



Perspectives by Ruth Lea

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Talk of deflation is greatly overdone



As the economy deteriorates, there is increasing speculation that the British economy may be facing a Japanese-style period of falling prices or deflation.^{1,2} Before taking the debate any further it is essential to be clear about the economic implications of different types of deflation.

Broadly speaking it is helpful to distinguish between positive (or “good”) deflation and negative (or “bad”) deflation. Good deflation is where prices are falling, especially in quasi-essential goods such as commodities and housing costs, boosting real incomes. Boosted real incomes, other things being equal, can encourage people to spend on other goods and services and thus stimulate the economy. The current easing in fuel prices, after last year’s speculatively-driven aggressive hikes, and falling mortgage interest payments, for those with variable rate mortgages, can both be seen as examples of good deflation. Bad deflation, on other hand, is where there is a generalized and persistent fall in prices - especially in non-essential goods and services. This state of affairs can encourage people to defer their spending as they wait for prices to fall further which, in turn, would depress economic activity generally. This, arguably, is happening in the housing market now.

“Good” deflation will probably continue this year. And as the annual inflation numbers fall towards zero and then turn negative, they will doubtless catch the headlines. But these developments are expected to be driven by two very specific factors which must be clearly identified:

- Last year’s fuel price hikes are not just being reversed on a quarter-to-quarter basis –thus easing inflationary pressures. As the year progresses the year-on-year calculations of CPI inflation will be significantly affected by last year’s hikes falling out of the calculations. In other words, the big price rises of last year will “unwind”. It is worth reminding ourselves that as recently as last autumn there was still a major concern about rising inflationary pressures from higher fuel prices which, incidentally, stayed the Bank’s hand in cutting interest rates.
- RPI annual inflation will also be significantly affected by the recent very aggressive cuts in interest rates, which are having and will continue to have an impact throughout much of this year. It is almost inevitable that year-on-year RPI inflation will fall well below zero by autumn this year. And, incidentally, because the RPI index is used widely in government circles this could cause a few policy headaches. State pensions are, for example, RPI-linked (to the September rate). Will the government cut pensions in line with the RPI? I somehow doubt it.

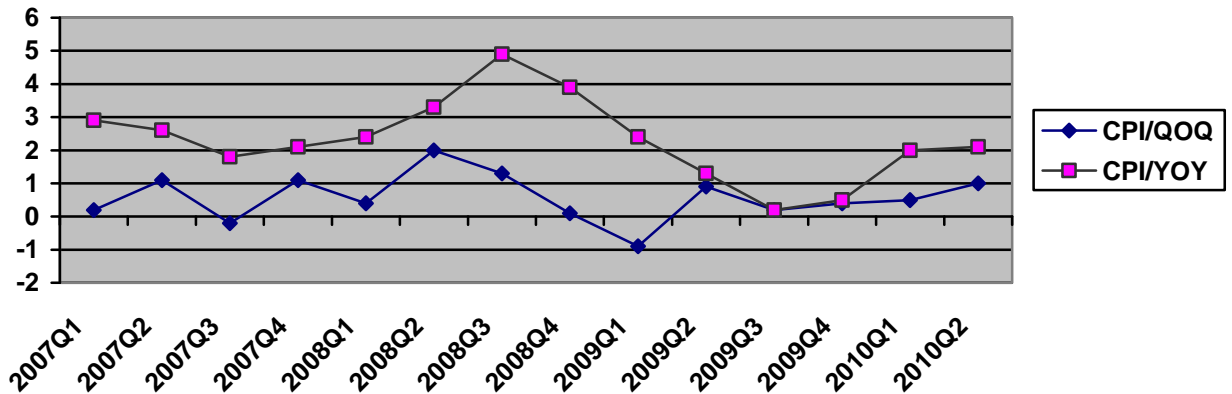
Forecasting inflation rates

The chart below shows the current “consensus forecasts” for CPI inflation. The annual headline inflation rate is expected to be almost zero by the second half of this year. But the following should be noted:

- Even though the quarterly index fell in 2008Q4, much of this fall reflected the one-off cut in VAT rate from 17.5% to 15%, which was introduced on 1 December 2008. This will be reversed in January 2010 if, as announced in the Pre-Budget Report, the rate is increased back to 17.5%.

- Even if CPI annual inflation falls to around zero – thus 2 percentage points below the Bank of England’s 2% target – there is little expectation of a generalized, persistent quarter-on-quarter decrease in prices. A clear distinction must be made between quarterly changes and annual changes.
- There is, in other words, no sign of “bad” deflation. This would accord with the Bank’s overall view that “the likelihood of a persistent period of deflation in the UK is judged to be small”.³ Given the very sharp devaluation of the pound and the knock-on effects for import prices, this should not be surprising.

