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Deflationary risk in the Eurozone

Atradius Economic Research - October 2014

The Eurozone recovery is gaining traction, but the economic outlook is still dogged by serious concerns. One such worry is inflation, which remains well below the European Central Bank's (ECB) 2% target and has been falling with a looming risk of deflation. We expect that inflation may remain low for years, and this would weaken the economic recovery.

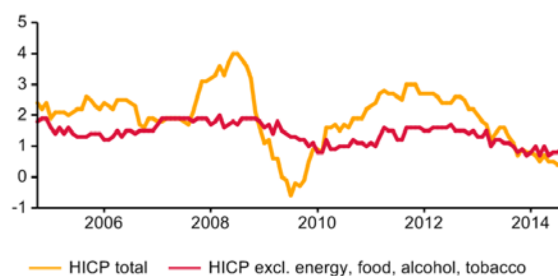
What's going on?

Consumer price inflation has been gradually decreasing since 2011 across many Eurozone markets and has sparked fears of imminent deflation. In August this year, year-on-year aggregate inflation for the Eurozone was only 0.4%, down from 3.0% in October 2011. The current inflation rate is well below historical rates and is far from the ECB's goal for price stability of just under 2%.

Lowering inflation cannot simply be written off in this case by factors like lower energy prices. Core Eurozone inflation, which excludes such volatile items as energy, food, alcohol, and tobacco, has also been falling: reaching 0.9% in August. Moreover, an appreciation of the euro against other currencies and the impact of increases in value added taxes explain some, but not all, of the disinflationary trend of recent years.

Chart 1 Eurozone core inflation

(year-on-year, % change)



Source: IHS

The anaemic low inflation has impacted all Eurozone markets: core and peripheral. Several countries, including Greece and Spain, have already faced deflation, while even strong-performing Germany experienced a low inflation rate of 0.8% in August 2014.

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Chart 2 Inflation
(Annual inflation rate, percent, August 2014)

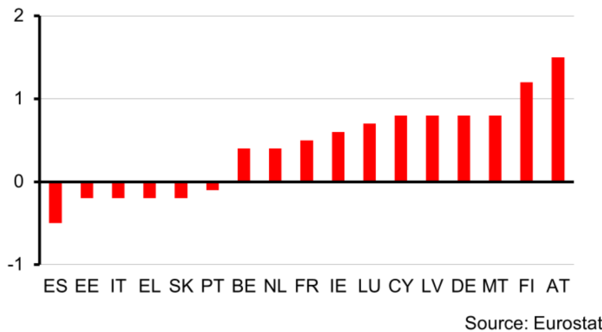
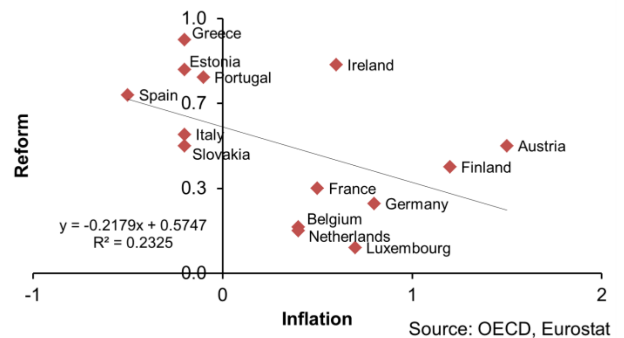


Chart 3 Reform action vs. inflation
(Reform 2011-2012; Annual inflation August)



What are the causes?

Disinflation has many causes, but some controversy exists over whether low inflation and deflation are actually bad for the Eurozone economy or are just a by-product of necessary adjustments. Deflation driven by technological innovation and productivity growth is good for the economy, while deflation driven by a weak economic environment is bad.

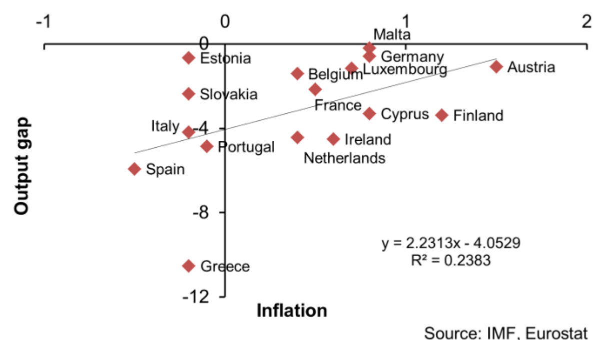
First of all, disinflation can be a sign that the recovery is setting in and that the painful structural adjustment process is finally working. With this perspective, deflation is a positive sign for the Eurozone economy, as lower wages and internal devaluations in the periphery are restoring competitiveness. In general, labour market reform should reduce frictions and bring wages back in line with productivity. Countries that implement more structural reforms should therefore have lower inflation. This is clear from the negative relationship, illustrated in Chart 3, between reform action, an indicator of responsiveness to OECD growth recommendations in 2012, and inflation. Portugal, Greece and Spain have all introduced many structural reforms and consequently are experiencing deflation.

