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Thinking ahead for Europe

What signal from the Fed? Should the ECB ease further?

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Inflation in the euro area remains stubbornly low. The headline consumer price index hovers around zero and even core inflation remains below 1%, which might be due to the second bout of weakness in oil (and other commodity) prices this year. Inflation is falling across the globe, and deflationary tendencies remain even in the longer-term expectations as the inflation expected five years out is also falling. But are lower oil prices a sound reason for central banks to keep monetary policy easier for longer?

The Federal Reserve left rates unchanged on September 17th, although many had argued that the real economy data, especially on the labour market, would have justified an exit (from the zero interest policy).

No similar decision on exit is in sight in the euro area. But some have argued that the ECB should consider further easing measures (pushing the deposit rate deeper into negative territory or increasing the size of its asset purchase program). But should further easing measures be even discussed at this point?

The ECB is aiming only at price stability. But the strength with which it eases policy when (HICP) inflation is below the target (of close to 2%) should take the macroeconomic environment into account. It is one thing to use non-standard measures when deflation is due to insufficient demand. But it is another to prolong these measures when deflation is due to cheaper supply.

For both the US and Europe, the gain from cheaper oil is important and could be worth up to 3% of GDP if one takes into account that other commodity prices have also fallen.

But this positive aspect seems to be forgotten by monetary policy-makers for whom cheap oil also has a negative side as it exacerbates the deflationary tendencies in the advanced countries which, in any event, seem to be mired in a low-growth trap while their central banks appear incapable of generating the inflation rate of 2% which most hold necessary for a proper functioning of the economy.

But why is deflation bad?

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One key argument for the euro area in particular is that it makes it harder for debtors, especially those in the euro-area periphery, to service their debt.

The fear that the technical deflation caused lower oil prices is bad for debtors is unfounded because it is based on a misunderstanding. What matters for debt-service capacity is the income of the debtors, not the general price level. With lower oil prices, the real income of households should go up as they have to spend less on fuel and heating. Lower oil prices thus make life easier for highly-indebted households in the US or in the euro-area periphery. Falling consumer prices should thus in this case be taken as a good sign.

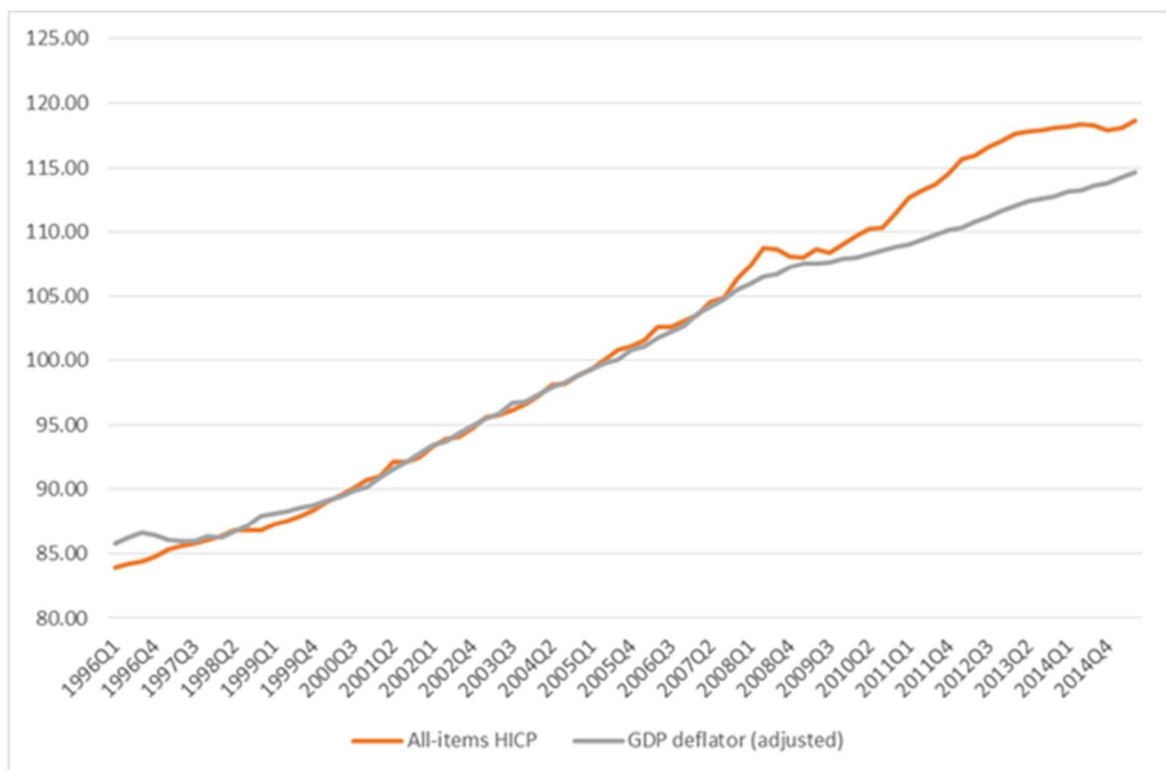
Most manufacturing enterprises will also benefit from lower energy costs, and thus be better able to service their debt. This is again particularly relevant in the euro-area periphery where the non-financial sector accumulated too much debt during the credit boom until 2007-08. Moreover, most of the savings in energy costs might initially show up in higher profits, but, over time, competition will force enterprises to pass on some of these windfall gains in the form of lower prices or higher wages. This is another important aspect of cheap oil: wages can increase to some extent without leading to (consumer price) inflation. Cheap oil will thus make it more difficult to judge the point at which wage pressures become inflationary.

