Eurozone inflation surges by far more than expected in October

With inflation above 4% and core inflation above 2%, the breeding ground for second round effects on inflation becomes more fertile. Whether it is fertile enough for inflation to turn structural remains to be seen, but the ECB will have to keep a close eye on it.

The inflation rate jumped to 4.1% in October, which ties this century's peak of July 2008. The jump was mainly caused by soaring energy prices on the back of the gas crisis and a steady rise in oil prices, but services inflation also boosted core inflation, from 1.9 to 2.1%.

The energy inflation rate is now a remarkable 23.5% and consumer gas prices have yet to be fully incorporated into these numbers because of contract adjustments not all happening immediately. Still, expectations of falling energy prices over the course of 1H do lead to disinflationary pressures, meaning that sustained energy inflation for the coming quarters is far from a base scenario at the moment.

The core picture is one of steadily increasing goods inflation as businesses price through supply chain price pressures to the consumer. This is set to last for some time as we don't expect the price pressures to abate until well into 2022. The jump in services inflation was more related to base effects from last year than anything else though, so while an increase from 1.7% to 2.1% looks alarming, the monthly rate of 0% inflation reveals cautious price increases despite the strong reopening in terms of demand.

Christine Lagarde said yesterday that the ECB is confident that their analysis is correct on how temporary inflation is. The market seems far from confident though as rate hike expectations have been coming forward to within a year from now.

The key question for whether that earlier rate hike is justified is when second round effects will come into play. The higher inflation rate will provide more fertile ground for fiercer wage negotiations, which could lead to second round effects on inflation. If this happens quickly enough, the current spell of high inflation may not be as temporary as the ECB suggests. While this is not the base case as wage growth is still very low and has yet to break from a declining trend, it should be watched with caution in the months ahead.

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