# Eurozone inflation jumps to 4.9%, so where do we go from here?

Eurozone inflation jumped to 4.9% in November on the back of energy and goods prices. With cyclical price pressures increasing medium-term expectations, the ECB seems set for a careful tightening of monetary policy despite increased virus risks


Shoppers in Italy

## It's mainly energy, but also watch core inflation move up

We haven't seen inflation this high since the eighties, let's break it down. The energy shock of 2021 is starting to have a substantial impact on consumers as energy inflation has shot up to 27.4% YoY. This is mainly because of gas price increases at this point as petrol prices were about flat in the eurozone in November. The natural gas price surged again this month, confirming an uncertain winter for energy prices. Looking at future prices, we only expect a substantial drop in the middle of next year.

Core inflation also increased though, it's not just energy causing this. A big jump in services inflation from 2.1 to 2.7% and a more modest non-energy industrial goods inflation increase from 2 to 2.4% suggest a broadening of inflation categories above 2%. With wage growth lagging, consumers are therefore now facing a broad increase in prices, pushing real wage growth significantly into the red.

## Expect much of the higher inflation rate to still be temporary

Undoubtedly inflation will drop again over the course of next year. The German VAT hike dropping out of the numbers in January will mark the first decrease while expectations of moderating energy prices and decreasing supply chain disruptions should further alleviate the inflation rate in the eurozone over the course of next year.

The big question mark is around rising goods prices. Pipeline cost pressures are not yet abating, causing us to expect increased goods inflation for most of 2022 which will take over as the dominant driver of headline inflation when energy inflation weakens. The big question is how far inflation will exactly drop over the course of next year. For that, second-round effects and cyclical factors are key.

## Evidence of second round effects is missing, but the cyclical upturn boosts inflation expectations

Evidence of second-round effects is very slim at the moment with the ECB indicator for negotiated wage growth hitting an all-time low last quarter, showing that immediate concerns about those second-round effects in the eurozone are much smaller than in the US where wage growth has been surging in recent quarters. Still, there are factors that are set to keep inflation above pre-crisis rates over the medium term.

Cyclically, the economy has surprised on the upside over the past quarters. We’re now much closer to potential output than we previously thought we would be with GDP less than 1% away from pre-crisis levels. At the start of this pandemic, we expected to get back to where we were only in 2023. Labour markets have also outperformed expectations with a very rapid recovery of job growth and unemployment remaining close to historical lows. The end of furlough schemes is unlikely to have a large impact on the eurozone labour market, which adds to wage pressures emerging. The risks of the virus definitely dampen expectations for growth in the months ahead, but the medium-term impact is still expected to be quite mild, especially with fiscal support returning.

## Expect the ECB to act on cyclical pressures, perhaps earlier than expected

All in all, we don’t expect inflation to drop much below 2% for late 2022. While second-round effects are largely absent for now, medium-term price pressures are increasing and we expect wage growth to rebound over the course of next year. While ECB tightening is not exactly helpful in increasing gas reserves or solving bottlenecks in Asian ports, it is relevant when it comes to medium-term price pressures. Of course, new restrictive measures against the virus and Omicron uncertainty add downside risks to the outlook but for now, we still expect the ECB to announce an end to its emergency PEPP programme for March and expectations of a first rate hike is moving closer to the beginning of 2023.

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