**CPI inflation (QOQ, YOY), non-seasonally adjusted quarterly data (%)
Past data (to 2008Q4) and forecasts (from 2009Q1 to 2010Q2)**

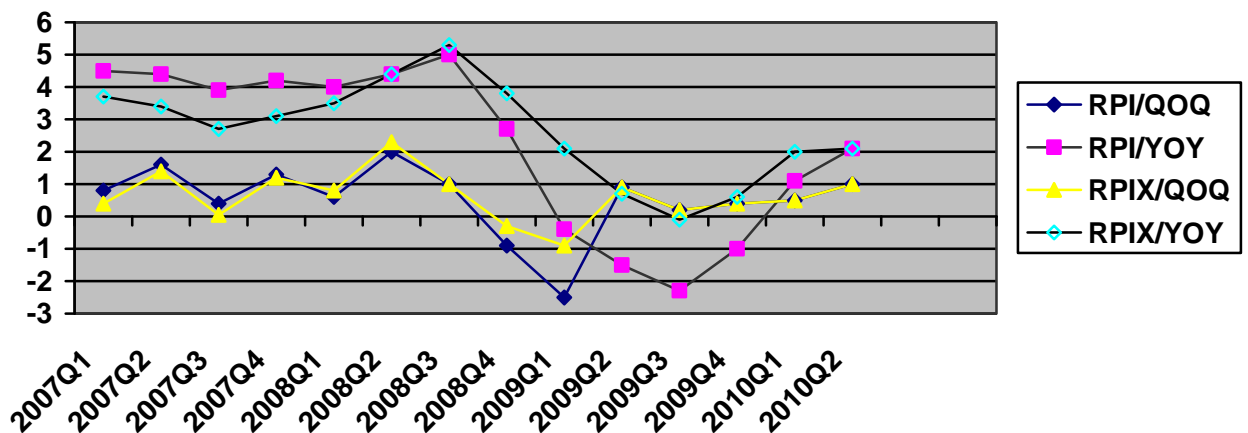


Sources of data: (i) ONS for past data; (ii) Consensus Economics, Survey date: 9 February 2009, for forecasts.

Turning to RPI inflation, the other lever is, of course, cuts in interest rates and their direct impact on mortgage interest payments. (Bank Rate was cut from 5% to 4.5% last October and may be cut from 1% to 0.5% on 5 March.) By the second half of this year I expect RPI annual inflation to be between minus 2% and minus 3%, as shown in the chart below. If interest rates start rising over the forecast period, then RPI inflation could start rising very rapidly.

RPIX inflation (RPI minus mortgage interest payments) should track CPI inflation quite closely, as its coverage is not dissimilar.^{4, 5}

**RPI and RPIX inflation (QOQ, YOY), non-seasonally adjusted quarterly data (%)
Past data (to 2008Q4) and forecasts (from 2009Q1 to 2010Q2)**



Sources: (i) ONS for past data; (ii) author’s forecasts.

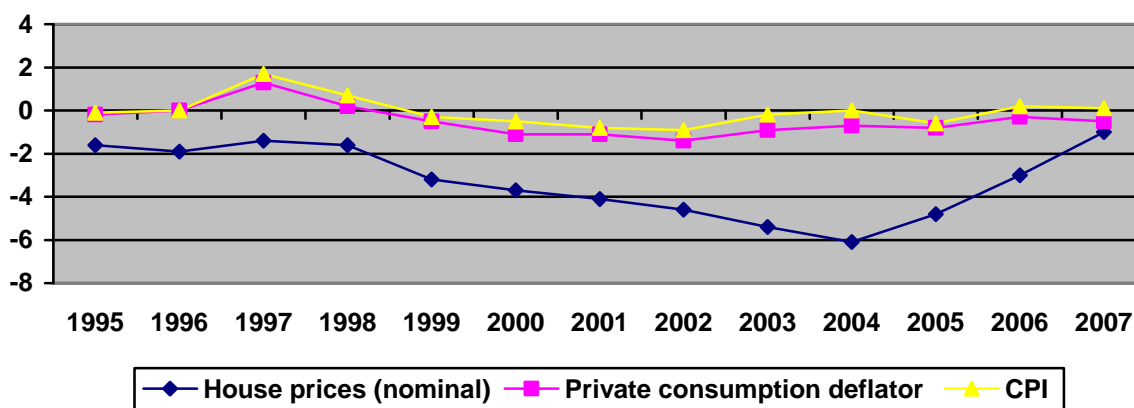
Inflation is more entrenched than expected

For those advocating the likelihood of a “bad” deflation scenario, January’s CPI data should act as a wake-up call. The annual CPI rate only eased from 3.1% to 3% as the weaker pound pushed up the price of imports and offset much of the benefit of lower fuel and housing costs.⁶ Significantly, “core” inflation – a measure that excludes food, fuel, alcohol and tobacco – rose to 1.3% compared with 1.1% in December. Meanwhile food prices inflation remained very strong at 10.1% (YOY). It is not expected that the sharp rises in food prices seen last year will go into reverse (as seen with fuel prices). Note too that the Consensus forecast (first chart, above) has CPI inflation back to 2% by the first half of 2010, boosted by the reversal of the VAT cut.

