ECO FLASH

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Eurozone: a disinflationary bias in the short and the medium term?

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- **The Covid-19 crisis will result in a sharp contraction of eurozone GDP. However, its effect on inflation is still unclear.**
- **The impact could be disinflationary over the short term, although no consensus has emerged as to the likely medium term trend.**
- **In March, total inflation in the eurozone fell significantly, also reflecting the effect of lower energy prices.**
- **The destruction of a portion of the productive capacity could constrain supply in the medium term, whilst public policies will support demand, thus encouraging an acceleration in prices.**
- **Conversely, a lack of demand relative to potential supply could maintain a disinflationary bias in the eurozone.**

The Covid-19 pandemic will cause a short but deep economic recession in developed countries, and particularly in the eurozone. That being said, its impact on prices remains uncertain. Unlike a 'normal' recession, in which economic activity is hit by a lack of demand, the current situation weighs on both supply and demand. One of the questions therefore is which of these two shocks will dominate. The recent publication of inflation figures for March clearly do not allow us to identify such trends, but they do provide initial information.

Slower prices in March linked to slower 'transport' prices

Total inflation in the eurozone, as measured by the Harmonised Consumer Price Index (HCPI), fell significantly in March 2020, to 0.7% y/y, from 1.2% in February (Figure 1).

This was in part due to the marked fall in the energy component (decrease by -4.5%) as a result of tumbling oil prices. The core inflation (corrected for the most volatile

Total and core inflation in the eurozone (y/y, %)

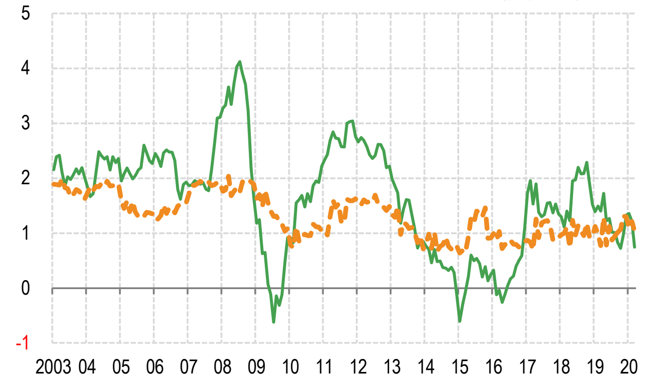

Figure 1 Source: Eurostat

Inflation by HCPI component (y/y, %)

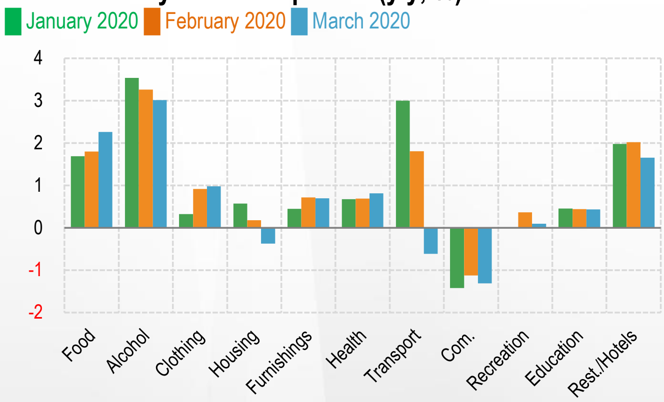

Figure 2 Source: Eurostat

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components) was also down, albeit by less, falling from 1.2% to 1.0%, in line with its average since early 2012.

Inflation has fallen in nearly all sectors (Figure 2). By far the most noticeable fall came in the 'transport' component, and this alone explains virtually all of the overall fall in inflation (Figure 3). Having risen by 1.8% in February 2020, prices in transport fell by 0.6% in March. Although prices in this sector are naturally sensitive to oil prices, this was nevertheless the biggest fall since mid-2016. Inflation in the 'transport services' segment saw a particularly sharp fall, from 2% in February to 0.2% in March (Figure 4), driven especially by the fall in 'air transport' (from 6% to 1%). This suggests that the rapid spread of Covid-19, both within countries and internationally, quickly weakened households' confidence and their wish to travel.

The three components for which inflation increased in March were food, health and clothing.

In 'food' firstly, the increase in inflation was fairly remarkable, jumping from 1.8% to 2.3%, the biggest monthly inflation since June 2018. It is worth noting that there was a similar trend in Japan[1]. This might reflect stockpiling by consumers in anticipation of a negative supply shock. The structure of food purchasing might also have shifted to more locally produced goods, given the significant disruptions to global production and supply chains, which may also have driven an acceleration in prices.

Meanwhile, in the 'health' component, the slight rise in inflation potentially reflected the increased demand for medical products during the epidemic. Lastly, the 'clothing' sector might be seeing a shift of consumers' demand from physical shops to online purchases.

