Snap | 31 August 2022

Eurozone inflation surpasses 9% as cost of living crisis deepens

August inflation jumped to 9.1%, another leg up in inflation as supply shocks persist. Core inflation increasing from 4% to 4.3% will be the key concern for the ECB in the run-up to next week's governing council meeting

The gas supply crisis and droughts are adding to persisting supply-side pressures on inflation at the moment

The eurozone inflation rate ticked up from 8.9% to 9.1% in August. The increase was mainly seen in processed food and goods prices, but services also ticked up slightly. Energy inflation fell for the second month in a row on base effects and lower petrol prices, despite soaring gas and electricity prices. The main concern is the surprise increase in goods inflation. The increase from 4.5% to 5% was much larger than expected and fuels worries about second-round effects from the input cost shock lasting longer.

Global supply-side pressures have been easing in recent months. Commodity prices have fallen, including food and oil, which has resulted in lower prices at the pump. Transportation costs have also moderated, and inputs are more widely available again. Still, specific European problems continue to push inflation higher. The gas supply crisis and droughts are adding to persisting supply-side pressures on inflation at the moment.

Demand-side inflation remains weak in the eurozone. The output gap is still negative, household consumption is well below pre-pandemic levels and retail sales have in fact been on a declining trend since November. The latest negotiated wage growth data for 2Q came in at 2.1%, which means there is no evidence of a wage-price spiral at this point, but that the eurozone is mainly facing an unprecedented squeeze in real incomes.

As the economy is slowing rapidly – and perhaps already contracting at this point – the question is how much the ECB needs to slam the brakes. Another hike of at least 50 basis points in September seems to be a done deal, with the hawks pushing for 75bp. The big question is how the ECB will respond after this, if indeed signs of economic distress become more apparent, and inflation remains highly driven by supply-side factors.

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