deflated expectations: euro area price stability & the ECB

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Europe's economic recovery is modest and uneven, and markets have been watching to see whether the European Central Bank (ECB) will take additional steps to combat deflation risk in the euro zone. When the ECB held monetary policy steady at its March meeting, central bank president Mario Draghi downplayed deflation concerns and asserted that the recovery was proceeding as expected. Though ECB rhetoric on the threat of deflation has turned tougher recently, we believe there is more deterioration in the inflation outlook than the ECB is willing to identify. Below, we outline factors the ECB may be underestimating, what could prompt easier monetary policy, and why now may be the time for the ECB to act.

KEY TAKEAWAYS

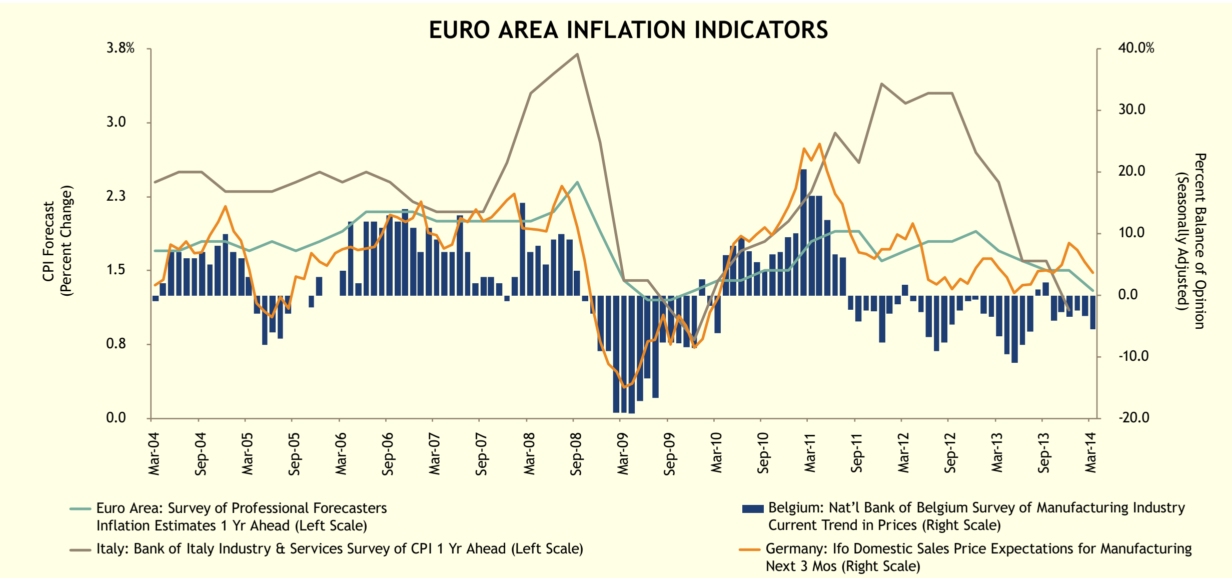
- Euro area deflation fears are not solely a peripheral story—core countries exhibit entrenched disinflation as well.
- The ECB risks losing a window for aggressive policy action as credit conditions near a turn. The euro's strength could be the new key to action.
- Look for the ECB to ease in the coming months, but outright asset purchases may have to wait until late 2014.

POCKETS OF DEFLATION RISK

Draghi has repeatedly said that the ECB expects inflation to remain low for an extended period, but he has rejected deflation risks. In February, he noted several points to suggest the euro area is experiencing "…more of a relative price adjustment than…a deflation phenomenon,"[i] including:

1. Firmly anchored inflation expectations; **2.** Low inflation is being driven primarily by food and energy prices, as well as tentative demand that should recover; **3.** The four program countries, Portugal, Ireland, Spain and Greece, are key drivers of disinflation. In our view, there is more to the story for each of these points.

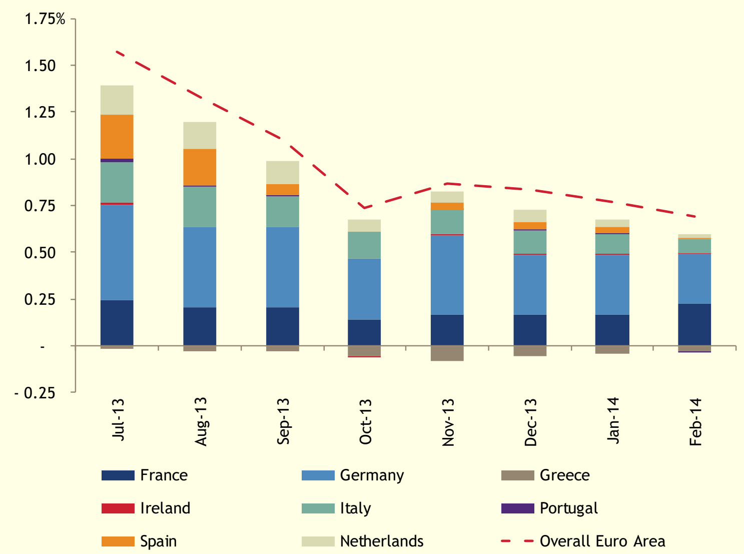
Inflation Expectations: The ECB argues that inflation expectations are in line with its goal of inflation below, but close to, 2%. However, some evidence suggests inflation expectations are not so firmly anchored. The ECB Survey of Professional Forecasters shows one- and two-year out inflation forecasts being repeatedly cut, now to 1.3% and 1.5%, respectively. And, as illustrated in the chart below, business surveys show deteriorating price expectations across core and peripheral countries.



