Eurozone inflation surges to ECB target as economies reopen

There it is, inflation moves to 2% and we believe it is set to remain at or above this level for the rest of the year. All eyes now turn to the European Central Bank ahead of the June meeting. However, we do see inflation falling back below 2% in 2022 as most inflationary pressures we identify remain temporary, for now

Everyone saw it coming, but still it is starting to make a lot of people sweat. Inflation is returning rapidly at the moment at a time when news about economies is increasingly upbeat and labour markets are profiting from the reopening. All eyes now turn to the ECB, which is unlikely to put tapering on the table at the June meeting as prominent ECB speakers have in recent weeks come out against premature tightening, and price pressures are expected to remain temporary.

What to make of an inflation rate at 2%

Energy inflation continues to dominate the increase in prices. Even though the oil price has effectively moved sideways since February, eurozone petrol prices have continued to rise modestly, reaching the highest level since mid-2019 two weeks ago. This, together with base effects, pushed energy inflation up from 10.4% in April to 13.1% in May. With the base effect moderating, we expect the energy impact to be reduced in the months ahead, but that doesn't mean that higher inflation is over.

Goods inflation is set to rise as well – which has hardly happened so far – as supply chain problems, shortages and high capacity utilisation are resulting in price pressures. In May, it increased from 0.4% to 0.7%, which is likely to be the start of a longer rally, as supply side issues are set to last for at least a few more months, and demand for goods continues to come in very strong.

For services, a lot of prices are still imputed as restrictions remain in place in a lot of countries, which makes real price developments harder to read. Reopenings have occurred over the course of May though, but the full inflation impact is probably going to show up in June. German data did reveal yesterday that prices for package holidays increased more significantly in May. We expect more reopening jumps to play into the services inflation data over the months ahead.

Unemployment declined to 8% in April, boosting recovery prospects

The labour market continues to improve as economies lift restrictions. With furlough schemes still in place across the eurozone, this is resulting in a very low unemployment rate given the GDP shock of last year, and this helps the prospects of a swift economic rebound. With incomes largely retained in the eurozone and savings rates surging over the lockdown periods, consumers stand ready to recover some pent-up demand. That will boost the GDP recovery and add to inflationary pressures, but the big question remains what happens when furlough schemes end. A strong economic recovery will limit delayed layoffs, but we do expect restructurings to occur, causing a more muted labour market recovery once support schemes end.

Temporary or structurally higher inflation?

With goods and services inflation set to increase more, elevated eurozone inflation is the best bet for the coming months. The discussion about whether this is indeed temporary or structural will be a very prominent debate for the months to come. We expect the recovery to moderate after a few strong months initially and see most goods inflation disruptions fading towards the start of 2022. That means we still expect inflation to come down to about 1.5% in 2022.

Author

Bert Colijn
Chief Economist, Netherlands
bert.colijn@ing.com

Disclaimer