

The Eurozone is officially in deflation

The Eurozone as a whole finally slid into outright deflation in December, as the pass-through from falling oil prices drove prices lower. Consumer price inflation fell from 0.3% to -0.2% (slightly below consensus expectations of -0.1%), the lowest since May 2009, and following five months in which inflation had hovered below 0.5%.

However, underlying inflationary pressures were more stable, if very subdued. Core inflation, which strips out the impact of energy and food prices and is regarded as a better indicator of medium-term inflation trends, actually ticked up a little, from 0.7% to 0.8%.

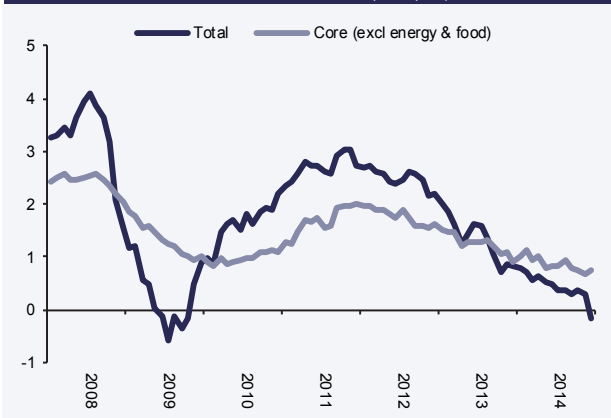
Nonetheless, this is still well below a rate consistent with the European Central Bank's (ECB's) inflation target of "close to, but below, 2%". Furthermore, more dovish members of the ECB's governing council will be concerned that headline deflation will further depress forward-looking inflation expectations and ultimately core inflation as well – thus leading to a more concerning deflationary spiral.

Against a backdrop of falling prices and weak growth, the Eurozone faces a number of challenging events in January. **The ECB may well respond to these developments by launching a quantitative easing (QE) programme at its next meeting on the 22nd January**, but there remains considerable uncertainty over its size and whether it will be legally possible to buy large quantities of sovereign debt (as has been done in the US, UK and Japan). A week prior, the European Court of Justice is due to issue an opinion on the legality of the ECB's Outright Market Transactions programme (by which the ECB effectively promises to make unlimited purchases of sovereign debt to prevent countries being forced out of the Eurozone), which could have implications for the ECB's ability to launch QE.

Greece's general election, following just three days later on the 25th January, will loom over the ECB decision. A victory by the opposition Syriza party, which seeks to arrest the pace of austerity in the country, could raise tensions with the Troika and even raise once again the prospect of Greek exit from the Eurozone.

With the ECB now battling deflation while constrained by legal and political barriers, and stubbornly high unemployment raising political tensions in the periphery, the Eurozone is likely to remain stagnant for some time to come, even if another major crisis is avoided.

EUROZONE CONSUMER PRICE INFLATION (%YR/YR)



UNEMPLOYMENT IN THE EUROZONE PERIPHERY (%)

