Editorial: Deflation or inflation: what is the main risk for the world economy?

Since last autumn, world economy is in a global slump. Most recent data show a sharp contraction in the activity at the end of 2008, followed by an additional downward adjustment in the first months of 2009 , even if scattered information can sometimes signal a stabilisation of the activity at a low level.

Meanwhile, as most raw material prices including oil price declined sharply since the middle of last year, inflation has decelerated dramatically. In the Euro area, the year-on-year increase of the consumer price index peaked at 4% in June and July 2008 before coming down to 0.6% in March. The index fell between June 2008 and January 2009 in absolute terms. Since the end of 2008, oil price have been stabilised around 40-45 dollars per barrel. Even if assuming they would remain at that level for the rest of the year, base effects would lead to a zero or slightly negative inflation mid-2009, followed by a mild acceleration afterwards.

However, as economic activity remains to be weak, deflation fears have appeared. Deflation must not be understood as a synonym for negative inflation. It describes an economic process in which the collapse of activity leads to a decrease in absolute terms of prices (including nominal wages), which in turn affects in a downward spiral global expectations both for activity and prices negatively. The Great Depression in the 1930s is the main historical example of deflation, but Japan's "lost Decade" referring to the 1990s constitutes another illustration.

Currently, economic indicators do not exacerbate such a trend in the Euro area. Inflation excluding food and energy prices, known as core inflation, has been remarkably stable over the last two years. It reached 1.8% in February 2009, the same rate than in March 2007. True, producer prices of intermediate goods were down by 3.1% on average in February 2009 compared to a year earlier, in the wake of the sharp decline in raw material prices, but the annual growth rates of producer prices of consumer and equipment goods were still in positive territory. Wage rates even accelerated last year according to the most recent data referring to the fourth quarter of 2008. Of course, disinflation and the deterioration of the labour market will put downward pressure on wages in the coming months. Nevertheless, a decrease in absolute terms is not expected. Finally, the yield differential between inflation-index bonds and nominal government bonds. i.e. the break-even inflation rate, suggests an inflation rate of around 0.5-1% rate in the next couple of years. This is rather low, but still positive.

However, if output will continue to fall, the risk of deflation cannot be excluded entirely. To avoid the economy falling into depression (the coexistence of recession and deflation), central banks have loosened considerably their monetary policy. Additionally, rescue packages for the banking system have been put in place in most countries. This policy has been effective insofar, as market rates for companies and households have begun to decrease. However, as key rates might come close to zero, as they are already in the U.S. and the UK, fears have emerged monetary policy could not support the economy further if the recession worsened. In the U.S. and the UK, central banks have switched to quantitative easing, buying public or private securities against cash. The ECB has still a card to play as central rate is still at 1.25%. However, the question of the implementation of heterodox measures might be raised in the near future. In that case, problems could arise if once the recovery would have taken place. Then, excess money supply might either favour inflation of goods and services or generate a new assets bubble.

To sum-up, monetary policy will face two different problems in the course of time. In the short run, the collapse of economic activity may give rise to the risk of

deflation, even if indicators do not support this idea for near future. The more central banks will loosen monetary policies to fight this risk, the sooner they may be forced to take the opposite decisions, when a recovery starts in order to avoid an acceleration of inflation. Price stability can be achieved in the current crisis but it will request an appropriate timing for monetary decisions. A tough job for central bankers!

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Is there a need to rebalance the UK economy?

There has been a marked shift towards services over the past generation

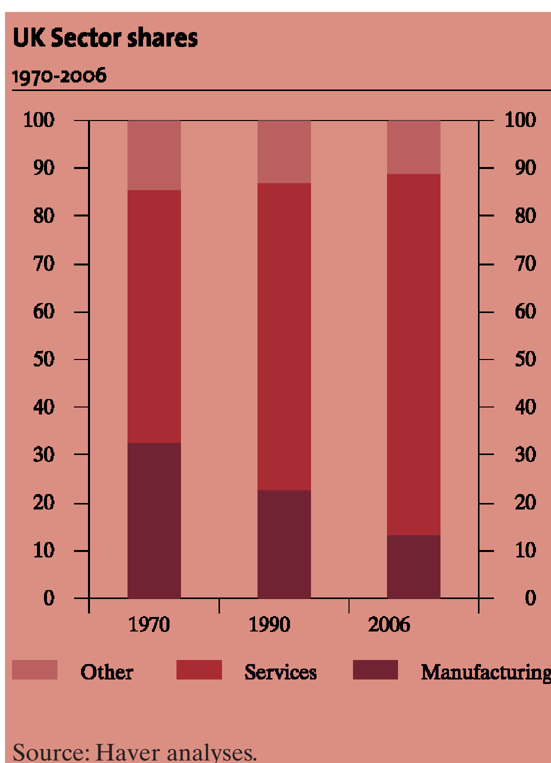
The sectoral composition of the UK economy has changed markedly over the course of a generation. As the economy has matured, there has been a move away from manufacturing – which accounted for 33% of Gross Value Added (GVA) in 1970 but just 13% in 2006 (the last year for which a full Blue Book breakdown is available) – and a move towards services, whose share has risen from 53% to 76%.

