a policy mistake.

The only open question is whether the ECB will go for 25bp or 50bp. Out in the open, only Austrian central bank governor Robert Holzmann has been advocating 50bp. The other hawks, like Isabel Schnabel, recently left the option of 50bp open but didn't officially subscribe to it. Sticky inflation data clearly stresses the need to continue hiking but with last week's weaker-than-expected GDP growth report and today's weak loan growth and loan demand data, the case for slowing down the pace and size of rate hikes has become stronger. We stick to our call of a 25bp rate hike on Thursday.

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