Needless to say, all of these trends should be considered with caution in the absence of more data. For the time being, the initial signs suggest a disinflationary bias in the short term. Although not necessarily a consensus, this view is fairly widespread amongst observers. In the short term, the sudden drop in demand would dominate the negative supply shock. The latter could also be limited by adequate inventory levels in developed countries.

Is there a medium term risk of strong inflationary pressures?

Although market expectations of inflation continue to fall (Figure 5), some analysts have highlighted the risk of significant inflationary pressures over the medium term. Others take a much more sceptical view.

- *The arguments for a medium term increase in inflation*

As in periods of war or natural disasters we are seeing the emergence of fears that demand stimulus, through the current monetary and fiscal support, will combine with a lasting reduction of supply caused by the destruction of productive capacity (materialized today by bankruptcies). As a result, a significant increase in inflation is to be expected once the epidemic is over. The quicker the return to pre-crisis production levels, the greater the public support will be pro-cyclical, and therefore leads to more inflation. In this framework, central banks, may be unable to tackle the rising

Components of eurozone inflation (pp)

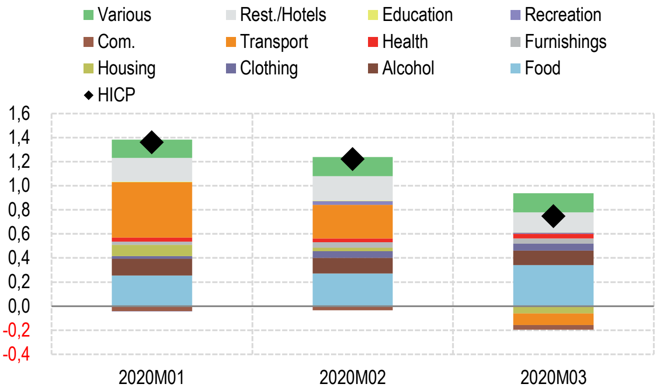

Figure 3 Source: Eurostat

Inflation in the 'transport' sector (y/y, %)

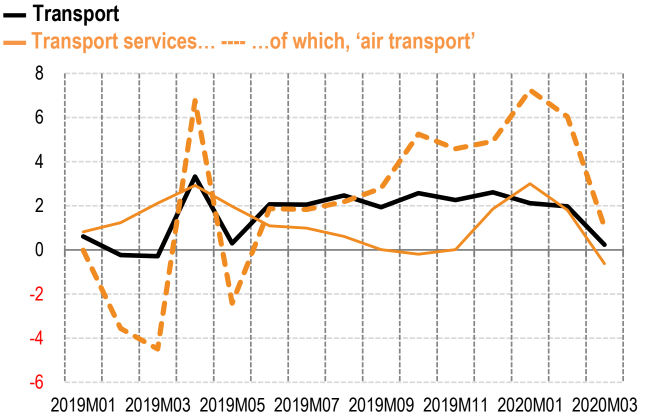

Figure 4 Source : Eurostat

Market expectations of eurozone inflation

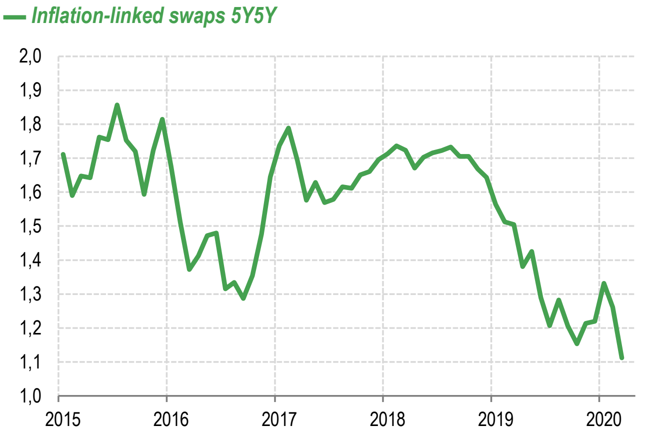

Figure 5 Source: ECB

trend in inflation by raising interest rates, given the surplus of debt. Stronger inflation will thus be justified as compensating for several years of below-target inflation[2].

[1] T. Watanabe, *The reponses of consumption and prices in Japan to the Covid-19 crisis and the Tohoku earthquake*, VoxEu, April 2020

[2] C. Goodhart et al., *Future imperfect after coronavirus*, VoxEu, March 2020

In addition, growing consumers' concerns could lead to a significant rise in relative demand for certain essential goods. If the lockdown continues, the stimulus to demand from government measures could lead to an increase in the relative prices of these essential goods and scarcity of supply. Inflation for these goods would therefore be greater[3].

