

# THE LETTER FROM THE BANK

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## INFLATION OR DEFLATION?

Most economic indicators are affected by the Covid-19 crisis, except for the price levels, for the moment. What lies ahead, inflation, deflation, or the continuation of this moderation? The question arises in the face of the very 'proactive' policy of central banks.

The debt exploded with the pandemic, the record levels seen during the subprime crisis in 2008 are largely exceeded. According to a memo from the Banque de France, net issuance of debt securities in the euro zone has reached 1,116 billion euros since the start of the health crisis (from March to August inclusive), with governments (874 billion euros, 78% of the total), large companies issuing bonds (122 billion euros), then banks and insurance (107.5 billion euros) leading the way. Who bought this mountain of debt? According to the study, 'these issues were absorbed mainly by the central banks' of the countries of the European Union, that is to say ultimately the European Central Bank (ECB), which aggregates these institutions. The 19 central banks of the euro zone therefore bought 59.2% of public debt issues and 63.1% of private debt issues carried out over the period, for a total of 756.7 billion euros.

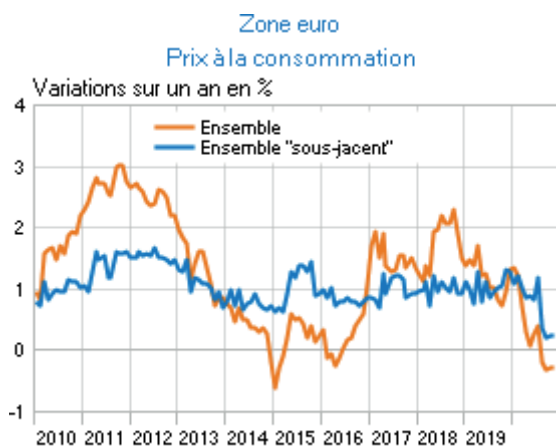
These redemptions are made by money creation, which raises fears of a return of inflation.

With the ECB replacing the market, we are witnessing the de facto merger of the Treasury and the central bank: the financing of the state's deficit is directly plugged into the printing press, which is worrying. The ECB's consolidated balance sheet reached a new record at 6,923 billion euros, the equivalent of 68% of the GDP of the euro zone (against 34.1% for that of the US Federal Reserve, 130.9% for the Bank of Japan, OECD record). Some economists and politicians are even calling for the outright cancellation of this debt held by the ECB, in order to make even greater budget deficits...

It should still be remembered that central banks were created and have a mandate to guarantee the value of money, in particular by ensuring that the money supply does not deviate excessively from the quantity of goods and services available, otherwise the labels risk going off.

That said, paradoxically, inflation is a target for these central banks. Federal Reserve Chairman Jerome Powell stated on 27 August that inflation could now stay above the 2% target 'for some time' before the institution has to act by raising interest rates to contain it. Similarly, at the ECB, Christine Lagarde seeks to reach this 2% target, without succeeding.

But in fact, why 2% and not 0% since the central bank's objective is to ensure price stability? 2% per year doesn't seem like much, but it still means a doubling of prices over 35 years. In fact the ECB is not aiming for 0% because it fears deflation; with 2%, it gives itself a margin of safety. But let us ask the question: is deflation really to be feared? After all it is normal for technical progress and competition to lower prices, it is the very logic of capitalism.



Source : Eurostat

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[Graph] Euro zone - Consumer price

Changes over one year in %.

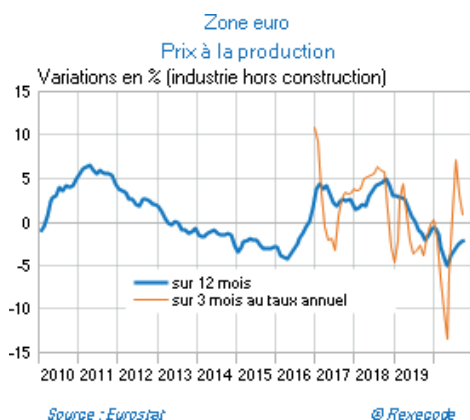
— trend  
— underlying trend

Source: Eurostat

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<sup>1</sup>Who has bought the debts in the euro zone since the start of the health crisis? Ticket no. 188, 20/11/2020

However, deflation is fatal for those who are highly indebted (the States, which the ECB carries at arm's length) because in this case their incomes fall (VAT in particular) when the amount of their debt remains constant, so strangulation is assured. Inflation, on the contrary, helps lighten this burden, here is the real reason.



