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Eurozone inflation hits record 5.1%, driven by higher energy prices

The headline inflation rate surprised with another increase as energy inflation jumped. The decline in core inflation is more in line with expectations and shows very little evidence of second-round effects in the eurozone so far. Expect the European Central Bank tomorrow to push back against early rate hikes

The main driver of the increase in inflation was energy prices

The surprise is that headline inflation remains higher than expected. With shrinking base effects from the oil price and the German value-added tax (VAT)-hike from last January dropping out of the numbers, most were expecting a larger decline in headline inflation than this. Those effects were outstripped by another tick up in energy prices, causing energy inflation to soar to 28.6% in January. This is not at all surprising. Thanks to volatile market energy prices and uncertain pass-throughs to the consumer, short-term energy inflation movements are very difficult to predict. Expect this to improve from Spring onwards.

The higher headline inflation and dropping core inflation reading means the following:

- Concerns about future second-round effects remain valid as energy inflation keeps the inflation rate at a higher level for now.

- The dropping core inflation rate confirms that the high inflation rate is not yet spreading and that the pass-through of high producer prices remains more modest than expected. Goods inflation fell back to 2.3% and services inflation stayed put at 2.4%. This shows that there is still no evidence of widespread second-round effects happening at the moment.

So this results in an inflation rate that provides both the hawks and doves plenty of ammunition for tomorrow's European Central Bank (ECB) meeting. It far from settles the debate between how structural or temporary this current inflation rate is. While expectations are that energy inflation will steadily decline, we also expect wage growth to rebound over the course of this year and still see more room for goods inflation to increase as high producer prices get priced through to the consumer. Overall, we expect headline inflation to weaken to about 2% at the end of the year.

With improving expectations for GDP and inflation for 2023 and 2024, that should be enough for an ECB rate hike in early 2023, but it is also important to stress that the eurozone inflation situation is much less acute than the US as second-round effect evidence remains largely lacking. Don't expect too much from the ECB tomorrow as we could well see President Christine Lagarde disappoint anyone expecting a 2022 rate hike.

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