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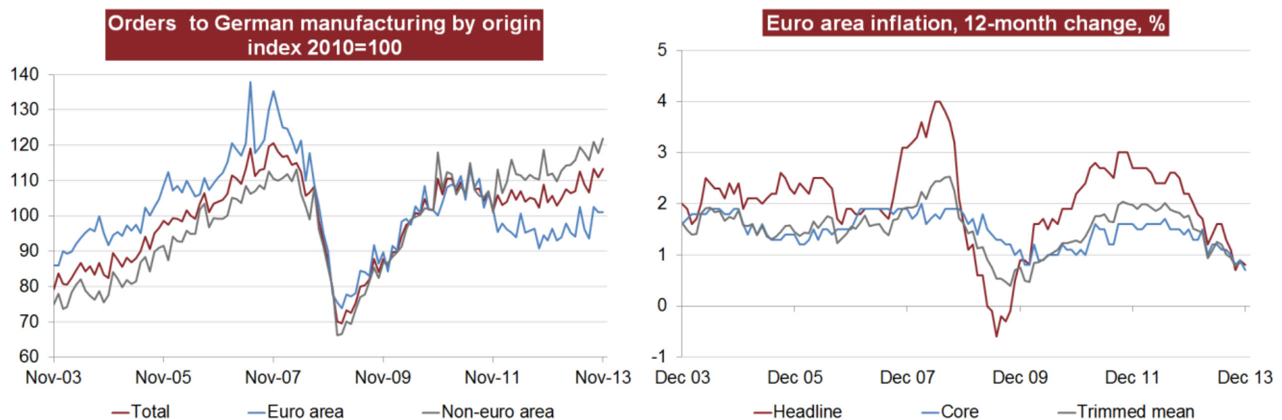
Deflation, political risk, cloud EA outlook

- **EA outlook remains mixed – but risks are now in the 'soft core'**
- **Deflation still substantial risk**
- **2014 should be year of weak euro**

Data published this week confirm the mixed outlook for the euro area. While all the numbers so far refer to the end of 2013, they give a good handle for developments in early 2014. Some of the data – eg, orders to German manufacturing, which show the difference between buoyant orders from non-euro area countries and weaker orders from the euro area – continue to stress the divergence between the different euro area countries. Others, such as the December flash inflation data show that the danger of deflation remains very real.



Euro area consumer prices rose by 0.8% in the year to December. Underlying inflation (excluding food and energy) fell to the lowest rate on record (ie, since the early 1990s) at 0.7%.

The ECB has tended to dismiss fears of deflation. That is not surprising; if the ECB acknowledged the risk of deflation, it would presumably have to act to counter it. But, following the November repo rate cut, the ECB's armoury is getting dangerously depleted. The repo rate could be cut again – but at 25bps, there isn't really much scope. Negative interest rates could be introduced on banks' reserves with the ECB; and the euro could be weakened, either by talking it down, or – much less likely – by intervention.

However, a deliberate policy of weakening the currency will encounter opposition both within and without the ECB. Moreover, the ECB would be a latecomer to that particular party. Central bank governors in New Zealand, Australia and Canada, to name but three, have recently made it clear that they want their currencies to weaken. Absent intervention, this is usually a game with a first-mover advantage.

Markets could do the work of the ECB though. Recent US data have generally been more buoyant than expected. Once markets gradually realise that the return potentials in the US are much better than

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previously thought, 2014 could be the year when the euro finally weakens, with the ECB only have to apply benign neglect.

By contrast, attempting to deflect deflation by boosting money supply– ie, engaging in quantitative easing in some form – still seems a step too far for the ECB. Even so, it is clear that this topic – and the entire deflation issue – was discussed at the January meeting of the ECB's Governing Council, albeit with no conclusion reached. The ECB simply stated that it was ready to take 'decisive action'. What action this could be was not specified. This implies that, unless the euro weakens significantly, the risk of deflation will prevail in the euro area probably for most of 2014.

Apart from deflation, the two main known potential upheavals threatening the euro area in early 2014 are political. The first is that the German Constitutional Court will either pronounce against the legality of the ECB's Outright Monetary Transactions (OMT) by stating that they are incompatible with the German Constitution, or accept them but make activation of the OMT essentially impossible by imposing it authorisation by the German parliament. The Constitutional Court's ruling is now expected in February. A negative ruling could be a significant blow to the euro area.

It could be that euro area has moved sufficiently away from the risk of breakup and acute crisis so that the pledge of the OMT is no longer necessary. But that may be too optimistic. The OMT has been the most successful crisis-solving measure of the past 3 years. If it is killed by the German constitutional court financial market volatility could return. It is not clear what other tool or policy could then be used to prevent bond yields from spiralling up. The initial response to bond yields rising was a succession of austerity budgets. But further pledges of fiscal austerity would likely be ineffective. And, with evidence that budget cuts do little to redress public finances when countries are in recession, governments and the European Commission have moved on from 'austerity at all costs'. In this scenario, the ECB will need to find some new measure that can be as credible as the OMT. If outright quantitative easing remains off the table, that will not be easy.

Political risk could also flare up in some countries. This is particularly true for Greece. It is looking increasingly clear that the Greek government will need further financial assistance this year. The changes in ownership of Greek government debt since 2010 mean that this will primarily be at the expense of official institutions in other euro area countries – ie, ultimately taxpayers. Although a restructuring of the debt doesn't necessarily mean financial losses for anyone (yet), the debate around it is likely to be inflamed. The Greek Prime Minister, Mr Samaras, would prefer any negotiations to be concluded before the May local elections. However, all of Europe faces elections to the European Parliament in May, with governments in the creditor countries preferring a deal with all its publicity after the elections.

Negotiations of a further bailout will also need to be held with Portugal. Most likely, the country will apply for a precautionary credit line, which would come with lighter conditions than a full-scale bailout. Tensions over these negotiations could destabilise investors' confidence in the viability of the euro area in a similar way as a negative ruling on the OMT.

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In the nature of Eurozone developments, the political problems will probably be overcome, most likely through some obfuscation. However, the economic outlook remains at best mixed, with Germany – and some of the periphery – recovering; while some of the other core countries (France, Belgium and others) likely to underperform in early 2014.

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