Sources: Haver Analytics chart as of 3/27/2014; data from ECB, Bank of Italy, National Bank of Belgium, and Ifo Institute.

Low Inflation Driven by Food, Energy & Weak Demand; Demand Should Recover: Food and energy have definitely been disinflationary forces over the last year. We are less confident that recovering domestic demand will be strong enough to stave off deflation risks. Although we see a trough in domestic demand in the periphery, we are troubled by performance in the core. Domestic demand sharply underwhelmed in Germany in the fourth quarter of 2013, and activity is soft in other core countries like Belgium, Finland and the Netherlands. France, where consumers are key to domestic demand and headline growth, is an important country to watch.

CONTRIBUTION TO EURO HEADLINE CPI



Source: Eurostat, data as of February 2014.

Decline in Euro Area Inflation Stems from Program Countries: Inflation is undeniably low in program countries (and negative in two of them, Portugal and Greece). But what's really sapping total euro area inflation? Disinflationary pressures in Germany and the Netherlands are big drags on headline inflation, along with Spain and Italy. Total euro area inflation fell from 1.6% last July to 0.7% in February. Of the 0.9 percentage point decline, the largest drops came from Spain and Germany (both -0.2), and Italy and the Netherlands (both -0.1).

NOW OR NEVER? IS THE ECB'S WINDOW CLOSING?

With sizable excess capacity in labor and product markets, and ongoing deleveraging in the financial, corporate, household and government sectors, the euro area is likely to grow slowly in coming years, with little upside price pressure. That leaves the economy vulnerable to potential downside shocks and deflation should the global recovery falter.

Yet, we worry the window for aggressive policy action may be closing if peripheral credit dynamics continue to show signs of improvement. Credit inflection points tend to lag the recovery in activity by three to six months. With euro area GDP turning positive in the third quarter of 2013, we are likely nearing the credit inflection point. Italian and Spanish bank survey data suggest this may be the case. According to the surveys, Italian and Spanish banks are slowly becoming less unwilling to lend, and consumer and business demand for loans is not falling as quickly as it once was. Additionally, the rally in peripheral government bonds has pushed yields below the rates at which banks could issue loans, incentivizing a return to lending in 2014 as the ECB's Asset Quality Review (AQR) and stress tests conclude. These modest improvements in credit dynamics represent a bit of a Catch-22 for the ECB. More normalized lending in the periphery will not close Europe's persistent output gap; however, better credit dynamics will likely make it more difficult for the ECB to justify future intervention.

The strength of the euro could be a key downside risk to the ECB's inflation outlook and might serve as ammunition within the Governing Council to justify additional policy easing. Although the exchange rate is not a policy target per se, the ECB acknowledges its effect on growth and price stability. In a very unusual move, Draghi recently quantified that impact. He noted that since the euro's 2012 trough, it has gained 8% on an effective exchange rate basis, and that every 10% effective exchange rate move shaves 0.4 to 0.5 percentage points off headline CPI.[ii] Net trade has been a critical contributor to the nascent euro area economic recovery, and through 2013, the strength of the euro seemed to sap export performance, even for Germany. Recent rhetoric from senior ECB officials, including Draghi, highlights their growing focus on the euro and commitment to countering the currency's strength.

TOOLS TO DEPLOY

The ECB's rhetoric on the euro is one tool that can be utilized, but currency markets will likely push for more. Ending the sterilization of the Securities Market Programme (SMP) remains an option, as does extending the fixed rate full allotment liquidity provision and strengthening forward guidance. A negative deposit rate remains a potential tool, although the bar to using it is high given the drawbacks for banks and money markets. We expect to see additional policy easing by the ECB in coming months. Outright asset purchases—the biggest potential tool and one markets have been seeking throughout the eurocrisis—are potentially more feasible later in 2014, after the AQR and bank stress tests lay to rest any banking system capital concerns.

ENDNOTES

[i] *Source: ECB president Mario Draghi introductory statement to press conference and Q&A, February 6, 2014.*

[ii] *Source: ECB president Mario Draghi introductory statement to press conference and Q&A, March 6, 2014.*