But this positive-style low inflation cannot explain the disinflationary trend across the Eurozone, as other core economies like France and the Netherlands, that have implemented much fewer structural reforms in the past couple of years, are also experiencing extremely low inflation. A closer look at the output gap offers further explanation for the Eurozone's bout of low inflation.

Weak economic conditions and a lot of excess capacity in the economy imply weak labour market conditions. High unemployment reduce workers wage bargaining powers, while firms are looking for ways to cut product prices when demand is soft. Both reduce inflation.

The output gap is a good measure of the slack in the economy and, for all Eurozone countries except Germany and Malta, that gap is still substantial. Chart 4 shows that there is a negative relationship between a country's output gap and its level of inflation. Italy, for example, with moderate levels of reform, has a relatively large output gap and this is driving down its prices. The output gap is of course also related to the need for structural reform, and structural reform may have a negative short-term impact on the output gap. The two causes should therefore be viewed together.

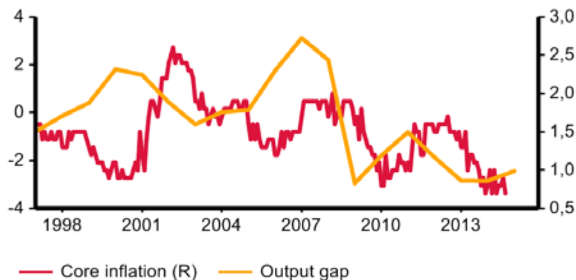
Chart 4 Output gap vs. inflation
(Output gap 2013; Annual inflation August)



There is also some evidence over a longer time span that there is a negative relation between the output gap and inflation, as shown in Chart 5. Given the IMF forecast, that the output gap is likely to stay large in 2014 and 2015 due to the marginal economic growth, this would suggest that inflation is likely to remain low over the next few years.

Chart 5 Output gap and inflation over time

(Output gap 2013 data-edge; core inflation % change)



Source: IHS, IMF, Eurostat

In view of the still large output gap across the Eurozone, the weak economic conditions predicted for the coming years and the need for further structural and fiscal reform suggest that disinflationary pressure will persist for the next five years at least. Inflation could of course be pushed up by rising energy and food prices, but the fundamental forces remain disinflationary. However, if low inflation in the Eurozone does turn into deflation, it is likely to stabilize at a modest rate, as happened in Japan. This is because a high level of deflation, or deflation spiraling out of control, would require a significant economy contraction across the Eurozone, and this is not expected.

What is the impact?

Past experiences of low inflation suggest it may significantly harm economic performance. There are generally four ways through which low inflation negatively impacts the economy.

The cost of servicing existing debt rises as inflation falls. Falling inflation leads to higher real interest rates as nominal rates are often fixed. In addition, debt is often serviced from income, which usually rises in line with inflation. Inflation thus lowers the value of fixed debt services in real terms while lower inflation raises that value. Lower inflation thus lowers the growth of the nominal income used to service outstanding debt. That means that the current low rates of inflation in the Eurozone are raising the importance of member countries' already high public and private debt levels. Rising debt service costs may in turn reduce consumer spending and business investment.

Consumer spending could be further undermined by expectations of deflation, with consumers postponing purchases in anticipation of lower prices. In fact, the inflation expectations may have already started to drift recently in the Eurozone, although they are still well above deflationary level.

In addition to a higher debt burden, companies face rising investment costs as real interest rates rise. This may induce them to postpone investment, reducing economic output and demand for labour. So far the real interest rate on new loans has not risen across the Eurozone as the ECB has implemented measures to reduce nominal interest rates.

Low inflation may also increase unemployment. As wages are rigid, the labour market is less able to adjust when inflation is low. Deflation compounds the problem as there is significant downward wage rigidity. As a result, instead of wages falling, the number of jobs may fall.

This low inflation is also making it more difficult for peripheral countries to regain their international competitiveness relative to the core Eurozone economies. They are attempting to do so by cutting both labour costs, for example by not letting wages rise with inflation, and prices. But the low inflation in the Eurozone core countries is hindering this policy since the peripheral countries must then lower their wages and prices much further to regain full competitiveness.