More structurally, the current crisis could lead to acceleration in the process of shortening of global value chains. The resulting loss of economic efficiency will push production costs upwards and ultimately feed through into consumer prices.

- *The arguments for a medium term decrease in inflation*

For supporters of a disinflationary bias, the risk of a destruction of productive capacity is admittedly real, but much more limited than in wartime or after natural disasters. The economic policy measures taken, notably in the eurozone, will help limit business failures (through measures to support their cash-flow) and the increase in 'traditional' unemployment. On this point, the widespread implementation in Europe of short-time working schemes will help to partially offset the shock to employment from the Covid-19 crisis[4]. Moreover, in wartime, the government generally plays the role of employer of first resort and buys a large quantity of products, thus pushing up inflation. This is unlikely to be the case today.

It is true that once the lockdown is lifted, the recovery in demand could be significant. Households' purchasing power has been protected by public measures and the collapse in commodity prices, financial conditions remain favourable and the forced savings built up during the lockdown can be fully spent once it ends. However, three factors could attenuate the recovery in demand and hence the risk of inflation:

- There could be a 'rush' from consumers as soon as the lockdown is lifted, but massive, simultaneous purchases of durable goods (cars for example) are unlikely;

- Precautionary behaviours could persist in an economic climate that will remain particularly uncertain[5];

- A significant supply shock can lead to business failures and layoffs, resulting in a lack of aggregate demand (consumption and investment). This demand shock can thus cause an additional negative impact on production and employment[6].

We might also expect that once social-distancing measures are relaxed, many sectors significantly affected by the Covid-19 crisis could offer sharp discounts to attract clients. In the 'transport' and 'hotels and restaurants' sectors, for example – which account for around 25% of the HCPI in the eurozone – a reduction in prices would have a non-negligible effect on overall inflation.

[3] R. Baldwin, *The supply-side matters: Guns vs butter, Covid-style*, VoxEu, March 2020
[4] C. Berson et al, *Short-time work: a useful tool in times of crisis*, Banque de France, April 2020
[5] S.R. Baker, *Covid-induced economic uncertainty*, NBER, April 2020
[6] V. Guerrieri et al., *Macroeconomic implications of Covid-19: Can negative supply shocks cause demand shortages?*, NBER, April 2020

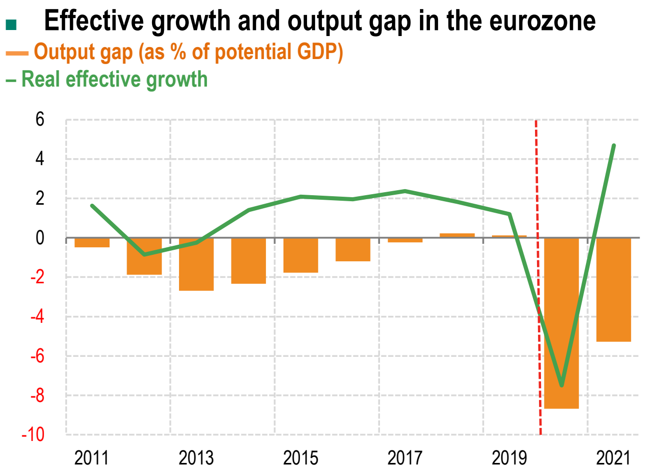

Figure 6 Sources: IMF, AMECO

Inflation dynamics will depend on the profile of the post-crisis recovery

Preliminary estimates suggest that the impact of the Covid-19 crisis in the eurozone countries will be temporary but substantial[7]. The profile of the economic recovery will determine the pattern of inflation. As has often been said, the nature of this recovery is particularly difficult to predict, and will be influenced by several factors: whether consumption is recoverable or not; levels of precautionary savings; potential fiscal consolidation to tackle debt surplus; the recovery in global trade; and so on.

The latest International Monetary Fund (IMF) forecasts[8] suggest that the eurozone GDP will contract by 7.5% in 2020, before recovering by 4.7% in 2021 (Figure 6). The output gap would as a result widen significantly[9], thus favouring a disinflationary bias in the eurozone.

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In conclusion, there does not yet seem to be a consensus over future price trends, particularly when it comes to the medium term. In any event, the eurozone has seen a number of years of relatively low inflation relative to the target of 2% over the medium term, and the ECB could be willing to accept greater inflationary pressures over the next few months. So whilst an increase in inflation can not be ruled out, this may be limited and focused on certain groups of products.

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[7] *Evaluating the initial impact of Covid containment measures on activity*, OECD, March 2020
[8] World Economic Outlook, *Chapter 1: The great lockdown*, May 2020, IMF
[9] Assuming estimated potential growth in the eurozone of 1.3% in 2019 and stable in 2020 and 2021.

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