GLOBAL ECONOMICS UPDATE

Is the risk of deflation back?

• While the drop in oil prices will push inflation down in the near term, the bigger disinflationary risk could stem from the effect of the coronavirus on economic activity. Indeed, we said after the global financial crisis that the world was now one recession from deflation. For now, the weakness of supply as well as demand should limit any disinflationary effects. But there is a risk that demand falls far further. And with interest rates already low, it might not even take an especially deep recession to get trapped in deflation.

• One aspect of the recent market turbulence has been the sharp fall in markets’ inflation expectations. Over the past month, the 5-year/5-year forward inflation swap rate (which broadly captures investors’ expectations of the average inflation rate between 5 and 10 years’ time) has fallen by 30bps in the euro-zone and 70bps in the US. (See Chart 1.) The US measure is at its lowest level since the financial crisis.

• The most immediate impact of recent developments on inflation will come from the drop in the oil price. If sustained, the recent fall to about $35pb will reduce energy’s contribution to OECD inflation from the +0.4pps seen in the latest February data to -1.0pps. Other things equal, that will reduce the OECD inflation rate from February’s rate of 2.3% to about 1% this month. But this is unlikely to have any second-round effects on wage growth, meaning that the effect will be short-lived.

• The bigger downward risk to inflation could come instead from the impact of the coronavirus on economic activity. There are a few reasons why we are not too worried yet. First, we currently expect a slowdown in global growth from 3% to 2% which, based on the past relationship between growth and core inflation, would not be enough to point to deflation. Second, the slowdown so far has been as much about damage to supply (the economy’s capacity to produce) as to demand. Their opposing effects on inflation should broadly offset each other. Third, central banks and governments have been quick to loosen policy.

• But recent developments have raised the risks that the economic effects are worse than we assume. In particular, the quarantine measures introduced by Italy arguably boost the chances that governments elsewhere impose more draconian measures than we have factored in. As we explained here, in that case, we might see global growth slow to more like 1%. And the deeper the downturn, the more likely that the damage to supply would be dwarfed by the hit to demand, increasing the downward impact on inflation.

• With nominal interest rates unable to be cut much further, the big risk is that falling inflation would drive up real interest rates, weakening asset prices and the real economy even further. Risks would be highest in countries where inflation pressures are already weak, debt levels are high and policymakers have the least room for manoeuvre; Japan and Italy spring to mind.

• This would all make it even more imperative for policymakers to take bold action. Even though interest rates and bond yields are already low, they have other options such as a “helicopter drop” (a fiscal loosening financed by a permanent expansion of the money supply). But as we explained in a Focus, the risk is that policymakers might be reluctant to take these more radical steps, raising the risk of a prolonged slump.
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