Euro area deflation?

Inflation is likely to abate rapidly in the euro area and will soon fall below 2%. It is possible, but unlikely, that we will see some months of falling prices in late 2009. Overall, much lower inflation will lead the ECB to cut rates.

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The previous note of October 26 hypothesized that weakness in economic sentiment – which is best seen as a real-time measure of the state of the business cycle – in the euro area would lead the ECB to cut rates by as much as 75 basis points in the next six months.

Key to the analysis was the idea that while the euro area business cycle was slowing rapidly, suggesting that large cuts in interest rates might be warranted in order to offset the impact of lower demand on inflation, headline HICP inflation would remain much above the ECB's objective of "below, but close to two percent," leading the ECB to cut more modestly that it otherwise would do.

The view that the ECB would cut rates turned out to be broadly accurate, as rates were reduced by 50 basis points already on November 6. This relatively large cut suggests that the ECB might cut more and/or faster than expected in the October 26 note. One reason for that might be that the ECB expects euro area HICP inflation to decline faster than that note assumed. This note looks more closely at the question of how fast inflation might fall. The main conclusion is that it might do so rapidly, and it is even possible that we will see a few months of deflation in the about a year's time. If so, this would give the ECB room to cut interest rates aggressively.

As a preliminary, note that it is relatively easy to forecast future changes in inflation when it has been disturbed by large and readily apparent shocks. For instance, a large price increase in one month will drop out of the inflation calculation after 12 months, leading inflation to fall back predictably towards its initial level. As a consequence, in periods of large energy and food price changes it is possible to forecast quite well how inflation will return to initial level over the next year. In the present situation, these changes hold the key to the ECB's policy decisions in the near term.

Figure 1 below presents one such forecast based on a simple model. The figure shows that inflation rose from 1.7% in August 2007 to 4.0% in June and July 2008 because of shocks to energy and food prices and some pass-through effect to other prices. As these shocks dropped out of the calculations, inflation started to fall in August and reached 3.6% September. Given the ECB's objective for inflation of "close to, but below 2%", this makes it difficult to cut rates to deal with the increasingly apparent effects of the financial turmoil on the real economy.

What might happen next? The central forecast suggests that inflation may come down very fast indeed: the forecast for December is for 3% inflation and the 2% level may be reached around June and inflation may fall to 1.5% in September 2009.

Inflation in the euro area has historically been rather volatile, and this shows up in the confidence bands for the forecasts. These are constructed in such as to indicate the range that inflation will fall in with 95% probability. Given the past volatility of inflation, it seems not implausible that prices will be falling – that is, there will be a few months of deflation – by September 2009.

Is this forecast likely to over or underpredict inflation? Since it neither incorporates the fact that energy prices are continuing to fall and the euro area economy appears to be slowing rapidly, it seems plausible that actual inflation will be weaker than the central projection.

Overall and barring new shocks, inflation in the euro area appears to be slowing rapidly and we might even see some months of deflation in the fall of 2009. This supports the hypothesis that the ECB will be cutting rates aggressively in the months to come.

Figure 1:
Actual and predicted HICP inflation in the euro area