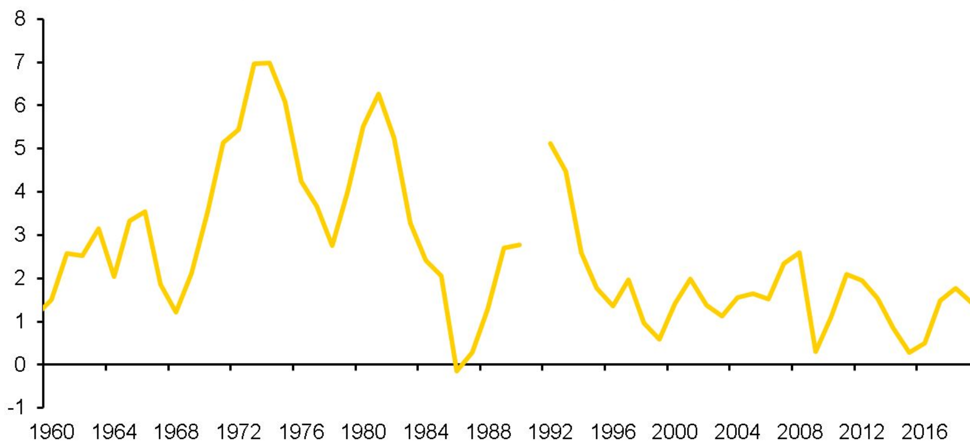
Week in Focus

3 April 2020

Corona: Deflation or inflation?

In the wake of the corona crisis, some observers fear deflation whilst others are concerned about a pickup in inflation. We analyse the various arguments and assess what the epidemic could really mean for inflation. **Page 2**

Coronavirus – diving into deflation or returning to higher inflation?
Consumer prices in Germany, annual data, percent change on year; until 1990 Western Germany



Source: Global Insight, Commerzbank Research

Oil prices in free fall: Oil prices have fallen to an 18-year low due to an unprecedented slump in oil demand. We have thus lowered our year-end forecast for Brent to $40 per barrel. **Page 5**

Outlook on week of 6 April to 10 April 2020

Economic Data Preview: German new orders should weaken due to the Corona crisis. In the US, several million people are still likely to lose their jobs every week. **Page 8**

Bond Market Preview: Debt sustainability concerns continue to linger in Italian government bond spreads. Jittery macro sentiment should keep Bunds supported and it remains too early to call the all-clear for corporate bonds. **Page 11**

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Commodities Market Preview: Possible production cuts are likely to push up the oil price, but the collapse in demand limits a recovery rally. **Page 14**

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Corona: Deflation or inflation?

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Unlike the Great Depression of the 1930s or the global financial crisis of a decade ago, the current economic slump is likely to impact on aggregate supply more than demand which is being supported by a huge amount of government aid. Excess demand is one of the key arguments arguing for higher inflation, although in the short term this effect will largely be offset by low wage growth in the wake of the crisis and the depressed oil price. Only in the longer term if at all, would inflation be expected to pick up as the epidemic accelerates the trend towards de-globalisation.

This time is really different!

In the first half of this year, economic output in Germany and the other euro countries is likely to slump to a degree that has only been seen in peacetime during the global economic crisis of 1929/30 and the financial crisis of 2008/09. In the course of these two crises, consumer prices either fell significantly (deflation) or barely rose for an extended period. For this reason, many people assume that the corona crisis will also have a deflationary effect, which would further exacerbate the already moderate rate of inflation in the euro zone, which will slow even further.

However, it is often overlooked that the current crisis differs from the other two in one important respect: Whereas in the earlier crises demand collapsed first, which then led to a sharp decline in production, this time the dominant factor is a government-ordered contraction of supply. So whilst in previous crisis episodes, there was initially considerable oversupply which put downward pressure on prices, this time the supply potential is falling faster and more strongly than demand. The supply-demand dichotomy is being exacerbated by the fact that governments are at least partially compensating for the loss of income and employment associated with a decline in production by means of aid programmes (i.e. they are attempting to support demand). Added to this are the state guarantees for corporate loans now available in many countries and the sharp rise in loans this triggers, which will further support demand.

The bottom line is that there is excess demand, which in itself is more likely to push up prices. However, there are likely to be various other effects in the near-term that will overshadow the impact of this excess demand.

In the short term, cheap oil will dominate ...

The recent slump in oil prices will probably push the inflation rate down so much that all other effects will fade into the background. We expect the inflation rate to be close to zero as early as April in both Germany and the euro zone.

In addition, the macroeconomic "income surplus" generated by the government measures will have little effect for the time being because many households will remain hesitant to ramp up consumption during the crisis. Moreover, many of the goods and services included in the consumer price index are not even on sale at present. And in sectors that are still open, such as food retailing, most suppliers are unlikely to take advantage of the stronger demand to raise prices, as they risk being branded as "crisis profiteers" which would damage their reputation. At best, there will probably be fewer discount campaigns.

... and after the crisis, lower wage growth neutralizes effect of excess demand

Once the epidemic abates and production bounces back, macroeconomic demand pent-up during the first half-year (the income surplus, in other words) should make its presence felt, aided by subsiding uncertainty. In some areas this should be met by additional production. In many service sectors in particular, such as tourism, this is unlikely as the output is permanently lost. Here, prices are likely to rise. A possible recovery in oil prices also suggests higher inflation.

On the other hand, the emerging deterioration in the labour market situation will certainly further erode trade unions' bargaining power, thus slowing down the already somewhat subdued wage growth, and thus reduce the cost pressure on companies. The de facto wage moratorium until the end of the year recently agreed between employers and the IG Metall trade union in the German engineering sector gives a first taste of this.

