ECB WATCH

COMMENTARY BY DAVID POWELL, BLOOMBERG ECONOMIST

Euro-Area Inflation Pick-Up Unlikely to Deflect ECB From Crisis Management

The acceleration in euro-area headline inflation in September is unlikely to stop the European Central Bank from cutting its key policy rate by the end of the year, though a reduction this week appears unlikely.

Underlying inflationary pressures remain muted, even after the consumer price index rose 3 percent year over year in September, according to the flash estimate, versus 2.5 percent in August.

The core reading was unchanged in August from July at 1.2 percent year over year after falling from 1.6 percent in June. The figure for September has not yet been released.

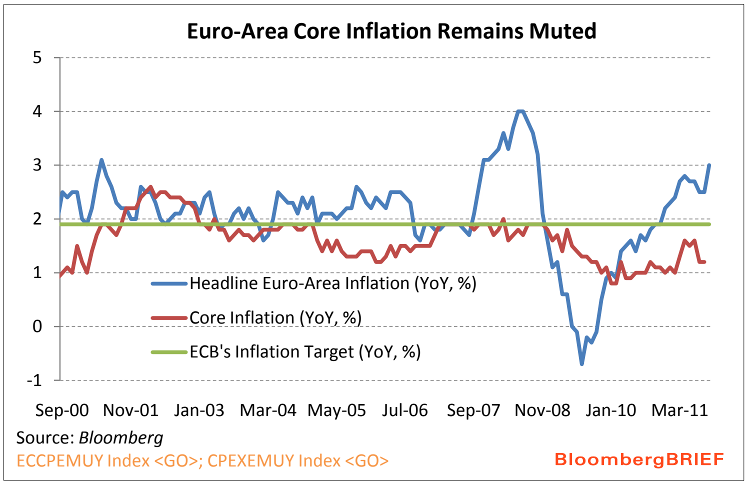
In addition, slack in the labor market should reduce inflationary pressures. The unemployment rate, which remained steady at 10 percent in August, is still above the Organization for Economic Cooperation and Development's estimate of the non-accelerating inflation rate of unemployment of 8.5 percent.

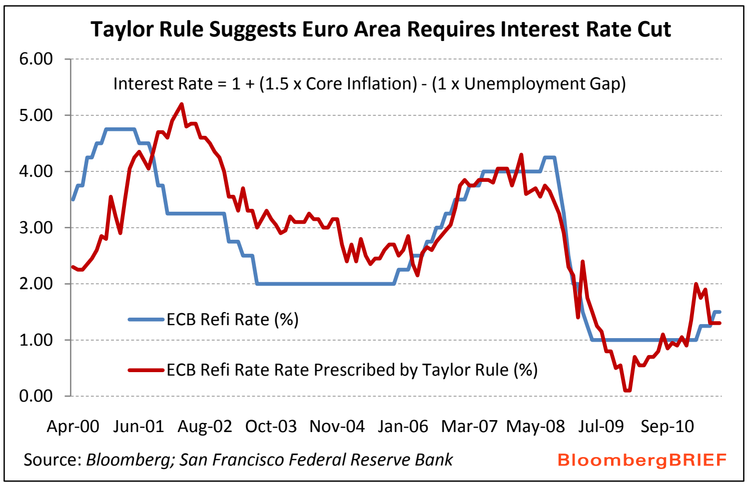
That combination suggests that the main policy rate for the euro area should be lowered to 1.25 percent under a Taylor Rule model.

The pick-up in headline inflation may not even be as pronounced as it first seems because of a change to the statistical treatment of seasonal items. Methodological changes were implemented in January that Eurostat estimates reduced the headline readings by 0.2 percentage point in July and August.

That effect may have been smaller or non-existent in September when fewer seasonal items such as fish, fruit and vegetables are used as the summer comes to an end.

Money supply data, released last Tuesday, suggests medium-to long-term inflationary pressures also remain muted. The three-month average of the annual growth rate of M3 money supply - the primary indicator that the ECB uses to judge threats to price stability under the second pillar of its monetary policy strategy - remained subdued at 2.3 in August versus 2.1 percent in July. That is well below the 4.5 percent level that the ECB has identified as consistent with price stability.





The Governing Council is most likely to debate restarting purchases of covered-bonds, which financial institutions use for long-term financing, and reintroducing 12-month loans to lower the financing costs of banks, according to an ECB official who spoke with Bloomberg News.

A debate on increasing the size of the central bank's Securities Market Programme appears to be off the agenda. The ECB's weekly financial statements suggest that the Governing Council has decided to cap its purchases at about 15 billion euros per week after an initial show of force in the week ended Aug. 12, when purchases totaled 22 billion euros.

That approach has failed to prevent the intensification of the sovereign debt crisis. The spread between the 10-year sovereign yields of Italy and Germany hit a new record high of 398 basis points on Sept. 22, before declining to 363 basis points last Friday. That compares with 268 basis points at the end of the week during which the ECB restarted the program.

The decisions of this week's meeting appear unlikely to halt that trend.

The attached article was a free sample from **Bloomberg BRIEF** Newsletters.