Economic Research

Economic Briefing

Euro area – inflation flirts with the 2%-mark

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The inflation rate in the eurozone fell sharply to 2.2% in August, bringing it close to the ECB's target of 2%. The main reason for this was a drop in energy prices, while the core inflation rate fell only slightly to 2.8%. Nevertheless, the ECB is likely to use the inflation trend in August as an opportunity to cut interest rates further. However, inflation is likely to rise again by the end of the year – not least due to the persistent upward pressure on prices for services.

Inflation rate falls significantly in August, …

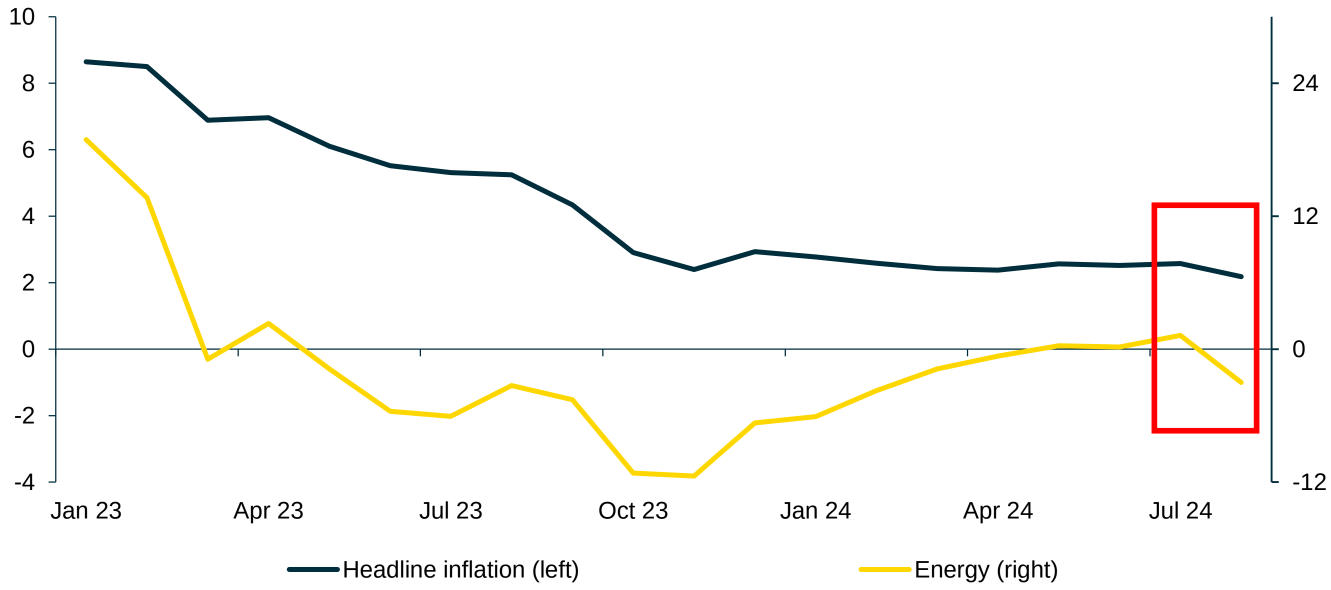
According to preliminary data from Eurostat, the inflation rate fell to 2.2% in August (from 2.6% in July). Inflation thus met the expectations of the economists surveyed in advance (Table 1). This significant decline is primarily due to lower energy inflation (from 1.2% in July to -3.0). The core inflation rate, excluding the often highly volatile prices of energy and food, fell only slightly to 2.8%, in line with expectations. It therefore remains well above the ECB's target of 2%. As the previous year's rate for the important services component remains stubbornly at the 4% mark and even rose to 4.2% in August, this is unlikely to change in the coming months.

… and could dip below 2% in September

The inflation rate will also be significantly influenced by the movement of energy prices in the coming months, partly due to their strong movements in the past year. For example, the rate of energy inflation fell noticeably this month not only because energy prices fell compared to the previous month. Rather, it was also because prices had risen significantly in August 2023, which now dropped out of the year-on-year comparison. As energy prices continued to rise noticeably in September last year, the rate of energy inflation will continue to fall in the coming month, even if current energy prices stabilize. The overall inflation rate could therefore even slip below the 2%-mark in September.

