MAY 05.22.2015

ECONOMICS: EUROPEAN PERSPECTIVES

DEBUNKING UK DEFLATION MYTHS

+ Darren Williams, Senior European Economist—Global Economic Research, darren.williams@abglobal.com

UK inflation has turned negative for the first time since 1960. In part, this has been due to falling energy and food prices, and we hesitate to call this deflation in the fullest sense of the word. We find little evidence in recent data or the historical record to justify the hysterical reaction of some commentators whenever inflation turns (or threatens to turn) negative for even the briefest period.

In April, Consumer Price Index (CPI) inflation in the UK fell to −0.1%. This is the first time that CPI inflation has been negative since records began in 1996, and the lowest rate of inflation (using the most comparable data) since March 1960. Predictably, some commentators seized on this news to claim that the UK had finally slipped into a deflationary spiral and warned of dire economic consequences.

Poor Guide

This is nonsense. Just because headline inflation has dipped a toe temporarily into negative territory, it does not mean the UK has succumbed to deflation. As we have argued in the past, the CPI is a poor guide to deflationary (or inflationary) tendencies in the economy. This is particularly true when inflation has been pushed into negative territory by declining food and energy prices, as at present.

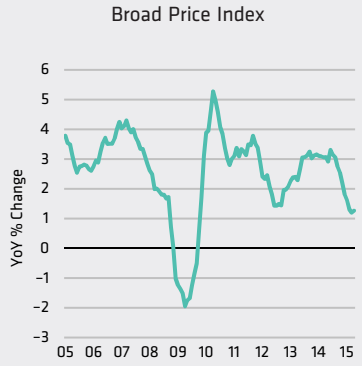
Even the question of whether inflation is actually negative or not depends on the indicator used. The Retail Prices Index (RPI) currently puts inflation at +0.9%, while the new CPIH index (which includes owner-occupied housing and has been touted as a possible replacement for the CPI) puts it at +0.2%. More tellingly, our own broad price index (which includes equity and house prices and is a superior guide to broader-based price pressures in the economy) puts inflation at +1.3%, far above its low of −1.9% in 2009 (*Display 1*), when deflation risk was much higher than at present because of collapsing asset prices.

Some indicators do, however, paint a more negative picture of UK inflation. The retail sales deflator, for example, is currently running at −2.2%, and a similar trend is evident in the British Retail Consortium's shop-price index, which has been negative since May 2013. But these indicators only serve to highlight a key point.

False Claims

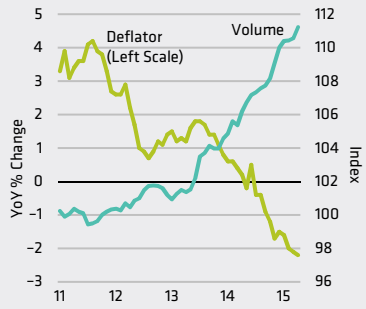
One of the main claims put forward by those who think central banks should do anything and everything in their power to avoid deflation (regardless of the risks to financial stability) is that falling prices encourage consumers to delay purchases. But we can find little evidence to support this assertion. Indeed, it's worth noting that people are constantly buying high-tech products like mobile phones and personal computers, knowing that, if they waited a few months more, they would be able to

Display 1
Broad Price Measure Still Positive



Through April 30, 2015
Weighted average of consumer prices, producer prices, house prices and equity prices.
Source: Haver Analytics and AB

Display 2
Sales Boom Despite Falling Prices



Through April 30, 2015
Source: Haver Analytics

purchase a more advanced model for the same price.

Nor do the UK data lend ready support to this hypothesis. As noted earlier, the retail sales deflator has been negative for some time. However, this has been accompanied by strong growth in retail sales volumes (*Display 2, previous page*). In addition, it's worth pointing out that clothing prices in the UK fell by half between 1996 and 2010 (mainly thanks to cheap imports from Asia), yet consumption of clothing increased almost fourfold over the same period. Supply-driven declines in prices are more likely to boost spending than depress it.

Things might change if a true deflationary psychology took hold. But there's little evidence of this. The Bank of England's first-quarter inflation attitudes survey showed a median expectation of 1.9% for inflation over the next year and 2.8% for inflation in five years' time. Both are low compared with past readings (*Display 3*), probably reflecting the low level of actual inflation. But they can hardly be described as worrying—particularly the relatively high reading for medium-term expectations.

Other responses to the inflation attitudes survey also suggest that we shouldn't be too worried about deflationary expectations setting in. In February, just 7% of respondents said they expected prices to fall in the coming year, up a bit over last year's readings but well below the 17% peak seen in the fourth quarter of 2008. This number fell to just 2% when people were asked about price developments in five years' time.

Moreover, when it came to spending, just 20% of respondents said their expectations of future price developments would lead them to cut back spending in the coming year. This compares with 34% a year ago and 52% in February 2013. These findings are supported by survey data showing that car-buying intentions have surged in recent months and are currently at their highest since 2002 (*Display 4*). Contrary to the fears spread by some commentators, recent price developments are more likely to support than hinder consumer spending.

Historical Record

Finally, it's worth considering the historical record on deflation. Falling prices have been rare in the postwar/fiat currency era but were common before that. In fact, Bank of England data show that the price level fell in exactly 50 out of the 109 years between 1831 and 1939 (or 46% of the time). We found that economic growth was negative in 12 of those years (compared with 10 of the years in which prices rose) and that it averaged 1.5% in all of the years in which prices fell, compared with 1.9% for years in which prices rose.

Misplaced Hysteria

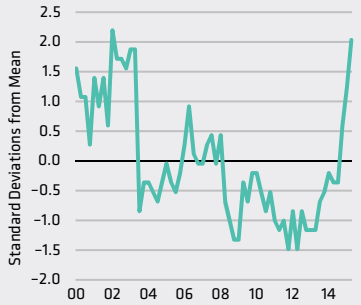
For some commentators, deflation is the main challenge facing developed economies and something that needs to be avoided, regardless of its genesis or the costs. But we find little evidence to suggest that falling prices are likely to encourage consumers to delay purchases (if anything, the evidence points in the opposite direction). And there's no sign that deflationary price expectations are about to set in.

The historical record does suggest that economic growth tends to be lower when prices are falling than when they're rising. But not by much, and certainly not by enough to justify the type of hysteria displayed by some commentators whenever inflation turns, or threatens to turn, negative for even the shortest period of time. ■

Display 3
Deflationary Psychology Still Absent

Through March 30, 2015
Median expectation
Source: Bank of England

Display 4
Car-Buying Intentions Surge



Through April 30, 2015
Source: Haver Analytics