Within the service sector there has also been a significant shift, particularly in the last decade, with the financial intermediation and business services sectors gaining share at the expense of all other parts of the service sector. Financial services and business services have grown at an average of 6.2% and 6.4% a year respectively in real terms (i.e. over-and-above inflation) since 1997, more than double the pace of the economy as a whole.

The success of these sectors has been a central factor underpinning a period of rapid economic expansion in the UK. GVA grew at an average rate of 2.7% a year from 1997-2008, despite manufacturing growing by just 0.3% a year over the period. Furthermore, large trade surpluses in financial and business services have meant that the UK can still pay its own way in the world, despite increasing deficits on goods trade.

Though the shift towards these sectors has seen only benefits to date, the UK economy has become increasingly reliant on these sectors – and to a much greater extent than all of its main international competitors. Financial services accounted

Graph 1



Source: Haver analyses.

for 10% of GVA in 2006 in the UK, compared with 9% in the US and less than 7% in the larger Eurozone countries. This greater dependence leaves the UK particularly vulnerable to the current problems.

Part of the expansion of financial services can be explained by the increased globalisation of capital markets. Large imbalances have built up in the global economy, with excess savings in the oil-exporting countries and Asia flowing to the west. This enabled western banks to lend more, though it also encouraged an increased reliance on money markets as a

source of funding at the expense of retail deposits. The combination of low interest rates, readily available finance and a desire to borrow caused savings rates in the west to plummet. This has been particularly noticeable in the UK, where the savings ratio has averaged just 4.2% since the start of the decade, compared with 9% over the previous twenty years. At the same time, more relaxed lending standards and cheaper credit have contributed to a surge in household debt levels, while also contributing to the creation of a house price bubble. Meanwhile, the capital inflows have resulted in a stronger pound and a significant deterioration in the UK's trade position, which has added to the problems faced by UK manufacturers.

The origins of the recession are in the financial sector

The origins of this recession can be traced back to the financial sector, beginning with the sharp increase in financial market volatility in July 2007. Banks particularly reliant on funding from money markets found this source dry up and the resulting restrictions on the availability of credit have seriously affected all sectors of the economy, though banking has suffered more than most with a series of high profile failures, a number of forced takeovers and a significant amount of government money pumped into the sector to prevent its outright collapse.

It appears that government intervention has stabilised the sector and with measures such as the Asset Protection Scheme in place and the implementation of the Crosby recommendations imminent, it appears that the government is putting in place a framework which will allow the banking sector to move forwards. Nevertheless, the financial & business services sector has already shed 220,000 jobs (3.3%) during 2008 and anecdotal evidence points to a pick up in the pace of job losses in the early months of this year. With the recession set to bring a sharp increase in unemployment, which will result in rises in arrears and defaults, the short-term outlook for financial services is challenging. We expect the sector to shed 500,000 jobs by 2011, some 10% of the total.A modest rebalancing of the UK economy is desirable

The experience of the past couple of years will serve as a spur to changing the way that the banking sector operates. In particular, banks will seek to find new and improved methods of measuring risk and are likely to show a lower appetite for risk going forwards, particularly with the state owning majority stakes in two of the UK's largest banks. Greater regulation is also certain, with the Turner Review recommendations of higher capital requirements and a need to hold assets in a more liquid form likely to result in slower lending growth going forward.

As a result, the banking sector is likely to grow at a slower pace over the medium-term than it has in the recent past, which means that other sectors will have to grow faster to make up the growth shortfall.

There is also a need to rebalance on the expenditure side to move away from a reliance on debt-fuelled consumer spending towards investment and export-led growth. However, economies cannot turn around overnight and some of the policies required to rebalance the economy are in direct conflict with the short-term requirements of an economy trying to pull out of recession. For example, the desire to increase the savings rate is at odds with exceptionally loose monetary policy aimed at strengthening consumer spending to halt the decline in GDP. Therefore, the process of rebalancing is likely to be a long and somewhat difficult transition.

