Eurozone inflation remains on track for a bumpy ride down

Headline inflation continues to drop quickly on energy price effects, but core inflation ticked back up in June. This is mainly related to base effects from government support and the underlying trend remains disinflationary. Concerns about persistent wage growth remain though as unemployment remained at historic lows in May

The inflation rate dropped from 6.1% in May to 5.5% in June, but the main focus for the European Central Bank is currently on core inflation, which ticked back up from 5.3 to 5.4%. This was mainly due to the effects on services inflation from German government support last year.

Our own seasonal adjustment suggests that both eurozone goods and services inflation saw a modest decline in June, in line with the current disinflationary trend. Non-energy industrial goods inflation dropped from 5.8% in May to 5.5% in June and we expect it to fall further in the coming months, while services inflation could remain elevated on base effects and possibly on wage growth, adding upward pressure to costs.

Headline inflation continues to drive the strong declines though. Food inflation has moderated substantially, although our own seasonal adjustment suggests a monthly uptick between May and

June. Still, the year-on-year inflation rate is coming down at the moment. Energy inflation is strongly negative on base effects as well.

The labour market remains hot, which is a key concern for the ECB. While there are initial tentative signs of cooling - think of vacancy rates having moved past their peak – unemployment remained stable at the historic low of 6.5% in May. For the ECB, this means that the risk of prolonged high wage growth remains in place, which is an important reason why the ECB is not pausing its hiking cycle just yet.

Other forward-looking indicators for inflation are looking benign though, with selling price expectations steadily dropping by the month and cost pressures outside of wages having fallen quickly. The sluggish economic environment is also adding little demand pressure.

So while the improving inflation environment will be encouraging for the ECB, the message coming out of Sintra this week has been pretty clear: there's more work to be done. The ECB thinks it is more costly to do too little in terms of hikes than to do too much, which means that we expect the ECB to continue hiking in July and September. By then, the blurring base effects from government support should largely have faded, which means that a pause will become likely.

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