

# Flash Note

## Euro area: inflation

### Core inflation still “some distance” from ECB’s criteria

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Euro area core inflation rebounded to 1.0% in January, from 0.9% in the previous month, in line with expectations. There is no escaping the fact that the ECB remains “some distance” from meeting its inflation criteria, as Peter Praet said this week.

Our inflation forecasts are consistent with a delayed normalisation in the ECB’s stance as core inflation looks unlikely to rebound on a sustained basis before the second half of this year. We expect services inflation to edge gradually higher, although a stronger EUR would cap any further rebound in core goods inflation.

The ECB’s three inflation criteria are likely to be fully met by September, when we expect a gradual tapering of asset purchases to start. The timing and pace of rate hikes will be driven by future developments in core inflation, which we expect to rise more rapidly going into 2019.

Peter Praet, the ECB’s Chief Economist, said this week that the central bank was still “some distance” from meeting the three criteria that would be consistent with a “sustained adjustment in the path of inflation”. Adjusting ECB’s communicating will prove to be a difficult exercise, but ultimately monetary policy will be driven by future developments in core inflation.

For all our bullishness on growth, **our updated inflation profile looks consistent with a delayed normalisation in the ECB’s stance**. Today’s flash estimate confirmed that euro area core HICP inflation rebounded, to 1.01% in January from 0.94% in December. But, we see **risks of further disappointment in the near-term, with core inflation hovering around 1.0-1.2% until summer**, before a sustained adjustment really starts.

More specifically, we expect two out of the ECB’s three inflation criteria to be met by June 2018 at the latest. The first criterion (“convergence”) is the easiest one to achieve, with the ECB staff projection for 2020 HICP inflation likely to be revised higher, to 1.8-1.9% in the next six months, assuming no further EUR appreciation. The third criterion (“resilience”, or “self-sustained”) is also derived from ECB staff projections using standard [elasticities](#) for the estimated impact of QE on growth and inflation spread over two years.

The second criterion (“confidence”, or “durable”) is the most difficult to achieve, in our view. It can be quantified in many ways, and the ECB will likely focus on a wide range of measures of underlying price pressure, including on the more encouraging ‘super core’ indices. Still, using a simple 6-month moving average of core inflation, currently at 1.01%, and a fairly loose threshold around 1.2%, we expect this criterion to be met in Q3 2018.

**Table: the ECB’s three inflation criteria**

Inflation criteria	Gauge	Latest	Taper threshold	Estimated date when criteria will be met
<b>Convergence</b>	Long-term ECB staff projection (headline HICP)	1.70%	[1.8-1.9%]	June 2018
<b>Confidence</b>	6-month average of core HICP inflation	1.01%	[1.1-1.3%]	Q3 2018
<b>Resilience</b>	Long-term staff projection excluding QE effect (*)	1.60%	[1.7-1.8%]	June 2018

*Source: Pictet WM – AA&MR, ECB (\* using QE elasticities from ECB models)*

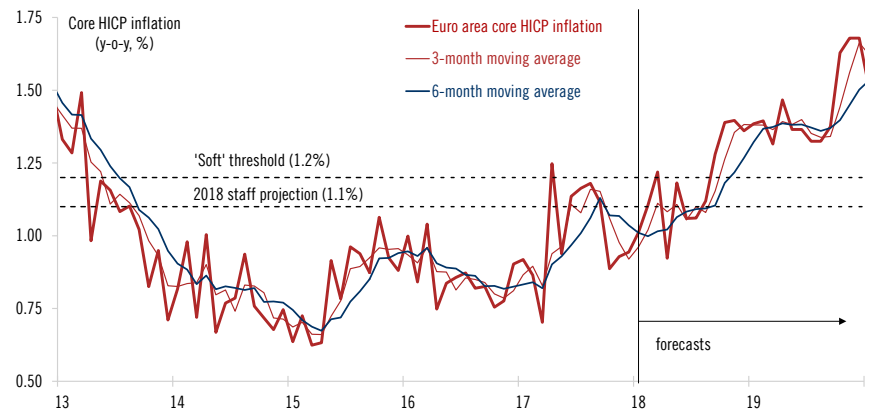
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ECB watchers will have noticed that the ECB's four inflation criteria from 2017 have turned into three this year. This is because the fourth one ("broad-based") was met in December, with 2020 HICP inflation expected to rise over 1.5% in over 95% of member states, based on their share in euro area GDP.

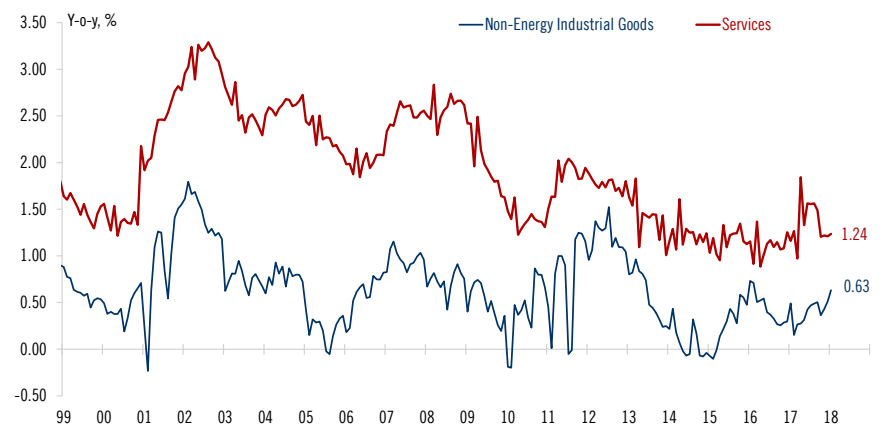
**Chart 1: euro area core HICP inflation and the ECB's "confidence" criterion**



