

Europe's Stumbling Inflation

By John Greenwood

Introduction and Overview

- The ECB began its tightening cycle with announcements in December 2021 and action to cut the PEPP and APP in March and June 2022, followed by rate hikes in the second half of 2022 and 2023.
- Since then, eurozone M3 growth has plunged from 6.2% year-on-year in September 2022 to -1.2% a year later, and 3.2% in August 2024. It has averaged only 1.8% p.a. since August 2022.
- Having generated inflation through excess M3 growth in 2020-21, it now looks as though the ECB will administer a dose of **deflation** to the eurozone as forecast in IMM#24, "Europe's Coming Deflation" (August 2023).
- All the elements of the monetary transmission mechanism are in place. Initially tighter money growth hit asset prices and industrial and consumer confidence.
- Economic activity was the next domino to fall with manufacturing especially badly hit.
- Goods and service price inflation in the HICP (Harmonised Index of Consumer Prices) will be the final symptom of the monetary squeeze.
- Currently policymakers are still worrying about the possibility of a rebound of inflation from so-called "second round" effects (i.e. wage settlements etc.), which, earlier this year, delayed rate cuts and monetary easing by the ECB.
- However, ECB balance sheet policies, Basel bank regulations, and the response of consumers and business to the current levels of interest rates all suggest that slow money growth will persist.
- In turn this means not only that inflation will be lower than most people expect – i.e. below the 2% target – but also that sub-target inflation will persist for longer. So much for expectations of "higher for longer"!
- Looking forward, given the typical 18- to 24-month time lag between broad money growth and inflation, CPI inflation will stay very low through 2025 and into 2026.

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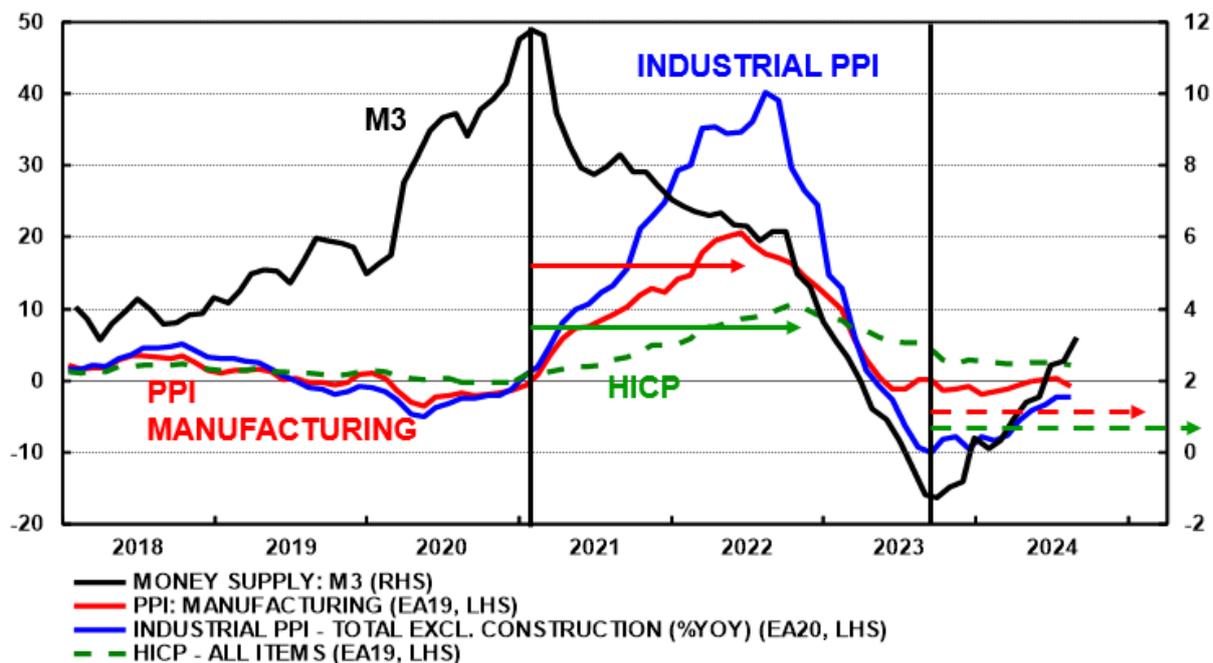
1. Introduction: a brief recap of ECB policies after Covid.

In IMM#24, “Europe’s Coming Deflation” August 2023, I forecast that negative M3 growth in the eurozone would translate into “outright deflation... in 2025”. Just over a year has passed and it is time to update that forecast.