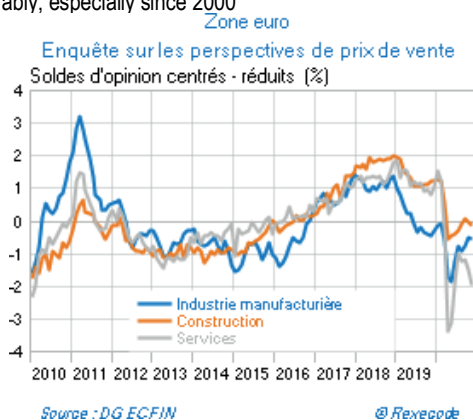
[Graph] Euro zone - Consumer price

Changes in % (industry excluding construction)

- Over 12 months
- Over 3 months at annual rate

Source: Eurostat © Rexecode

There is also a problem of measuring this inflation. The increase in prices, as assessed by INSEE and the European statistical bodies, currently remains closer to 0% than to 2%, but does this correspond to reality? Not really if you ask your loved ones or if you look at your budget. Why such a distortion? Largely because the 'basket of goods' of the consumer price index only counts housing at 6%. INSEE only takes into account rents and considers the acquisition of property as an investment, which therefore does not have to be included in the index. This reasoning is somewhat specious because the main home represents as much consumption as an investment, and moreover it does not yield any return, unlike an investment, but costs in various expenses. And while it constitutes a capital, its increase does not pay off if one moves in their own city or in another metropolis since the prices increase everywhere. Housing expenses are more in the order of 20% of the household budget, as the INSEE admits in other studies, which has changed the situation considerably, especially since 2000



Sources:

The memo from the Banque de France:

<https://blocnotesdeleco.banque-france.fr/billet-de-blog/qui-achete-les-dettes-en-zone-euro-depuis-le-debut-de-la-crise-sanitaire>

Sources: ECB - European Central Bank, Eurostat, DG ECFIN, Rexecode

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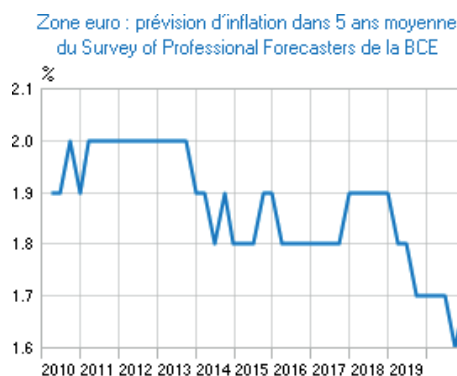
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and the sharp rise in property prices.

Moreover, in quick succession, at the end of September, the Governor of the Banque de France, François Villeroy de Galhau, and the President of the ECB, Christine Lagarde, asked that housing be better taken into account in the calculation of inflation. This would be the way for them, finally, to reach this famous 2%, and for the price index to become more realistic.

Having said that, beyond these statistical aspects, it is the substance of inflation that is likely to change in the years to come: the prices of consumer goods, which have been very wise up to now thanks to strong international competition, are likely to rise as a result of the wishes of 'de-globalisation' of many governments, and the possible imposition of a carbon tax at the borders of the European Union. Energy prices will inevitably rise in the name of the "energy transition", such as electricity (financing of wind turbines) and fuel. Conversely, property in metropolitan areas (offices and housing) risks suffering from the spread of teleworking, and quite simply from the post-Covid crisis; the time for regular price increases may be over. In the face of printing fears, real assets like gold, works of art and vintage cars could benefit. Even if the average inflation rate does not move much, deep moves could take place.



[Graph] Euro zone: 5-year average inflation forecast from the ECB's Survey of Professional Forecasters

Source: ECB – European Central Bank © Rexecode

Above all, let us not forget that with the record printing of central banks since the Covid-19 pandemic, we are playing with fire. Japan is doing worse than the EU and the US, but that's not a reason. In addition, a rise in interest rates in the event of a price slippage turns out to be unthinkable, the mountain of debt, public and private, makes central bank policy irreversible, as a rise in rates would suffocate debtors. In the end, it seems that deflation is less to be feared than inflation ...

[Graph] Euro zone – Selling price outlook survey

Balances of opinion centered - reduced (%)

- Manufacturing industry
- Construction
- Services

Source: DG ECFIN © Rexecode