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

Looking at today's euro area flash HICP release, **the bad news was that services inflation once again rebounded by a smaller margin than expected**, to 1.24% y-o-y in January. We struggled to fully understand the drivers of such protracted weakness in services prices, although we have highlighted a number of exogenous factors in the past, including package holiday, air fares, education, healthcare. Had services inflation not surprised to the upside in France in January, the disappointment would have been even larger. Still, our forecasts remain consistent with a gradual increase in services inflation over the course of this year and next.

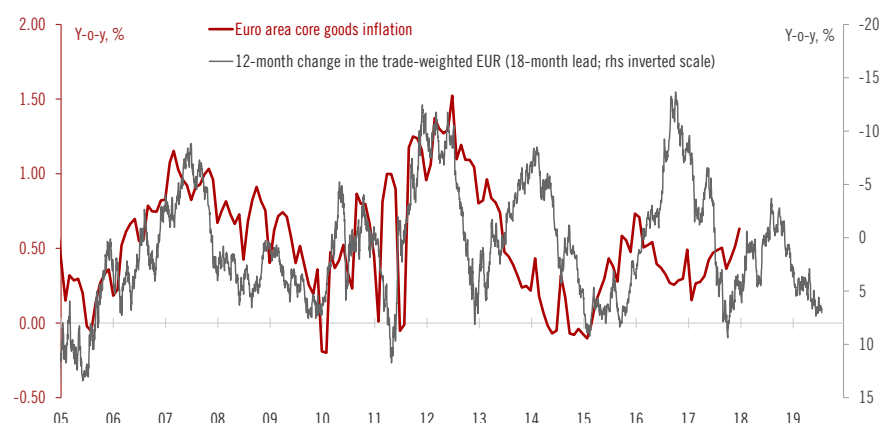
**Chart 2: main components of euro area core HICP inflation**



Source: Pictet WM – AA&MR, Eurostat

**The good news came with a further rise in core manufacturing goods inflation**, up to 0.6% y-o-y in January despite EUR appreciation and early discount sales weighing on prices in France. There is little evidence at this stage that last year's appreciation in the trade-weighted currency has had an impact on euro area goods inflation. **The ECB believes that the FX pass-through has diminished, but the drag could always materialise with a lag.**

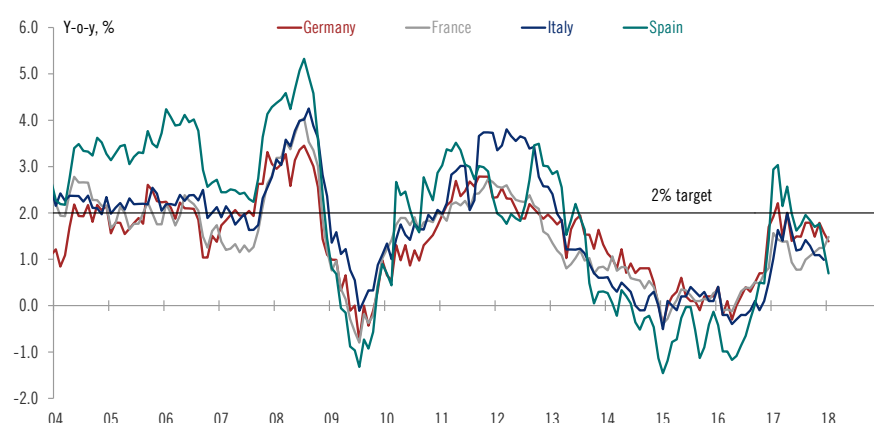
**Chart 3: core goods inflation and the trade-weighted EUR**



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

In terms of countries, HICP inflation was weaker-than-expected in Germany (down by 20bp, to 1.6% y-o-y in January) and in Spain (down by 50bp, to 0.7% y-o-y), but above consensus in France (up by 30bp, to 1.5% y-o-y). Preliminary HICP figures for Italy will be released on Friday.

**Chart 4: core goods inflation and the trade-weighted EUR**



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

In the end, our ECB scenario remains unchanged, including in terms of communication, tapering and rate hikes, but the balance of risks is moving – in our view, in opposite direction for 2018 compared with 2019. The combination of above-potential growth and rising inflation expectations from surveys (PMI price pressures; Survey of Professional Forecasters) should strengthen the ECB's confidence and lead to hawkish changes in its communication over the course of the year (see "Guide me if you can!"). We expect a transition in forward guidance from QE to policy rates in March, followed by a tapering announcement in June or in July.

But, ultimately, it is actual core inflation that will drive policy decisions. We expect a more sustained adjustment in core prices to start in H2 2018, and to continue in 2019. **In short, we see risks tilted towards a more dovish ECB in the next six months, but once the normalisation process starts, we expect the ECB to tighten faster than markets expect, at least initially.**

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