

Flash Note

Euro area: HICP inflation

Drop in euro area inflation amplified by statistical distortions

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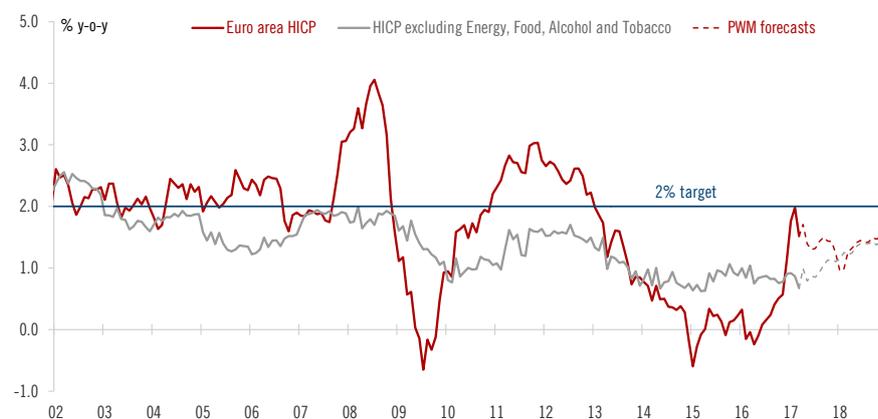
Euro area headline inflation declined by a larger margin than expected, to 1.5% in March (from 2.0% in February), while core HICP inflation dropped to a two-year low of 0.67% y-o-y (from 0.86% in February).

The main explanation for the disappointing core inflation figure is related to statistical effects, in our view, including the timing of the Easter break in Germany. We forecast headline inflation to rebound to 1.7% in April, with core inflation up to 1.0%.

Looking ahead, the outlook for price stability remains uncertain despite the stronger economic recovery. This should help ECB doves in the short term, although we continue to expect a change in communication at the June meeting, including a more neutral balance of risks and an adjustment in forward guidance on the deposit rate.

Euro area inflation declined for the first time in almost a year, by a larger margin than expected by the consensus. **Headline HICP eased to 1.5% in March**, from 2.0% in February, **while core HICP inflation** (excluding energy, food, alcohol and tobacco) **dropped to a two-year low of 0.67% y-o-y**, from 0.86% in February. The harmonised inflation rate dropped by 70bp in Germany (to 1.5%), by 90bp in Spain (to 2.1%) and by 30bp in Italy (to 1.3%). It remained stable in France (at 1.4%) as a sales discount effect was reversed.

Chart 1: euro area HICP inflation (headline and core)



Source: Pictet WM – AA&MR, Eurostat

Lower oil prices along with unfavourable base effects have pushed energy inflation lower, to 7.3% y-o-y in March following a February peak of 9.3%. Unprocessed food inflation eased as well, from 5.3% to 3.0% y-o-y in March. However, the ECB's main focus will continue to be on core prices.

In our view, the lower core inflation print was largely the result of statistical effects, including **the timing of the Easter break in Germany** (in April this year instead of March last year) which should be reversed next month as services prices rebound (transportation, restaurants, package holiday). It is worth noting that pure seasonal factors accounting for the timing of Easter holidays were consistent with core inflation down to 0.7%. Downside surprises were probably limited in other components. Non-energy industrial goods inflation rose slightly, to 0.2% y-o-y in March.

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Arguably, the March inflation print should help the ECB doves in the short term, if anything because **the staff projection for 2017, at 1.1% on average, will be even more difficult to achieve.** More generally, the ECB's [four inflation criteria](#) for QE tapering are still far from being met, with little progress since Draghi first described them in January. But, the ECB is unlikely to overreact to just one data point but instead should continue to look through the volatility in inflation numbers.

Chart 2: euro area core HICP inflation and ECB staff projections

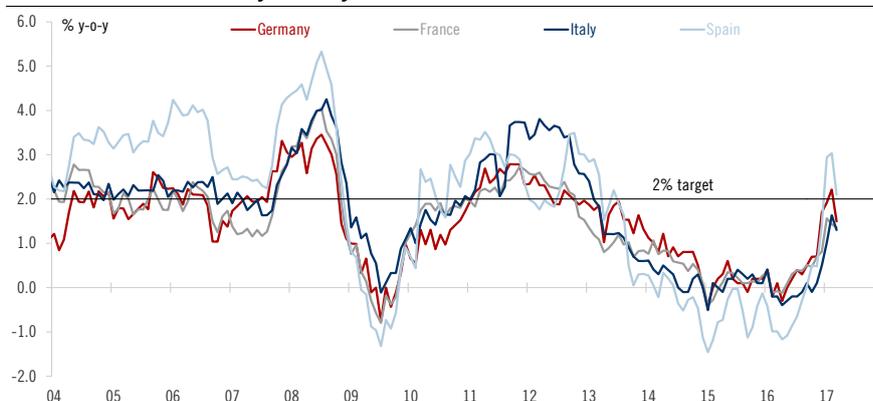


Source: Pictet WM – AA&MR, ECB, Eurostat

Looking ahead, we expect euro area headline inflation to rebound to about 1.7% in April with core inflation back to 1.0%, i.e. at the higher end of the range in which it has been fluctuating over the past four years. **The last inflation print the ECB will get before its June policy meeting will be released on 31 May, and it is likely to decline again to 1.5% or below, depending on future developments in FX and oil prices.**

In short, **we continue to expect a change in ECB's communication at the June meeting, including a more neutral balance of risks and a change in forward guidance on the deposit rate, but the subdued outlook for core prices and wages is likely to prevent a more hawkish shift at this stage, let alone a tapering announcement** (see "[ECB: escape the \(NIRP\) room](#)" for details about our ECB call).

Chart 3: HICP inflation by country



Source: Pictet WM – AA&MR, Eurostat

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