There is one positive aspect of low inflation. If wages are 'sticky', that means they may continue to grow or remain stable even when inflation is low or falling. This would then push up the purchasing power of workers which could translate into higher consumer spending, aiding economic growth.

Japan's experience

Japan's case was characterised by a series of negative and mutually reinforcing factors, many of which are shared by the Eurozone. At the end of the 1980s, Japan saw an asset price bubble, prompting the Bank of Japan to step in with sharp monetary tightening. This caused the stock market to crash, asset prices to plummet and the economy to fall into recession. Consequently, non-performing loans increased drastically and credit became extremely constrained. In the absence of an expansionary monetary policy from the Bank of Japan, deflation set in a couple of years after the crash.

This shows just how harmful deflation can be for the economy. Following the bubble's burst, Japanese corporations held high levels of debt, which remained the same in nominal terms. Then, as prices fell, the real value of corporate debt increased. To avoid further increases in debt, these firms reduced investment which in turn lowered growth, deepening the economic downturn, increasing unemployment and widening the output gap. Japan's greatest weakness was the policy response to its economic woes, including unsuccessful experiments in quantitative easing.

Japan is still suffering from effects of the 'Lost Two Decades'. Economic indicators finally seem to be returning to healthy levels as Abenomics sets in, with its 'three-arrowed' reform programme (fiscal stimulus, monetary easing and structural reform) to address chronically low inflation, decreasing worker productivity, and an ageing population. However, the implementation of structural reform has been delayed.

The Eurozone shares many similarities with the Japanese case, including downward shocks to asset prices and high rates of non-performing loans in several economies. If the tepid growth continues, with large excess capacity, its rate of inflation could creep ever more closer to zero.

Which countries are most likely to be impacted?

The disinflationary trend is visible across the Eurozone, but not all countries are expected to face the same issues. Countries that have a large output gap and those that still have to implement the most reforms will face the highest disinflationary pressure. To create a list of the countries most likely to be impacted, we first select the Eurozone markets that have a budget deficit larger than 3.0%, as these are subject to the Excessive Deficit Procedure which forces them to implement fiscal and structural reform. Then we look at the forecast output gap in 2014 for those countries. We then rank the countries for both variables, and add the two results to rank the countries again based on this combined score. That final ranking is thus based on an unweighted average of the other two ranked scores.

Those most susceptible to lowering prices are generally the peripheral countries that are currently working to recover their economies from the crisis and to regain competitiveness with the core, as shown in Table 1. But one of the core countries, France, also makes the list. Taking into account the weak economic growth in France and Italy over the first half of 2014, these two are especially likely to face further disinflationary pressure.

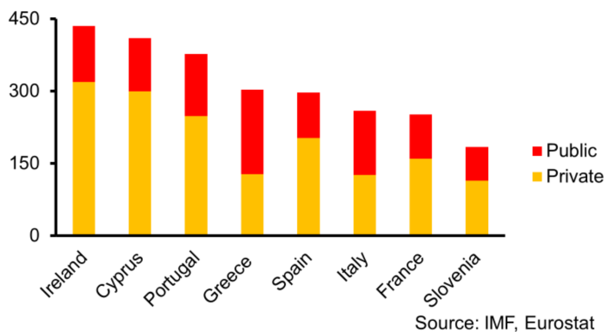
Table 1 Vulnerability rankings

Overall rank	Country	Fiscal balance 2014 (% of GDP)	Output gap 2014 (% of potential GDP)
1	Spain	-5.7	-5.0
2	Portugal	-9.2	-3.5
3	Cyprus	-5.0	-3.4
4	Greece	-3.6	-9.4
5	Italy	-3.3	-4.3
6	France	-4.0	-2.8
7	Ireland	-4.7	-2.5
8	Slovenia	-4.0	-3.3

Sources: EIU, IMF, Atradius

As mentioned, one of the main ways in which low inflation reduces economic growth is by raising the real debt burden. Chart 6 ranks the selected countries by the total debt in their economy. The combination of low inflation and high debt will make the economic recovery more difficult and vulnerable to setbacks in these markets, with a subsequent negative impact on the overall Eurozone economy.

Chart 6 Impact ranking
(Debt as % of GDP, non-financial sector)



Source: IMF, Eurostat

Since the Eurozone is the world's second largest economy, persistent low inflation or deflation may also pose a severe risk for other countries, especially its primary trading partners in the rest of Europe. Countries like Hungary and the Czech Republic, both of which export goods worth about half of their GDPs to the Eurozone, may face weaker growth potential as a result of lower demand from the Eurozone. This may also be exacerbated by depreciation of the euro and lower confidence.