The ECB began its tightening cycle with an announcement in December 2021 of the end-date in March 2022 of the ECB’s net purchases under the pandemic emergency purchase programme (PEPP) and of the asset purchase programme (APP) in June 2022. This was followed by rate hikes in the second half of 2022 from -0.5% to 2.0% and to 4% in the first nine months of 2023. As a by-product of these policies, M3 growth in the eurozone plunged from 6.2% year-on-year in September 2022 to -1.2% in September 2023 but has subsequently crept up to 3.2% in August 2024.

Having generated inflation through excess M3 growth in 2020-21, it now looks as though the ECB will administer a dose of **deflation** to the eurozone.

**Figure 1. Extrapolation of Time Lags between M3 Growth and Inflation
EUROZONE: M3, CPI & PPI INFLATION RATES (%YOY)**



Source: LSEG Datastream

In Figure 1 the solid red and green arrows indicate the lags in effect between the peak of M3 growth and the peaks in PPI inflation and CPI inflation respectively. Next, the dashed arrows show the likely timing of the low points in inflation assuming the lags in effect during the recent monetary contraction are the same length as during the monetary expansion phase of 2020-22. On this basis, the largest degree of deflation should start to appear in year-on-year terms in early 2025 for producer prices and around mid-2025 for consumer prices.

For more on the lags between money growth and inflation readers are encouraged to refer to “Five Lessons from the Covid Inflation”, IMM#43, published on 15 July 2024. In that study of 20 economies, the range for the lag in effect between broad money growth and CPI inflation (both measured as 12-month moving averages of year-on-year percentage changes) **varied from 19 to 35 months**, except for Brazil where the lag was just 14 months. The combined, unweighted **average lag in effect between the peaks of money growth and the peaks of inflation was 23.9 months** – very close to Friedman’s typical two-year lag between changes in monetary growth and changes in inflation.

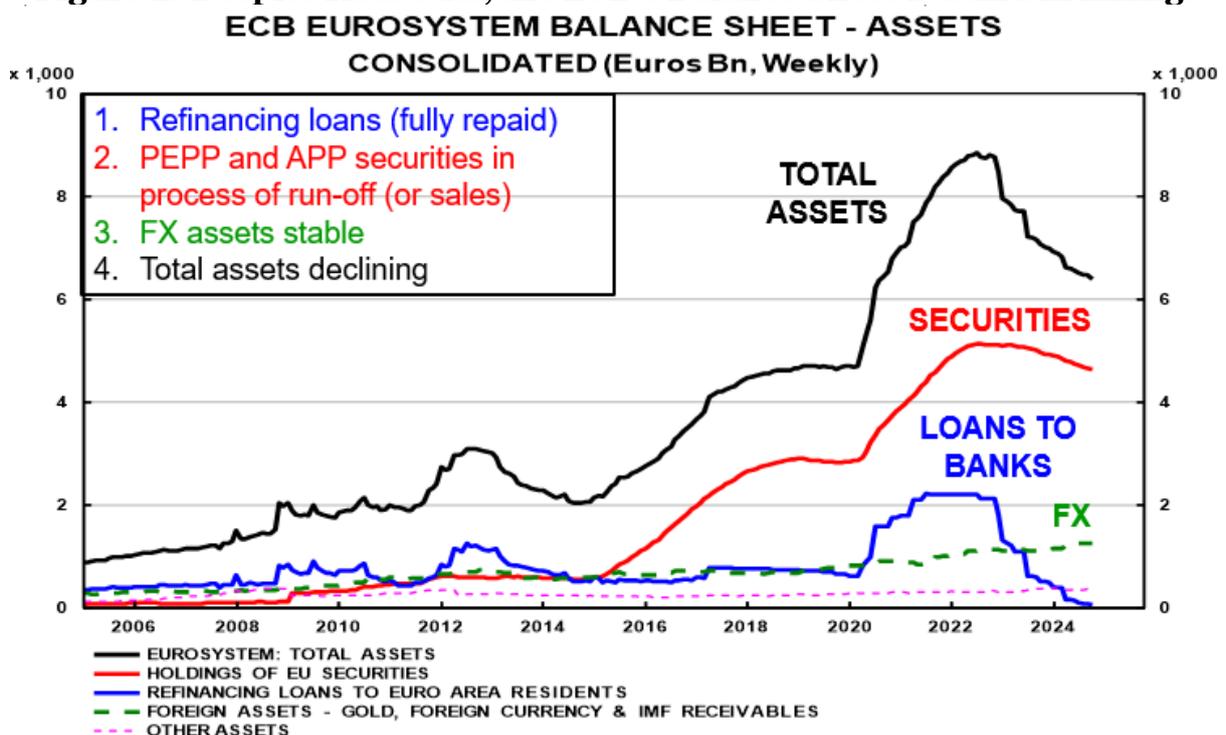
How much confidence can be placed in the forecast above that the most intense period of deflation risk in the eurozone will be in the first half of 2025? Several supporting strands of evidence can be drawn from the monetary effects that one would expect to see through the transmission mechanism. That is, if we are indeed to see some deflation, the effects of the monetary slowdown of M3 on asset prices, economic activity and consumer prices should already be apparent. The next sections consider these transmission effects in order.

