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ECONOMIC WATCH

Synthetic inflation indicator in the Eurozone, closing the gap in a sustained manner

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Since the outbreak of the global financial crisis and in response to the subsequent European debt crisis, **the European Central Bank (ECB) has adopted various measures to stabilize the economy that aim at achieving its ultimate goal: price stability.** In particular, since mid-2014, low growth, but even more so, the sharp drop in inflation expectations in the eurozone has pushed the ECB to adopt several unconventional measures. Firstly, it introduced negative interest rates. Secondly, it provided banks with long-term financing at very low interest rates. And thirdly, it decided to launch a programme to buy public sector securities which joined the purchase programme of private sector securities (ABS (asset-backed securities) and covered and corporate bonds), better known as quantitative easing (QE).

As the ECB already emphasized, **the risks of deflation have largely disappeared**. In fact, together with the unconventional measures taken by the ECB, the combination of several events on multiple fronts (globally and in the eurozone) are contributing, in a very gradual but progressive way, to the pushing up of inflation in the eurozone, as well as of market expectations towards ECB´s inflation target, although they are still far from being reached.

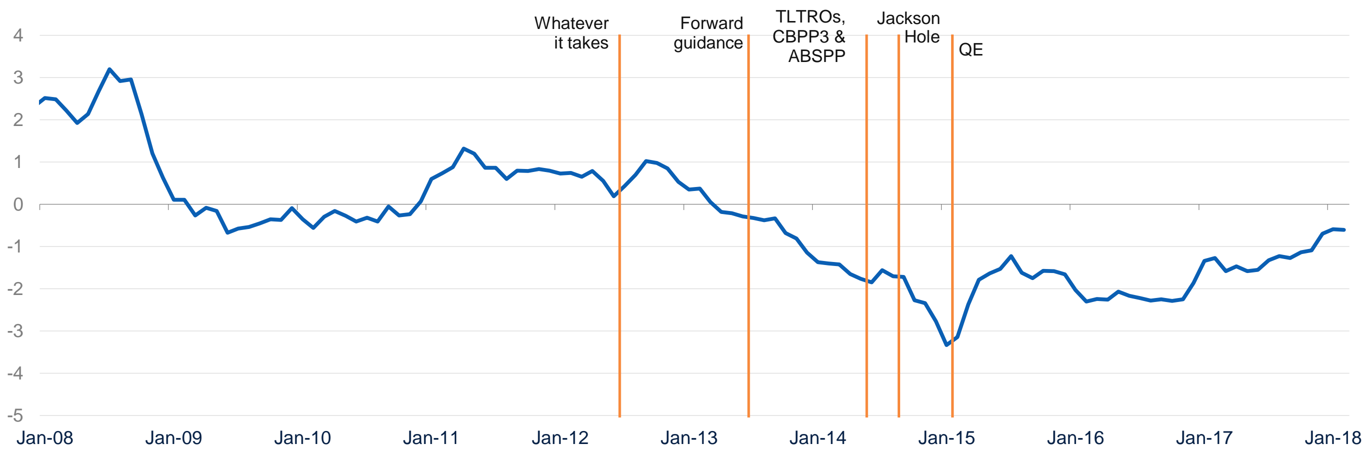
Ahead of the eventual data-dependent monetary policy normalization process in the eurozone, the BBVA Research synthetic inflation indicator would allow assess to see how a broad set of measures are evolving and **how inflation indicators are moving back to levels consistent with the ECB mandate** and, consequently, to anticipate any future steps the central bank might take.

Measures taken by **the ECB and, in particular the implementation of QE, have achieved their objective of halting the deterioration of inflation expectations** despite the protracted period of very low inflation, which is reflected by all the components of the synthetic inflation indicator, which have begun to converge to their historical mean. This is especially true of the long-term indicator, and less so of the more contemporary indicators (Graph 1). In particular, long-term inflation expectations came up from the bottom in the summer of 2015 thanks to the upward revision of the long-term inflation forecast (5 years ahead), derived from the Survey of Professional Forecasters (SPF) and the rebound in market expectations (5Y5Y inflation swap), rapidly reverting the pessimism about inflation in financial markets. Nonetheless, this improvement was abruptly erased due to episodes of uncertainty in China, which dampened inflation expectations (and dragged down forecasts) significantly in a context where oil prices declined to around 30 USD per barrel. During this episode, while the overall indicator did not return to its lowest level in early 2015, those components related with long-term expectations were very close to their historically lowest level.

In 2017, in a context of a visible cyclical improvement in the eurozone, thanks among other reasons to the very accommodative monetary conditions, tailwinds for inflation expectations began to blow from the other side of the Atlantic. Market expectations of reflationary policies in the US economy and their global spillover after the presidential election was one of the most discussed topics during the first part of 2017. The upward trend in oil prices also supported this optiminst regarding inflation outlook. This led to an upward revision of growth and inflation forecasts and, consequently, to the improvement of medium and short-term indicators. While US reflactionary expectations progressively faded, it was offset by the cyclical progress in the eurozone also supported by the synchronized global growth), thus favoring the rebound of short and medium-term indicators, due to both current data and the upward forecast revision in the short-term as well as SPF's 2Y inflation forecast.

