Eurozone inflation jumps ahead of ECB meeting

Eurozone headline inflation ticked up from 2.4 to 2.6% in May, and core inflation increased from 2.7 to 2.9%. While the European Central Bank seems set to lower rates next week, the debate over how much the ECB can release the brakes on the economy over the rest of the year will be heated

Eurozone headline inflation jumped in May, mainly thanks to higher services inflation. The effect was seen in several larger countries, with Germany, Spain and France all experiencing significant increases. While base effects do play a role – think of German public transport ticket prices – this does illustrate that the final throws of getting inflation back to target are not necessarily easy.

With the ECB on the eve of deciding on a historic rate cut, this adds to doubts about the future inflation path. While many forward-looking indicators remain benign, a hot labour market, continued supply chain disturbances, and a recovery of purchasing power will make for an interesting debate at the ECB governing council as they decide on the path of monetary policy from here on in.

Core inflation seems set to decelerate again, but the question is at what pace? Services inflation remains elevated for now but forward-looking indicators do gradually move in the right direction. Still, we expect services inflation to trend around 3.5% towards the end of the year, well above target. If goods demand returns on the back of higher real wage growth, goods inflation could accelerate somewhat again towards the end of the year as supply chain problems still modestly curb supply.

Wage growth is a key element in bringing inflation down, but surprised to the upside in the first quarter. The ECB was correct to dismiss this as resulting from German one-off payments as other countries see faster deceleration. Still, with unemployment remaining at a record low of 6.4%, the decline in wage growth over the rest of the year remains uncertain. For the ECB, the outlook for wages is encouraging enough to cut rates for the first time since 2019 next week. The question remains: how many cuts can follow, and the May inflation serves as a warning that next week might not mark the start of a traditional cutting cycle.

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