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Eurozone inflation falls further below zero

Temporary factors are causing disinflation in the eurozone, but the longer it lasts the more worrying it becomes. That seems to give plenty of ammunition to the ECB doves to argue for more stimulus in December

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Headline inflation fell from -0.2 to -0.3% in September. The decline was driven by a drop in core inflation, which fell further from 0.4 to 0.2%. It has to be said that this has been caused by a smorgasbord of temporary factors though, although all of those together do add to the risk of inflation staying lower for longer.

The German VAT reduction is responsible for a significant part of the downward pressure, which is of course a transitory effect, and energy prices also continue to contribute to the downturn. Besides that, goods prices have been influenced significantly by a shift in the timing of the mandatory sales period in some eurozone economies. The dip that this caused in August was followed by a further decline in September, meaning that there is a delay in the reversal of the sales effect.

Perhaps the most worrying decline in the inflation rate comes from services inflation, which usually shows very little volatility and is a large component of the core inflation index. Services inflation was 1.6% in February and has dropped to just 0.5% in September. We find that this is predominantly due to large drops in prices for services related to social distancing, indicating that the coronavirus has had a significant deflationary impact.

For the European Central Bank, most of these factors ordinarily should not cause a change of direction. Still, core inflation this low is hard to ignore, especially since President Lagarde has recently put a lot of emphasis on the importance of the core measure. Also, the second round effects of low inflation for quite some time could become a factor for the medium-term expectations, which is enough for the doves to argue for more stimulus in December.

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