

Euro Area

Will the ECB do a BoJ? Unlikely at the Nov meeting, in our view

- Economic Forecast
- Fiscal Policy
- Monetary Policy

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- **Language change possible** — Despite slightly better confidence readings (ESI & PMIs), signs of easier lending standards and the fall in the price of oil during October, we see a significant chance of the Governing Council (GC) statement incorporating some language change to reflect the need to deliver more monetary policy stimulus soon. Importantly, near-term inflation looks to be much lower than the ECB's implicit 0.7% Q4 forecast in September and the pronounced weakness in inflation expectations likely represents a serious challenge to the ECB's credibility. We doubt that referring to possible corporate bond purchases will be enough in terms of signaling or in terms of effectiveness from a balance sheet targeting standpoint.
- **HICP rebounds to 0.4% YY, matching expectations** — The Euro area flash HICP estimate rebounded to 0.42% YY in October after 0.31% YY in September. The largest contributors were unprocessed food (0.06pp), and energy & services (0.05pp each). Looking ahead to the rest of the quarter, we forecast that HICP inflation will stay around 0.4% YY, forecasting 0.37% YY in December. Core inflation slowed marginally, with the narrowest measure falling to a five-month low of 0.7% YY in October from 0.8%, largely because of rounding (0.746% in Oct vs. 0.754% in Sep). We believe that the ECB will be pleased with the upward trajectory in the headline rate, and will continue to argue that its accommodative monetary policy stance will help generate higher rates of inflation over the medium-term.
- **Persistent downward drift in inflation expectations** — We believe that the biggest issue that the GC will have to address in November and beyond is the challenge to its ability to deliver medium term price stability. Inflation expectations have weakened further since the Oct 2 meeting: the 5Y5Y breakeven rate is down 8bp to 1.84% and the market prices 1Y inflation at just 1.49% in four years' time.
- **Focus on balance sheet concerns** — we expect that most of the journalists' questions to Mr. Draghi will relate to the disappointing dynamics of balance sheet expansion. Since Oct 3, the Eurosystem's balance sheet has shrunk by €21bn according to the weekly ECB financial statement. Even if covered bond purchases were to be maintained at the current pace of €2.8bn per week, and supplemented by ABS purchases from November, even an ambitious €4.5bn per week would not be sufficient to offset the average weekly repayment of expiring 3-year LTROs of around €5.3bn in the last four weeks. Corporate bonds will likely be discussed as a further instrument in the ECB's private sector asset purchase toolbox, but we doubt that this amounts to an effective solution, and likely not before 2015 at the earliest.
- **What happens next?** — Persistent low-inflation and fragile economic activity are exacerbating the risks of further dis-anchoring of inflation expectations. We expect that the ECB will recognise the threat to its mandate and will decide to widen the list of purchasable assets to include government bonds in late 2014 or early 2015.

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Appendix A-1

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