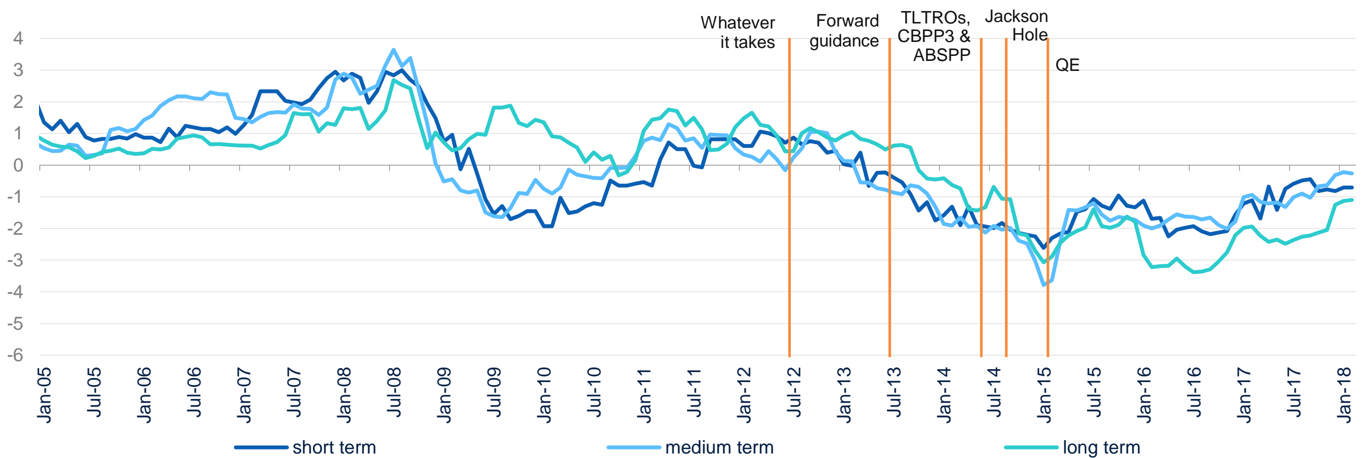
More recently, the indicator has not only resumed its upward trend, but it has also somewhat accelerated. There are several factors behind such movements: (i) the **cyclical economic momentum in the eurozone** has improved even further (medium-term indicator improved as ECB and SPF upgrade their inflation forecast, but only converging very gradually to the target by 2020), (ii) **the more accommodative stance of the ECB** since 2014 and (iii) **the global economic environment** has stepped up and broadened to more countries (the last two factors helped to improve to long-term inflation indicator, mostly due to market-based data). The short-term indicator is the only one that still remains behind, as headline inflation continues to be dragged down by the temporary base-effects of energy prices, that are expected to revert in coming months, and core inflation remains subdued.

Figure 1 Composite synthetic indicator to monitor inflation (Standard deviation from the mean)



Source: BBVA Reseach, Bloomberg, ECB

Figure 2 Synthetic indicators to monitor inflation (Standard deviation from the mean)



Source: BBVA Reseach, Bloomberg, ECB

What can be expected from the ECB going forward?

The recovery in the **Eurozone remains robust and on track but some inflation indicators remain subdued**, inflationary pressures are building slowly and heterogeneously across countries; hence, it is a **long way from getting back to the ECB's 2% targe**t. In this context, the **ECB is still reiterating** that at this point, it should **still be patient and persistent with stimulus**. Regarding this, in a recent speech, Peter Praet, the ECB's Chief Economist, said 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" which is *sine qua non* condition for the withdrawal of stimulus by the ECB. Moreover, ECB President, Mario Draghi, recently stated that their confidence that inflation will converge towards their objective has strengthened, but they cannot "yet declare victory."

In the coming months, **the ECB will remain cautious and highly dependent on inflation data, but once it is more confident on achieving the sustained adjustment on the path of inflation, it will start to adjust its forward guidance**. According to the minutes of December's meeting and statements from ECB members, there is a broad consensus among the Governing Council that communication will need to evolve. We expect that such communication should be gradual, but without a change in sequencing, i.e. reducing the focus on bond purchases and then raising the emphasis on interest rates.

Against this background, the **ECB faces an important challenge in 2018: to adjust the recalibration of the asset purchase programme** (QE) (defining the end date) **and begin to communicate the next exit phase from its accommodative monetary policy**, (when rate increases will take place), and doing all this without there being a tightening of financial conditions. For the time being, the Central Bank is in no hurry, but sooner or later it will need to be ready to adjust its policy. What is clear is that **this normalization will not occur immediately or simultaneously**. The case of the Federal Reserve in the US (the Fed) shows that the exit strategy from unconventional measures is complex and will take time.

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