Standard Life Investments

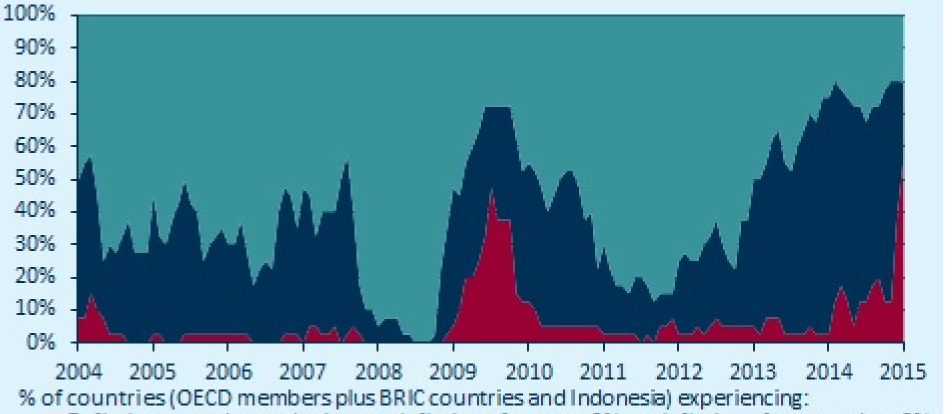
# Weekly Economic Briefing
# Global Overview

## Cutting to the core of inflation
**03 March 2015**

Consumer price inflation readings at the start of this year were dire around the world. Of the 40 OECD and major emerging market economies that we track, 22 had an annual inflation rate below zero in January (see Chart 1). That was the highest proportion on record, including during the depths of the global financial crisis. The lowest readings were recorded in Greece (-2.8%) and Spain (-1.5%), the countries going through the largest internal devaluations within the Eurozone. However, deflationary pressures were acute across the currency union, with Austria the only country above zero. Outside of Europe, inflation also turned negative in the United States, while the UK's 0.3% inflation rate was the lowest since the early 1960s. It was mostly emerging markets at the other end of the scale; Brazil, India and Indonesia had inflation rates above 6.5%.

Overall, global inflation is historically low for two main reasons. The most immediate is the plunge in oil prices since the middle of last year, which has shaved more than a percentage point off headline inflation in most countries. Excluding energy prices, only a handful of Eurozone countries are experiencing a generalised fall in consumer prices. At a deeper level though, core inflation in the developed world was already depressed before the oil shock. Indeed, none of the large OECD economies currently have above-target core inflation rates, which highlights why so many countries have been aggressively easing monetary policy in recent months. It is imperative that policymakers find ways to push inflation up over the next year. Oil prices themselves will do some of the work, as February's 20% rise enters the annual calculations and last year's falls drop out from July onwards. Indeed, this means that we may well have already passed the trough in global inflation. Getting core inflation higher will be more difficult, as it requires sustained above-trend growth. Fortunately, we are seeing healthier signs across a range of countries. Wage growth has picked up in the US and the UK, with unemployment continuing to fall. Japanese labour market slack has been completely eroded, which should start to feed through to wages and core inflation as the year progresses. Meanwhile, the Eurozone is finally on the cusp of above-trend growth, underpinned by a German economy generating strong wage outcomes.

**Chart 1: Oil shock passing through**




*Source: Eurostat, National Sources, Datastream, Bloomberg (as of January 2015)*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# Europe

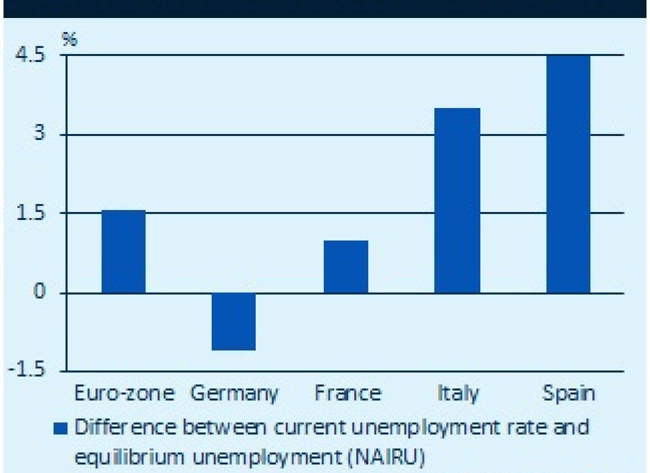
## One size does not fit all

Eurozone inflation posted a rare upside surprise in February. The flash estimate of price growth came in at -0.3% in year-on-year terms (y/y), up from the -0.6% reading in January. This follows upside surprises in larger Eurozone member states. Germany posted -0.1% y/y inflation in February, following a fall of 0.5% y/y last month, beating expectations for an unchanged rate. In Spain, prices fell by less, at -1.2% y/y (previously -1.5% y/y), while prices in Italy increased by 0.1% y/y (previously -0.5% y/y). **Does this upturn mean that the Eurozone inflation scare is over?** Not yet. The smaller than expected fall in prices was driven by volatile energy and food components. Energy prices were down 7.9% y/y in February (previously -9.3%), while food, alcohol and tobacco prices increased 0.5% y/y following a small fall last month. When we exclude these components, the underlying trend in prices remains consistently weak, with core inflation unchanged at its record low of 0.6% y/y. Therefore, while we may well have seen the trough in the headline inflation measure, this should not afford cause for complacency. Instead, the focus should remain on boosting aggregate underlying inflation, which is less affected by changes in international prices or exchange rates.

Large swings in commodity prices and the euro exchange rate have dominated recent movements in European inflation, with price growth broadly moving in unison across the region. However, there is reason to believe that inflation will start to increasingly diverge as the importance of these drivers fade. Large differences in domestic conditions remain between member states in the Eurozone, illustrated by various estimates of spare capacity (see Chart 6). This would suggest that appropriate policy settings should be markedly different across the region according to any normal monetary policy rule. Instead, the headline policy stimulus delivered by the ECB is the same, **implying that policy is too loose in the core and still too tight in the periphery.** Furthermore, the transmission of monetary stimulus is likely to vary by member state. Borrowing rates remain considerably lower in Germany, which also does not have to contend with the structural overhang of high levels of indebtedness.

Looking at Germany in more detail; there does look to be a risk that current policy settings start to cause some overheating. There is already evidence that wage pressures are emerging from a tight labour market. Indeed, IG Metall, the bellwether trade union, agreed an annual pay increase for members in Baden-Württemberg of 3.4%. The aggressive monetary stimulus in the pipeline should erode spare capacity further, fermenting additional price pressures over coming years. While this will help to narrow competitiveness imbalances in the Eurozone, it will pose a headache for policymakers. **There may also be concern over the emergence of financial imbalances in this traditionally low-leverage economy.** House prices have risen more than 5% over the past 12 months in Germany and 22% since early 2010 according to Europace data, in stark contrast to stagnant prices before the crisis. Rising real incomes and extraordinarily low lending rates provide strong incentives to borrow and invest at present (see Chart 7). From a financial stability perspective, it is crucial that this borrowing is directed towards productive uses and the underwriting of this credit remains robust.

**Chart 6: Differing amounts of spare capacity**




*Source: Eurostat, OECD (as of January 2015)*

**Chart 7: Credit taps opening?**


*Source: Deutsche Bundesbank, Datastream (as of January 2015)*

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