Higher rates of savings could bring benefits across the economy

The current problems will kick start the rebalancing process. The severe credit restrictions of the past year have helped to arrest the upward march of the debt-to-income ratio and the next two years should see a significant consumer retrenchment, as precautionary saving increases as a guard against rising unemployment and

households attempt to rebuild the wealth losses of the last year.

In previous cycles the savings ratio has drifted back down as the economy has recovered, but this time around there is a need to sustain higher rates of saving. Currently saving for retirement is far too low, with many intending to rely on the state pension in retirement. However, not only does this offer a relatively poor standard of living for pensioners, an ageing population will place increasing strains on the benefits system and public finances. The current ONS population projections estimate that pensioners will make up 21% of the UK population by 2031, compared with 18.7% in 2006, despite a progressive increase in the retirement age.

Higher rates of saving will mean slower growth in consumer spending, so there will be a need to offset this with stronger growth elsewhere if aggregate demand growth is not to weaken. Increased saving could aid this transition, both increasing the funds for investment and reducing the dependence on international sources of funding. In the short-term higher saving is likely to mean slower GDP growth and a wider output gap. However, this will underpin lower inflation and allow interest rates to be lower, with the reduced cost of capital crowding in extra investment. Over the longer term this could boost the productive potential of the UK economy through capital deepening. The current turmoil in money markets could ensure that this link is stronger in the future, particularly if protectionist policies make capital less mobile. Nevertheless any extra saving which is invested abroad will also benefit the UK by adding to its stock of international assets, which would strengthen future flows of international income to the UK, supporting living standards.

Higher rates of saving could also provide support to UK exporters. Increasingly large capital inflows kept the value of sterling particularly high over the past decade, coinciding with a long period of poor export competitiveness and contributing to the rapid decline of the UK's manufacturing base. However, as these capital flows have dried up over the past eighteen months the value of sterling has dropped sharply, losing around 20% over the last year alone on a trade-weighted basis, and the decline in UK exports, while sharp, has been less severe than elsewhere.

A higher savings ratio over the longer-term, which underpins an increase in UK investment abroad and an increase in domestically-funded investment at the expense of foreign funding, would provide conditions for a lower exchange rate. A sustained gain in competitiveness would provide a significant boost to exports while the increase in relative import prices, alongside weaker consumer demand, should limit import penetration. There would also be a significant positive impact on the current account.

The manufacturing sector, which accounted for more than 60% of UK exports in 2008, would benefit directly through improved export competitiveness. A move towards greater investment would also help manufacturers and it is clear that the next 10–20 years will see an increasing focus on the environment, which should provide opportunities for producers of green technology.

However, it would be unrealistic to expect these factors to bring about an increase in manufacturing's share of the economy. Even the industrial powerhouses of the developed world, Germany and Japan, have seen manufacturing's share of GDP decline over the past 20 years. The UK will still be unable to compete with emerging economies in many low value added industries and, as the global economy continues to mature, the market for manufactured goods will be constrained by the continuing shift in consumer tastes towards purchasing services. Nevertheless, alongside the loss of declining industries the UK has begun to specialise in the high value added sectors of manufacturing such as aerospace, pharmaceuticals and biotechnology and we expect the UK to continue to establish a dominant position in these sectors. This should enable the UK to stabilise, or at least slow the pace of decline, of manufacturing's share of GVA.

With financial services likely to grow at a slower rate than in the recent past, the bonus will be on other parts of private services to make up the growth shortfall. A

weaker exchange rate will aid exporting service industries and we would expect to see the tourist industry, in particular, benefit from the UK becoming a more affordable destination for foreign tourists and from non-UK destinations becoming more expensive. The rapid pace of technological change should continue to support strong growth in communications – one of the star performers of recent years – while the maturing of the economy will see the importance of business services continue to increase. Indeed other sectors may benefit from financial services becoming less dominant – the City has long been able to attract the most-talented graduates with the promise of financial rewards but a more subdued banking sector might lead to a more even spread of skilled labour driving innovation across the sectors in the future.

