Subdued euro inflation requires great ECB balancing act

Preliminary figures for both headline and core inflation are at the low end of expectations

1.5%

Eurozone headline inflation

Consensus: 1.6%

The energy question

Preliminary inflation figures for September surprised on the downside. Headline inflation remained stable at 1.5% (consensus 1.6%), while core inflation (excluding energy and unprocessed food prices) also stabilized at 1.3% (consensus 1.2%). While the latter was slightly higher than consensus, we prefer to look at core inflation defined as inflation excluding energy, food, alcohol & tobacco prices. This measure of core inflation actually fell back to 1.1% from 1.2% in August. The energy inflation rate came out at 3.9% from 4.0% in August. The energy component is likely to remain extremely volatile in the months to come, as the erratic behaviour of oil prices in the last quarter of 2016 will generate zigzagging base effects. In that regard, we could see inflation slightly rising in the coming months to drop back again below 1.5% again from January onwards.

The ECB's dilemma

To be sure, core inflation has most probably troughed. Yesterday's European Commission survey clearly indicates increasing pricing power amongst European businesses, while wage growth is also likely to pick up somewhat on the back of the falling unemployment rate.

> *The upward trend in core inflation is likely to remain gentle.*

Our estimate of the Eurozone Phillips curve sees core inflation increasing to 1.6% at most by the end of 2018. While the end of deflation gives the hawks within the Governing Council ammunition to demand a rapid extinction of quantitative easing, inflation is likely to remain below the ECB's target for some time to come. That still pleads for caution, also taking into account that too rapid an exit from QE could push the euro exchange rate up again, exerting downward pressure on inflation.

October's meeting is likely to be one of the greatest balancing acts in the ECB's history. On the one hand, it will have to announce some kind of tapering, given the increasing scarcity issues in terms of bonds to buy. At the same time, it will have to try to avoid that the markets interpret the announcement as overly hawkish, thereby leading to a premature tightening of financing conditions. We indeed believe the ECB will reduce the monthly amount of purchases, but could surprise the markets in terms of the length of the programme, potentially lasting beyond the summer of 2018. At the same time, the ECB will continue its efforts to shift the emphasis of monetary policy to interest rates again, soothing the markets with the implicit promise that a deposit rate hike is not to be expected before the end of 2018.

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