

Snap | 29 September 2017

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.

Author

Peter Vanden Houte

Chief Economist, Belgium, Luxembourg, Eurozone

peter.vandenhoute@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central

Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.