Chart 1 - Energy prices force the headline rate downwards again

Harmonized consumer price index, headline rate and the energy subcomponent for the euro area, year-on-year rates in %



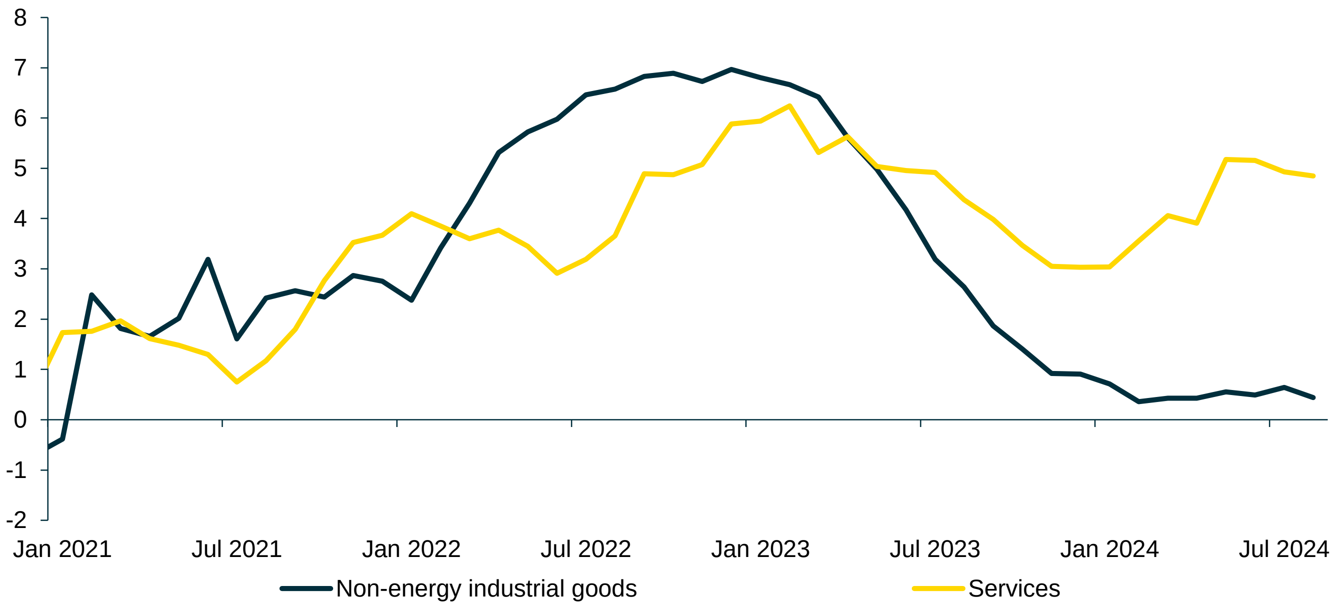
Source: Eurostat, Commerzbank-Research

Underlying inflation remains strong

However, the rate of inflation is likely to pick up again in the fourth quarter. This is because the underlying upward pressure on prices remains unbroken despite the slight decline in the core inflation rate. The year-on-year rate for service prices even rose to 4.2% in August (from 4.0%) and is likely to remain at this level in the coming months due to rising wages. Looking at the annualized 6-month rate, which provides a picture of short-term momentum, the upward trend in prices has actually increased since the beginning of the year (Chart 2). There are also signs of a trend reversal in the inflation rate for goods excluding energy. At 0.4%, the annualized 6-month rate remains very low. However, it has risen slightly in recent months and, in view of the renewed rise in prices for intermediate goods and very high international transportation costs, this slight upward trend is likely to continue. All in all, the core inflation rate should be back above 3% by the end of the year. Overall inflation is expected to climb back to around 2.7%.

Chart 2 - An upward movement of the core rate returns

Subcomponents of HCPI, seasonally ajusted 6-months rates, annualized in percent,
August 2024: Estimated by Commerzbank based on annual rates



Source: ECB, S&P Global, Commerzbank-Research

Lower inflation rate sets the stage for ECB interest rate cut

The August data was the last inflation update before the ECB Governing Council meeting on September 12. With inflation close to its target, the ECB is likely to cut key interest rates further, especially as the wage growth of 3.6% in the second quarter was not quite as strong as in the first quarter (4.7%). However, if the inflation rate settles at around 2.5% next year, as we expect, and thus above the ECB's target, this would limit the scope for further interest rate cuts. For this reason, we assume that the key interest rate will be higher at 2.75% at the end of next year than is currently priced into the market (2.19%).

Table 1 - Euro area inflation

Year-over-year change in percent

Indicator		Aug-24 preliminary	Forecasts CB	Forecasts Consensus	Jul-24	Jun-24	May-24
Consumer prices	%, y-o-y	2.2	2.1	2.2	2.6	2.5	2.6
Core rate 1)	%, y-o-y	2.8	2.8	2.8	2.9	2.9	2.9

1) HICP excluding energy, food, alcohol and tobacco. Source: Eurostat, Commerzbank Research

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