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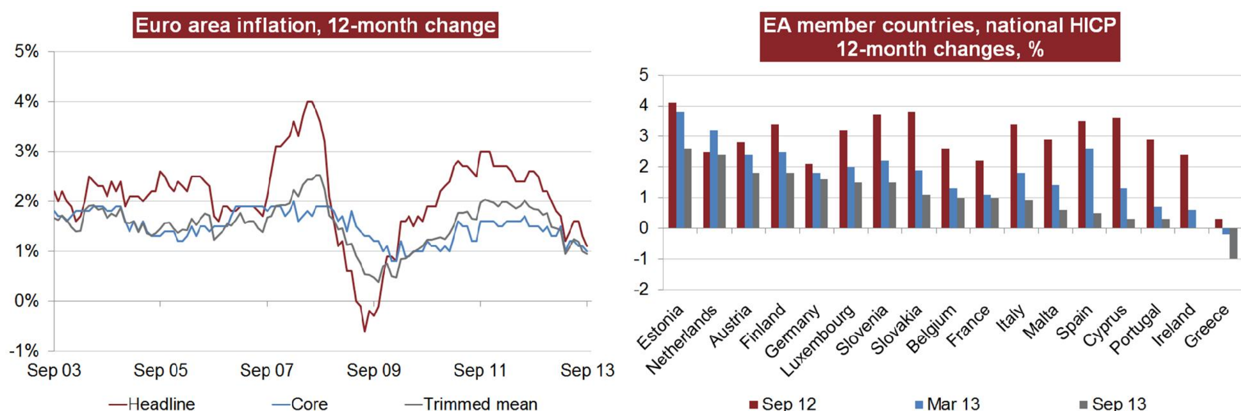
Is the EA headed for deflation?

- **EA headline inflation reached a 3½-year low in September**
- **Large and persistent negative output gaps imply continued disinflationary pressure**
- **Deflation over the next 12 months is at least a significant risk**

Last month, euro area consumer prices rose by 1.1%, the slowest rate in 3½ years; underlying inflation (excluding energy and food) was 1%, in this case only a five-month low. The trimmed mean rate, possibly a better guide to underlying trends than a core rate that strips out the same items every month, was also 1%, although in this case it was unchanged from August.[1] With the exception of the Netherlands, all EA member countries have lower inflation than a year ago as well as than six months ago; and Greece is in deflation since last March.

This would not be the EA's first brush with deflation. The level of consumer prices fell from May to November 2009, before accelerating to close to 3% in the autumn of 2011. However, the concern is that the EA could be headed for more sustained falls in the level of consumer prices. Is this likely? And, if it is, what is the ECB going to do about it?



That deflation, even more so prolonged deflation, is undesirable, is generally accepted. This is even more the case in an excess debt situation, like that of the euro area. However, since deflation, like inflation, is over any sustained period of time a monetary phenomenon, it is at least in theory easy not only to cure, but to avert by accelerating the growth of broad money.

The main argument supporting a deflationary outlook for the euro area is that the area-wide output gap remains negative and large. Moreover with output growth at least through most of 2014 likely to remain

[1] A trimmed mean inflation measure strips out the fastest and slowest increases every month, but is not tied to specific categories. The EA trimmed mean inflation measure was developed by Stein Brothers and is available on our website.

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below trend, the output gap will remain negative. Crucially, what matters for the change in the rate of inflation is the *level* of the output gap, not the *change*. As long as the output gap is negative, then all things being equal – which is economists' code for commodity prices and exchange rates – the rate of inflation will tend to fall; and *vice versa*. According to the IMF's latest *World Economic Outlook* (October 2013), the EA this year has a negative output gap of -2.8% of GDP. Although the IMF is forecasting that the output gap will narrow, it will not close over the next five years. By way of comparison, it 2009, the IMF estimated a 2.9% negative output gap. The numbers produced by the Oxford Economics (OE) model are different, but the trend is similar. OE estimates that the EA had a negative output gap of 3.1% of GDP in 2009; that this has widened to -4.2% of GDP in 2013; and that it won't close over the next five years.[2] Both the IMF and OE also estimate that output gaps in all EA member countries are negative. The continued spare capacity in the EA implies that disinflationary pressures will continue.

However, the EA output gap was negative throughout the period from 2009 until 2013. How come the rate of inflation did not remain negative over that period? The likely answer is twofold. First, commodity prices rose. This is also seen in the fact that the headline rate of inflation accelerated faster than the core rate, which strips out food and energy. Second, the euro weakened – if erratically – over the period. By contrast, the near-term outlook is more likely to be one of euro strength than euro weakness, putting further downward pressure on consumer prices.

A further factor that increases the risk of deflation is the ECB's perceived institutional bias. When the ECB originally defined its inflation aim, the Bank simply set a ceiling of close to but below 2%. After criticism that this was asymmetric, the ceiling was redefined as a target. Although there has been no official further clarification, I have been at one ECB conference where a then member of the Executive Council refined it by saying 'close to but below 2% - and 1.9% is too close'. There have also been unsubstantiated rumours that, internally, 1% is more of a target than 2%. Be that as it may, the ECB is widely believed at least not to be too unhappy about an inflation rate well below 2%. Moreover, the ECB is likely to be less concerned about deflation in some of the periphery countries, seeing this as a necessary component of the shift towards a lower cost base (the 'internal devaluation'), in spite of the increased debt burden it would involve.

Finally, bearing in mind the point made above about sustained inflation and deflation both being monetary phenomena, recent broad money trends are worrying. The previous deflationary episode came after a sharp slowdown in M3 growth, from 12.4% in the year to November 2007, to less than 4% by May 2009. Recent broad money data is also discouraging, with M3 growth slowing from 3.9% in October 2012 to 2.3% in August 2013. This is not as precipitate a fall; but broad money growth remains well below rates consistent with medium-term EA trend rate output growth (likely to be around 6% for M3 to achieve 1½% GDP growth).

As noted above, this should in practice be easy to deal with. The ECB ultimately controls the quantity of money. An asset purchases program similar to that of the Bank of England's could quickly boost broad

[2] Disclaimer: I am a Special Advisor to Oxford Economics.

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money growth. However, this runs up against the institutional constraints of the euro area. In essence, what assets should the ECB buy? The obvious answer would be government bonds; but, in the monetary union, this immediately runs up against the question, which government's? 'Safe' or triple- rated only? Or from all members, weighted by GDP or by outstanding debt or by some other factor (eg, population size, size of national contribution to EA M3?) Since these purchases would be on the secondary market, they need not come into conflict with the ban on financing governments (a ban which has in any case lost much of its credibility). But it would still run up against likely opposition form the creditor countries if it involved buying debtor country bonds. (In truth, there is no need to buy bonds at all; as long as the central bank buys *something* from the non-bank private sector, that sector's money balances rise and can be spent *ad infinitem*. But getting the ECB to buy other assets than government bonds is probably a forlorn hope.) Moreover, the ECB has shown a marked resistance to engaging in any kind of quantitative easing, for reasons of principle as well as because of these technical difficulties.

It is probably too early to sound the deflation alarm. However, turning around inflationary or deflationary trends takes time. Looking at the four large EA members, only Germany now has prices rising in excess of 1% (1.6% in the year to September) and here to the rate of inflation has slowed, from 2.9% in September 2011 and 2.2% in September 2012. Another period of deflation sometime over the next year cannot be ruled out. The ECB should do everything in its power to avert it. But it almost certainly won't.

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