Eurozone: war pushes up inflation to historic high

Inflation jumped to 7.5% in March as energy and food prices soared and core inflation advanced to 3%. Expect the European Central Bank to tread carefully as economic circumstances deteriorate, and inflation is set to remain severe for the months ahead

Eurozone inflation rose 2.9% in December

My wallet shrivels just writing this, but inflation has jumped to 7.5% in March. This happened mainly on energy and food prices that jumped due to the war in Ukraine, but core inflation also continued to advance as both goods and services inflation accelerated. Still, the divergence between headline and core inflation grew bigger with supply shocks to energy and food remaining the big driver behind the historically high readings.

The question is whether the worst is behind us now and that seems doubtful. First of all, the immediate developments of inflation are highly conditional on developments in the war. That makes any short-term expectations more prone to error than usual, but our base case suggests an even higher reading in April at least, on the back of lagged developments in consumer food and gas prices. Even a double-digit inflation print cannot be ruled out at this point.

From here on, there are multiple factors stemming from the war that are set to keep upward pressure on prices. First of all, second-round effects are likely to occur somewhat quicker due to high energy prices at the moment. Secondly, the war – together with Chinese lockdowns – is causing supply chain disruptions to flare up again. This keeps pressure on producer prices and subsequently on consumer goods inflation for longer. We therefore expect inflation to come in at 6% or higher for 2022.

This puts the European Central Bank (ECB) in a very tough position. First of all, current inflation can hardly be influenced by the ECB, because this is a supply shock caused externally. For the medium-term, policy is difficult to set. On the one hand, demand is already being slowed significantly by the massive squeeze in real wages, production disruptions, dropping consumer confidence and tighter financing conditions because of higher bond yields. On the other hand, sitting on their hands will raise risks of de-anchoring inflation expectations that could prove painful in the medium term.

The ECB is running out of painless options to battle current economic problems, so we expect it to tread carefully. Without signs of higher wage growth that could point to a wage-price spiral starting or de-anchoring inflation expectations, we expect some normalisation of monetary policy in the coming months with an end to quantitative easing in the third quarter and rate hikes in the fourth quarter of 2022 and first quarter of 2023.

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