ECB, QE and the Deflation Debate in the Euro Zone

Deflation talks were very much in vogue across the G10 world throughout the second half of last year, yet the reflating policies endorsed by some of the central banks (the Fed and the BoE in particular), the green shoots perceived in some economies and an improving market sentiment have rekindled somewhat premature inflation talk in some countries of late - in particular in the US (see our recent Special Fx on '*US Inflation: Where and When?*'). When it comes to the euro zone though, the March PPI figures (down to a 22 year low of -3.1% y/y) have recently rekindled deflation talks and so has the limited reflating nature of the ECB's policy approach so far.

In turn, this captures the fact that the US is a step ahead in the cycle, a central element in our bullish medium-term dollar outlook: we have moved from deflation talks to inflation talks in the US whereas euro zone deflation debates may persist for a while longer. We do not buy into the euro zone deflation story but we acknowledge that the more prolonged economic slump will keep downward pressure on prices for a longer time than in the US. Moreover, the less aggressive euro monetary (and fiscal) policy responses also mean that inflation risks are a distant prospect, with the deflation debate still more relevant for the euro zone.

There is not a universal definition of deflation but most would agree that the combination of a general decline in prices, a contracting economy and negative monetary growth would capture deflation symptoms.

Euro zone prices are falling …

The sharp decline in the March producer prices (to a 22 year low of -3.1%, from -1.7%) represented the third consecutive monthly fall in prices and will not be the last. While falling energy prices have had a lot to do with this negative trend (-7.3% y/y in March), those who believe in the euro zone deflation story would highlight other points. Reflecting a depressed domestic demand, consumer goods prices are now negative in the euro zone (latest reading at -1.2% y/y), with non-food consumer goods PPI (which correlates well with the euro zone core CPI) close to the 0% mark. The euro zone CPI y/y rate is positive (see April reading at 0.6% y/y), but negative yearly base effects from energy prices and downward forces from the domestic sector mean that the euro zone will most likely record negative y/y inflation rates throughout the summer.

Meanwhile, the sticky nature of wage inflation (especially in the euro zone) implies that the sharp deterioration observed in the euro zone labour market over the past few months (see March unemployment rate climbing to a high 8.9% from 7.2% a year ago) has not filtered through into wage growth yet. Future increases in unemployment (the euro zone unemployment rate is expected to rise to as high 11.0%-11.5% by 2010) will undoubtedly translate into decelerating unit labour costs at a later stage (euro zone unit labour costs are expected to ease to around 1% y/y by 2010 from 3.3% in 2008), adding to the disinflationary/deflationary forces already identified at the consumer and producer levels.

… but Inflation expectations are rising

When it comes to assessing current price conditions and the outlook for prices, inflation expectations is as important an indicator (ECB President Trichet only recently stressed that the five-year/five-year forward breakeven inflation rate is '*very, very important*') as the CPI, PPI or wage growth and the former is pointing upward in the euro zone. Indeed, the euro five-year forward has been rising of late, climbing to 2.65% on May 7th (vs close to 2.3% in January and compared to 2.4% in the US). **This is a compelling element in refuting the deflation theory in the euro zone**. Of course, a prolonged period of deflation at the consumer level would eventually risk filtering through onto inflation expectations negatively, but we expect negative CPI readings for just a few months through the summer, not long enough to bring inflation expectations into negative territory.

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… Money Supply is decelerating sharply while the economy is contracting

There has been a marked deceleration in the euro zone M3 money supply over the past year (see March M3 growth decelerating to a March 2004 low of 5.1% y/y from 5.8% in February). The broad M3 data may have been distorted by the recent sharp steepening in the euro zone yield curve (as the shorter-end maturities assets included in M3 are looking less attractive vs to the longer maturities, not included in M3). However, it should also be noted that notwithstanding the ECB's pledge to provide unlimited liquidity to the region, total ECB lending to the banking sector has fallen from around Eur900bn in early 2009 to Eur700bn in April 2009.

As for the real economy, it is still expected to contract by as much as 4.3% (IMF forecast) this year and by a further 0.4% in 2010. Recent survey evidence has proven more encouraging (indicating that the worse is most likely behind us) but this is not a recovery story yet, it just appears that the pace of decline in the economy is easing. It should also be noted that the core data remain well in negative territory (see latest euro industrial production data) and this is unlikely to change any time soon. There is soaring spare capacity in the euro zone, with an **output gap** (actual GDP growth rate – potential growth rate) estimated by the IMF at 4.3% of GDP this year and 5.4% of GDP next year, an important element for those buying in the deflation story.

… **and the ECB's policies are not reflationary**

At the May 7th meeting, the European Central Bank has finally announced its intention to implement non-conventional monetary policy measures and while this was a first step in the right direction, it was also symbolic in size and will have limited reflationary effect on the economy, if any. The announced Eur60bn purchase of covered bonds represents only 0.40% of the nominal value of the European covered bond market or just 0.6% of nominal GDP. Moreover, that could still change, but so far, the ECB's language suggested that the central bank's main intention was to improve market liquidity conditions further. Here, it seemed that the Eur60bn covered bonds purchase announcement was not about boosting monetary growth or the economy. By stressing that the monetary authorities have not started a policy of '*quantitative easing'*, Mr Trichet's remarks implied that the central bank may decide to sterilize its bonds purchases, which would imply no reflationary effects on the economy.

… What does it all mean for the euro?

The mere fact that euro zone inflation expectations are on a rising path is central in refuting the deflation story in the euro zone. However, the prospect for negative headline CPI later this summer, at a time when the economy is still contracting sharply, when output gaps are large and policy responses are non-reflationary mean that deflation concerns will persist for a while longer in the euro zone. This, at a time when deflation talks are yesterday's story in the US, where it is inflation talks have recently resurfaced. All this captures that whether it is the economy or policy responses, the US is a step ahead of the euro zone in this crisis, a central element in justifying a more bearish euro outlook for H2 and going into 2010.

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