2. Widening Evidence from the ECB’s Abrupt Monetary Slowdown.

In this section we will review developments on the balance sheet of the ECB, along with consequent changes in asset prices, business and consumer confidence, and economic activity.

2.1 The ECB’s Balance Sheet

Figure 2. Despite Rate Cuts, the ECB’s Balance Sheet is Still Shrinking.



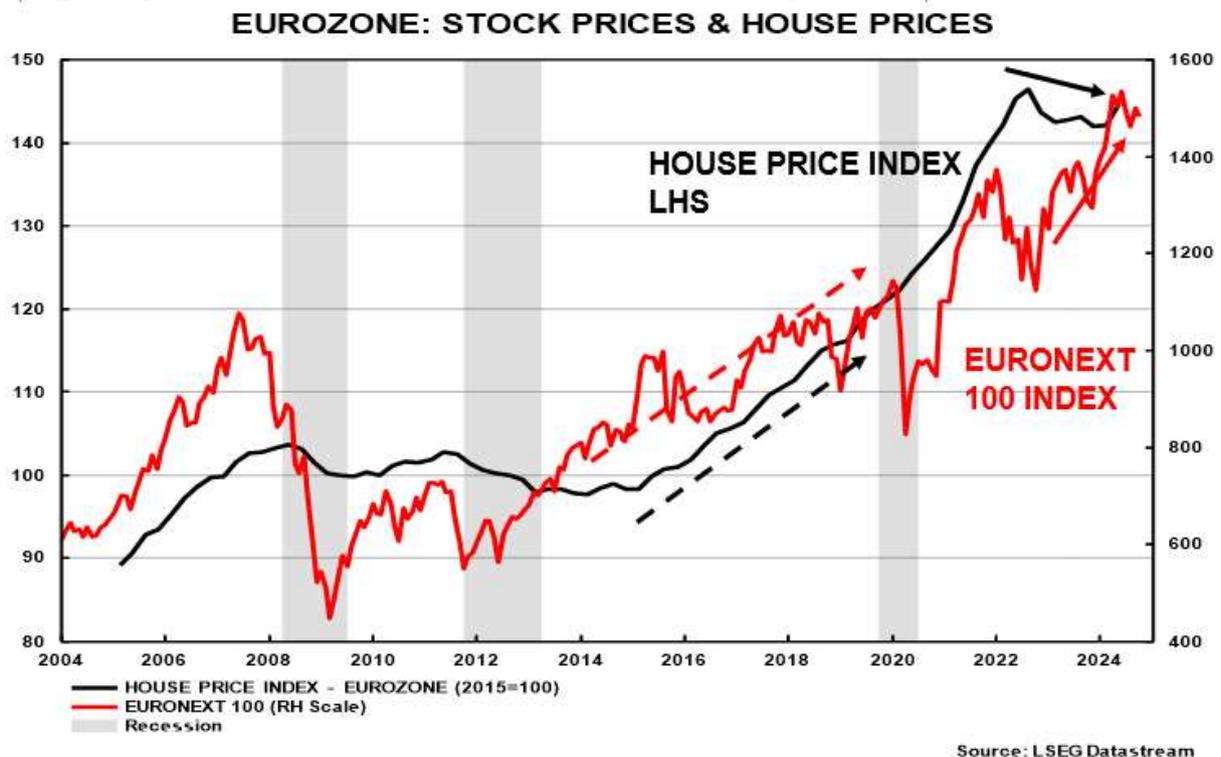
Although the ECB announced the ending of its easing policies between December 2021 and March 2022, it continued to raise rates until September 2023, and then held rates at unchanged levels (with the main refinancing rate at 4.5%) until June 2024.

Moreover, the balance sheet did not peak until June 2022 at 8.836 trillion euros, But it then began a steep decline from November 2022. Initially the refinancing loans (LTROs and T-LTROs) were repaid, as shown by the declining blue line in Figure 2. Subsequently a much slower decline in the holdings of securities by the ECB (shown by the red line) has begun, and this will likely continue for an extended period.