The long term: De-globalisation and the flood of money

However, on a multi-year horizon, the corona epidemic could increase inflation. Many companies are currently experiencing the vulnerability of global production chains. In the coming years, they are likely to realign their production more regionally. This will tend to increase production costs and argues for higher inflation. Another argument for higher inflation is the crisis-related high credit requirements of companies, which is causing money supply to rise faster.

Flood of money only temporarily argues for a little more inflation

In the financial crisis following the Lehman bankruptcy, when the central banks flooded the banking sector with liquidity, the money remained held in the financial sector. By contrast, the money in the hands of citizens and companies, i.e. money supply M3, hardly increased at all, which is why inflation did not rise.

This is different in the Corona crisis because now the focus is not on the banks, but on the real economy. Non-financial companies must survive the state-imposed shutdown of social life for which they will need more credit and the equivalent value of the loans is credited to the bank customers' accounts. In contrast to the financial crisis, the money supply M3 is likely to rise significantly this time which argues in principle for more inflation.

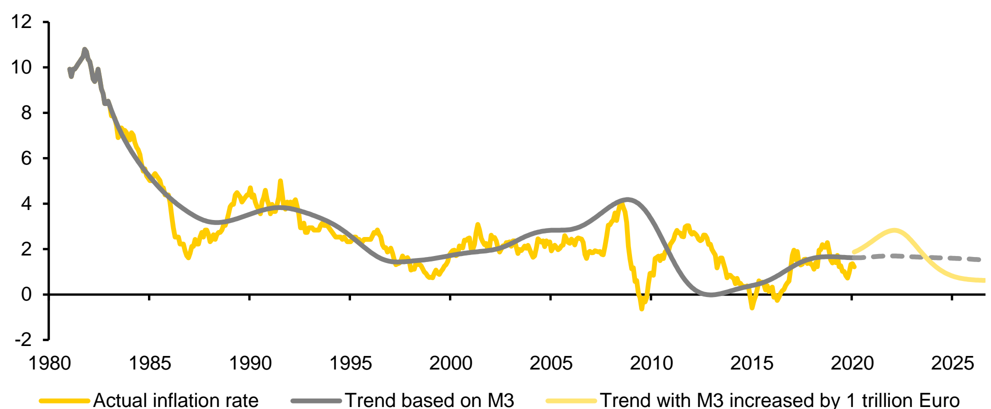
In order for the banks to be able to grant more loans to businesses, the regulatory authorities have released capital buffers totalling 120 billion euros. According to the regulators this will enable the banks to grant additional loans of up to 1,800 billion euros. For our model, which estimates the inflation trend in the euro area with the help of the M3 money supply, we have assumed that the M3 money supply will increase by a total of 1000 billion euros by the middle of the year. This is significant and, according to our model, could push inflation towards 3% in the next two to three years because of the usually long time lags (chart).

In fact, the increase is likely to be much lower because lower wage settlements as a result of the crisis will dampen increases in service prices.

In addition, inflation is likely to rise only temporarily, as companies will gradually repay the emergency loans once the epidemic subsides. For our model calculation, we have assumed that credit and money supply will return to the previous path observed before the epidemic by the end of 2024. Monetary growth will then slow down again and monetary inflationary pressures will be reduced accordingly.

Euro area: Could inflation be pushed to almost 3%?

Euro area inflation rate; actual and trend based on M3; starting April 2020 simulation of the trend based on constant M3 growth and M3 increased by 1 trillion Euro



Source: ECB, Commerzbank Research

De-globalization speaks for more inflation

A second frequently heard argument for higher inflation in the long run is de-globalization. Many companies are currently finding that global value chains are being torn apart, bringing production in their home locations to a standstill due to a lack of supplies from abroad. As a reaction, many companies are likely to relocate part of their production back to their own economic area. European companies will therefore source less from Asia and instead

cooperate more closely with other companies in Europe. This should tend to make production more expensive. But many questions remain open:

- First, the extent of this effect is difficult to quantify. The Bank for International Settlements (BIS), for example, has shown in several studies that the influence of domestic cost drivers, which usually argue for higher inflation, has declined with the emergence of global value chains. Conversely, this suggests higher inflation in the face of de-globalisation. However, the studies have not been able to show the extent to which globalisation has pushed down inflation; hence, the inflationary effect of de-globalisation is also unclear.
- Second, wage costs in China have risen sharply by an average of 11% over the past ten years, and minimum wages have increased even faster. China has thus become less of an exporter of low inflation over the past few years. This lowers the inflationary impact of de-globalisation.
- Third, little is known about the time lag with which globalization and de-globalization affect inflation. For example, globalization, measured by the share of world trade in world GDP, has been stagnating for ten years now without inflation having risen in Western countries to date. Instead, the measures of underlying inflationary pressures have tended to surprise downwards.

All in all, it is plausible to assume that de-globalisation portends higher inflation. But the extent and timing of this effect is very uncertain, which makes it difficult to quantify in medium-term inflation forecasts.

Conclusion: Higher inflation risks only in the long run

The coronavirus epidemic will cause inflation to retreat in the coming months because the collapse of oil prices dominates all other factors. If the virus dies down and the economy recovers from the middle of the year onwards, the demand that was held back in the first half-year will be partially recouped. But this should largely be offset by the fact that the rise in unemployment is weakening the bargaining power of trade unions and reducing the rise in service prices. In the long term, corona-related inflation risks will however outweigh these dampening factors, although it is difficult to quantify how de-globalization will increase inflation. The ECB can be expected to stick to its loose monetary policies for a long time to come.

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