Which firms and sectors will be impacted?

Low inflation will be a problem for some firms, while for others it is less of an issue. The same holds true for sectors. There are basically two ways in which firms are impacted;

- Firstly, the rise in real interest rates and real debt will harm companies that have a lot of debt financed with fixed interest rates and on long-term contracts. Persistent low inflation, or deflation, could lead to solvency problems for these firms. Sectors where financing by debt is common are thus especially vulnerable.
- Secondly, the reduction in aggregate demand by consumers and in business-to-business transactions would hurt firms that are vulnerable to changes in the business cycle. As seen in the past, a prolonged period of low demand can lead to rising credit risk for businesses.

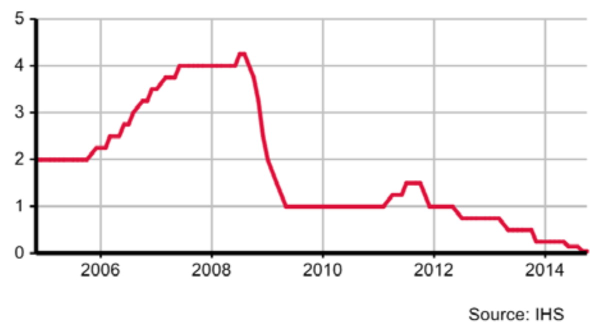
What can be done to mitigate the risk and impact of disinflation?

There is no 'silver bullet' to counter deflation. The European Central Bank (ECB) has indicated that it will take measures when it believes inflation to be imminent: and its latest actions have reflected this commitment. As low inflation has persisted below expectations for many months, the ECB has finally introduced urgency into its policymaking.

In June, the ECB cut interest rates, including the bank deposit rate, to below zero and made long-term loans to banks more accessible. The lower rates serve to encourage banks to lend more to consumers. On 4 September, ECB President Draghi also announced a plan starting in October to buy "simple and transparent" asset-backed securities backed by loans to the private sector as well as a covered bond buying programme. He also reaffirmed the ECB's commitment to employ "unconventional instruments" (i.e. buying government bonds) in the event that inflation continues to be too low. The most visible result of the change in policy has been the 10% drop in the value of the euro against the dollar. This should stimulate Eurozone exports and may stimulate inflation through higher import prices.

Chart 7 ECB interest rate

(ECB refinancing rate, percent)



Source: IHS

However, it is uncertain whether the current design of monetary policy is sufficient to address low inflation and growth, given the poor experience of the Bank of Japan in the 1990s.

Japan's deflationary spell may be blamed on a less than forceful policy response by the Bank of Japan. Abenomics since 2012 has been more aggressive and Japan's economy seems to be finally turning around. Aggressive expansionary monetary policies were implemented in the US and the UK with less hesitation and it seems that this has allowed them to rebound from the crisis quicker than the Eurozone. The quantitative easing policies undertaken by the Federal Reserve and the Bank of England were successful in reducing real debt burdens for the government, corporate and household sectors, and increasing GDP growth and inflation relative to the

Eurozone. This suggests that the ECB should be confident that taking such strong actions in the coming months may just allow them to avoid deflation.

Beyond domestic policies to counter Eurozone deflation, there are several international risks to deflation over which the Eurozone authorities have little or no control. These include sharp tightening in US monetary policy, geopolitical shocks like the Ukraine conflict, and an economic slowdown in emerging markets. These could push the Eurozone back into recession, increase the output gap and create a deflationary environment. These are very real risks, and current policymaking must therefore prioritise stable, sustainable growth to reduce the Eurozone's vulnerability to international events.

Conclusions

We believe that a prolonged period of low inflation or modest deflation is a major risk for the Eurozone economy towards which authorities must remain vigilant, but it is not inevitable. The Eurozone is finally beginning to recover: domestic demand is strengthening, activity is increasing, and firms are likely to begin investing more again thanks to better prospects – and that means employing more workers - thus boosting consumption and reinforcing the positive growth.

But the Eurozone recovery is not yet robust. Output gaps and unemployment remain extremely high. Credit growth is still subdued and the ongoing deleveraging processes in the periphery make the recovery weak and vulnerable. However, the ECB's latest policy stances have renewed confidence that the Eurozone may be able to avoid deflation and continue to grow.

As a result, we think the most likely scenario is one of persistent low inflation. This still has negative side-effects for the Eurozone recovery and also leaves the monetary union particularly vulnerable to a downward shock that may send it into deflation.

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