Britain is not Japan

It is, therefore, highly unlikely that Japan’s deflationary experience of recent years will be replicated in Britain. As can be seen from the chart below, Japan’s house prices “inflation” over the period from 1995 to 2007 averaged an annual fall of around 3% and the private consumption deflator averaged an annual decrease of about ½%. Even average CPI inflation was marginally negative.

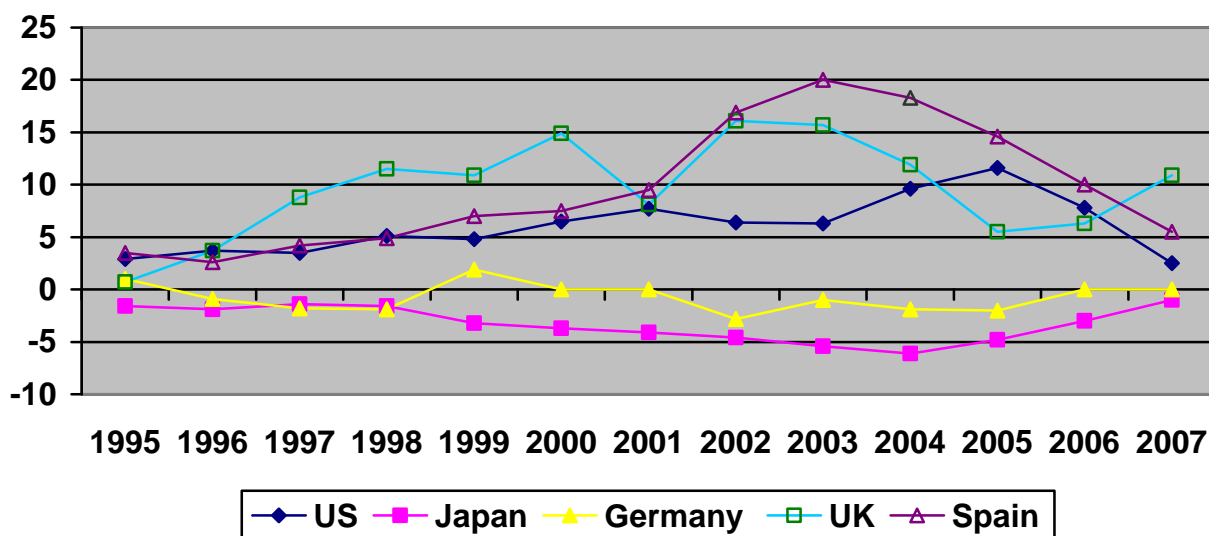
Japan: year-on-year changes (%) for inflation measures



Source: OECD, Economic Outlook, December 2008.

The next chart underlines one aspect of just how extraordinary Japan’s experience has been in recent years - though Germany’s housing market was weak over this period. Granted, however, many housing markets in western economies are now bursting and, granted too, it is very difficult to say with any confidence when the US, the UK or the Spanish housing markets will stabilise.

House prices (nominal) annual inflation (%): international comparisons



Source: OECD, Economic Outlook, December 2008.

Final consideration: inflation rather than deflation?

The MPC is expected to sanction quantitative easing on 5 March in order to stimulate the money supply. As I discussed a fortnight ago this is a sensible policy as money supply growth is currently inadequate to sustain economic recovery.⁷ The concern will be that as QE gets under way the money supply will expand too quickly and prove inflationary. But Bank of England Governor Mervyn King has emphasized that the MPC still have the 2% CPI inflation target as their remit. This implies that the MPC will be very vigilant and, if there are signs of inflationary money supply developments, they will promptly act to tighten policy. There is no reason to believe they will not prove conscientious in this endeavour. But no-one should underestimate the difficulties of the logistics.

References

1. Norma Cohen and Chris Giles, "Britain below zero", *FT*, 28 February 2009.
2. Gary Duncan, "Spectre of deflation starting to stalk the economy", *The Times*, 18 February 2009.
3. The Consensus forecasts shown above are similar to those in the Bank of England's February 2009 Inflation Report.
4. In practice the CPI's coverage is quite similar to the RPIX – or indeed the RPI. The main differences are in the area of housing costs. In particular, the CPI does not include council tax, as well as the following RPI categories relating to owner occupiers' housing costs: mortgage interest payments (which are excluded from RPIX), house depreciation, buildings insurance, ground rent. And other house purchase costs (such as estate agent's fees and conveyancing fees). There are other minor items in the RPI but not the CPI (e.g. VED). Conversely there are items in the CPI not in the RPI (e.g. spending by high income households). Source: ONS, Consumer Price Indices Technical Manual. Contrary to some reporting, the RPI does not include house prices per se.
5. In January 2004, the Bank's inflation target was changed from 2.5%+/-1% RPIX inflation to 2%+/-1% CPI inflation. RPIX inflation, on average, runs higher than CPI inflation.
6. Norma Cohen, "Inflation more entrenched expected", *FT*, 18 February 2009.
7. Ruth Lea, "The Bank looks ready for "unconventional" measures", Arbuthnot Banking Group Perspective, 16 February 2009.

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