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COE-Rexecode Leading Indicator for the Euro Area

The Coe-Rexecode Start-End Recession Index[1] for the Euro Area is intended to detect in real time the start and the end of a recession. It is therefore a coincident indicator of recession. Below 0.5, the indicator indicates a regime of "no-recession". Over 0.5, it means a change in regime into a recessionary regime. In August 2008, the indicator surged to 0.62 (revised), sending a strong signal of entry in recession. This signal was consequently confirmed by a slight negative change in GDP in the third quarter of 2008 followed by a sharp decrease by 1.5 % in the last quarter. In January 2009, the indicator is maintaining at its highest value of 1, like in November and December. The indicator will have to recede under 0.5 to send a signal of the end of the recession. We are far from it.

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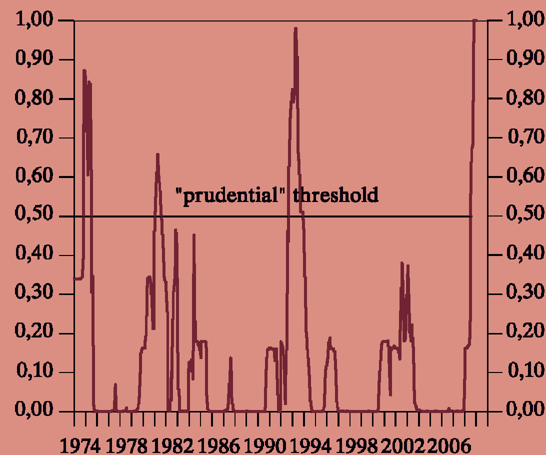

[1] The COE-Rexecode probabilistic start-end recession index (SERI) shows the instantaneous probability that the economy is in recession. A Hamilton model is applied to n series that coincide with the reference business cycle. For the euro area, the series selected are the unemployment rate, the manufacturing production index, the new car registrations and the household confidence index. For each time t, the model computes n conditional probabilities of being in recession. These probabilities are then aggregated taking into account the risks of false signals and missed signals. The signal of change in regime (expansion or recession) is given when the SERI index crosses the significant threshold of 0.5.

Forecast of the EUREN/CEPREDE High Frequency Model

Last update: April 12, 2009

	08Q1	08Q2	08Q3	08Q4	2008	09Q1	09Q2	2009
Jan 08	2.1 ; *0.6*	2.0 ; *0.2*			2.0			
Feb 08	1.9 ; *0.4*	1.8 ; *0.2*			1.8			
Mar 08	1.9 ; *0.5*	1.8 ; *0.3*			1.8			
Apr 08	1.9;*0.5*	1.9 ; *0.3*			1.9			
May 08	2.0 ; *0.8*	1.8 ; *0.1*	1.5 ; *0.4*		1.8			
Jun 08	[2.2 ; 0.8]	1.9 ; *0.1*	1.6 ; *0.4*	1.8 ; *0.4*	1.9			
Jul 08	[2.1 ; 0.7]	1.6 ; *–0.1*	1.3 ; *0.3*	1.4 ; *0.4*	1.6			
Aug 08		1.6 ; *–0.1*	1.1 ; *0.2*	1.3 ; *0.5*	1.5			
Sep 08	[2.2 ; 0.7]	[1.5 ; –0.2]	0.9 ; *0.1*	1.1 ; *0.6*	1.4			
Oct 08			0.8 ; *0.0*	0.7 ; *0.2*	1.3	0.5 ; *0.5*		0.5
Nov 08			0.8 ; *–0.0*	0.43 ; *0.0*	1.2	–0.2 ; *0.1*		0.0
Dec 08			0.7 ; *–0.1*	0.0 ; *–0.4*	1.1	–0.6 ; *0.1*		–0.5
Jan 09	[2.1 ; 0.7]	[1.4 ; –0.2]	[1.4 ; –0.2]	–0.7 ; *–1.0*	0.9	–1.8 ; *–0.4*	–2.0 ; *–0.4*	–2.0
Feb 09				–0.9 ; *–1.2*	0,8	–2.4 ; *–0.8*	–2.7 ; *–0.5*	–2.7
Mar 09	[2.2 ; 0.7]	[1.4 ; –0.3]	[1.4 ; –0.2]	[–1.3 ; –1.5]	[1.0]	–2.1 ; *–0.8*	–2.8 ; *–1.2*	–2.5
Apr 09						–2,7 ; *–0,7*	–3,2 ; *–0,8*	–2,7

In brackets: GDP-Data published by EUROSTAT. In italics: quarter on quarter rates.

The April 2009 update of the EUREN/CEPREDE model exhibits slight changes from the March forecast, presenting negative qoq rates for the first and the second quarter of 2009. For 2008 Q4 the data published by Eurostat showed a more negative development than our last model forecast.

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