Eurozone inflation soars to target, putting the ECB in an awkward spot

As this jump in inflation just thinly masks underlying core weakness and uncertainty about the economy is high, it is unlikely to convince the ECB to normalise policy more quickly

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As prospects of a trade war with the US loom and euro-risk returns, Eurozone inflation jumps to 1.9%. Core inflation improves from 0.7% to 1.1%. After distortions to the inflation rate because of the timing of holidays, the May rate should provide a somewhat fairer view of how strong price growth is at the moment although there was still some holiday impact. The services inflation reading is still quite volatile as it jumped from 1% to 1.6%. Non-energy goods production remained weak though and fell back from 0.3% to 0.2% in May.

This core inflation reading is still below where we would expect it to be with the improving labour market and increased selling prices indicated in business surveys. And, as selling price expectations have been weakening in the recent soft patch of economic data, it does not seem like we are at the start of a marked increase in inflation.

The understatement of recent months was also helped by a weakening euro, which dampened some of the effects from the higher oil price. Petrol prices jumped significantly in May, on the back of an oil price of around $80 per barrel for most of the month and a weakening euro.

Be careful what you wish for, ECB. After years of pushing for inflation to return to just under 2%, it could not have come at a more difficult time. Eurozone financial market turmoil has returned because of Italian politics this week and it is very difficult to see how the Italian political situation is going to play out. Economic data has been weakening over the past months, and the ECB is eager to determine whether this is just a soft patch. Finally, the US seems on the brink of announcing tariffs on European steel and aluminium, which clouds the exports outlook and could have an additional inflationary impact if the trade conflict gets out of hand.

The ECB therefore now has to decide whether it will provide certainty straight away by announcing an extension to QE or take a "wait and see" approach at the June meeting. Then it could just hint at an extension while taking another six weeks to see how the political situation in Italy and the trade conflict with the US play out, and take in more economic data. As this jump in inflation just thinly masks underlying core weakness, it is unlikely to convince the ECB to normalise policy more quickly.

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