Central banks all over the world have chosen not to aim for absolute price stability, but rather for some increase in the price level of about 2%, because they fear the downward rigidity of wages. In a constantly changing economy, some prices need to go up, relative to the general prices, whereas others need to go down. These fluctuations around the average are easier to achieve when very few prices have to go down. The same applies to wages. It is easier to achieve relative wage adjustment when the average moves up slightly so that few wages have to fall in nominal terms. However, with oil prices falling, this argument loses much of its force since wages might be able to increase even if (consumer) prices do not. This is another reason why central banks should be less concerned about the persistence of low inflation.

Public finances should also benefit from the deflation or low inflation engendered by falling oil prices. Government revenues depend on the value of domestic production, i.e. GDP, and not only consumption. Lower oil prices depress consumer prices, but should boost production and GDP. Absent large price changes for raw materials, the consumption price index, which is usually used to measure inflation, evolves along with the price deflator for the entire economy (the GDP deflator). But this will not be the case this year since consumer prices are falling, but the GDP deflator (and nominal GDP) is still increasing. This should lead to solid government revenues, which is good news for highly-indebted governments throughout the industrialised world, but particularly for the euro-area periphery.

Figure 1 below shows that until 2007 the consumer price index tracked by the ECB and the GDP deflator followed almost exactly the same trend. But this changed when the global crisis hit. A large gap opened up, as consumer prices increased by over 5 percentage points more than the GDP deflator. During this period the actual economic conditions were thus tighter than the average HICP inflation rate of 1.8% (2008-14) would lead one to suspect, as the GDP deflator increased only by a little over 1% per annum).

Figure 1. HICP and GDP deflator compared



Source: Own calculations based on ECB data.

Part of the gap might be due to a fall in productivity, but most of it was due to the period of high oil prices until mid-2014. The gap has narrowed and the GDP deflator is now increasing by about one percentage point more than the HICP (which is almost flat). The relative turnaround in the relationship between GDP deflator increases and the HICP inflation rate the ECB if focusing on is thus close to 2 percentage points. This implies that economic conditions will become much easier in the euro area even if the ECB does not fully achieve its target of close to 2 %.

The near-deflation fall in (consumer) prices, which the euro area is experiencing right now, should thus be seen as a positive development. The euro-area periphery in particular can look forward to an ideal combination of low interest rates, a favourable euro exchange rate and a boost to real incomes from cheap oil. Lower oil prices might make it more difficult for the European Central Bank to achieve its target of an inflation rate close to 2%, but in reality lower oil prices represent a boon for Europe and in particular for the beleaguered euro-area periphery.

Much of the impact of lower oil prices comes with a delay. This implies that the ECB might be mistaken even if it looks at (HICP) inflation for the medium term. When oil prices went up, the ECB chose to 'look through' the temporary impact, it should do the same now that oil prices continue to fall.

In practical terms this suggests that there might be no need for the ECB to prolong its asset purchase programme, even if inflation remains below 2% by end 2016.