So far, the ECB has cut rates twice (in June and September 2024) in what purport to be easing actions. But at the same time, in quantitative terms, the shrinkage of the ECB's balance sheet implies an on-going tightening. Together the cautious rate cuts ("following market rates down") and the balance sheet shrinkage suggest that broad money growth will continue to be less than required for a full-scale easing. In other words, we should not expect any quick revival of M3 growth towards the 5% p.a. required to meet the 2% inflation target.

2.2 Asset Prices

Figure 3. Stock Prices Benefit from Global Rally, but House Prices Stall.



Asset prices typically respond sensitively to changes in monetary growth. As Figure 3 demonstrates, in the aftermath of the euro debt crisis (2011-12) euro-area stock prices and house prices rose steadily until the onset of the Covid pandemic in March 2020 (dashed arrows).

The steep downturn in equity prices in 2020 was followed by a strong recovery. House prices avoided any decline during Covid due in part to the increased demand for safe space, but like equity prices they surged on the back of rapid M3 growth in the single currency region.

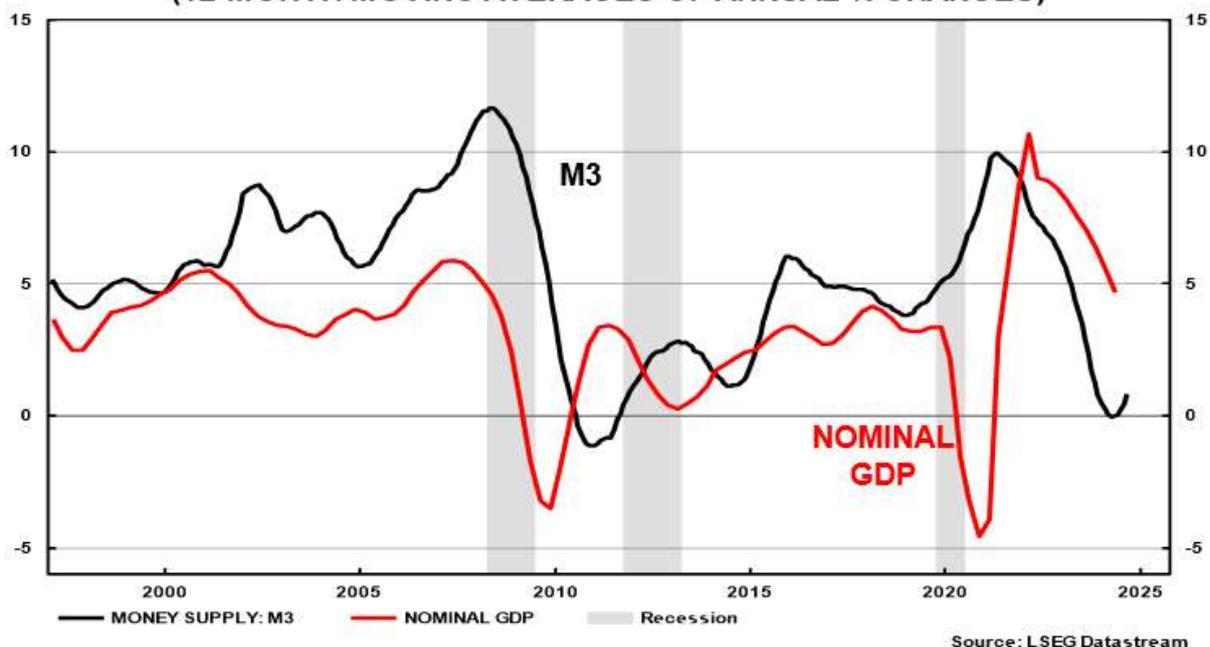
With inflation rising and monetary growth ceasing to be so expansionary in 2022, stock prices peaked in early 2022 while the index of house prices continued to rise until 2022 Q3. Since then, euro-area equities have followed the global upward trend, but house prices have been stalled across most of the region (solid arrows in Fig. 3).

The main takeaway is that without substantially easier monetary conditions in the eurozone – lower rates and especially faster M3 growth – European equities will be dependent on momentum in global markets while house prices are likely to remain subdued.

2.3 Economic Activity and Business Confidence

The Quantity Theory posits a relation between broad money growth and nominal income or spending, provided that income velocity (the inverse of the demand for money) is relatively stable. Since the founding of the eurozone in 1999 until the start of Covid, income velocity has fallen at an average rate of -2.1% p.a. (or -1.8% p.a. if we include the Covid period). Not surprisingly, Figure 4 shows a good relation between M3 growth and nominal GDP in the euro-area.

Figure 4. Trends in Nominal GDP Dominated by Prior M3 Growth
EUROZONE: M3 AND NOMINAL GDP (% YOY)
(12-MONTH MOVING AVERAGES OF ANNUAL % CHANGES)

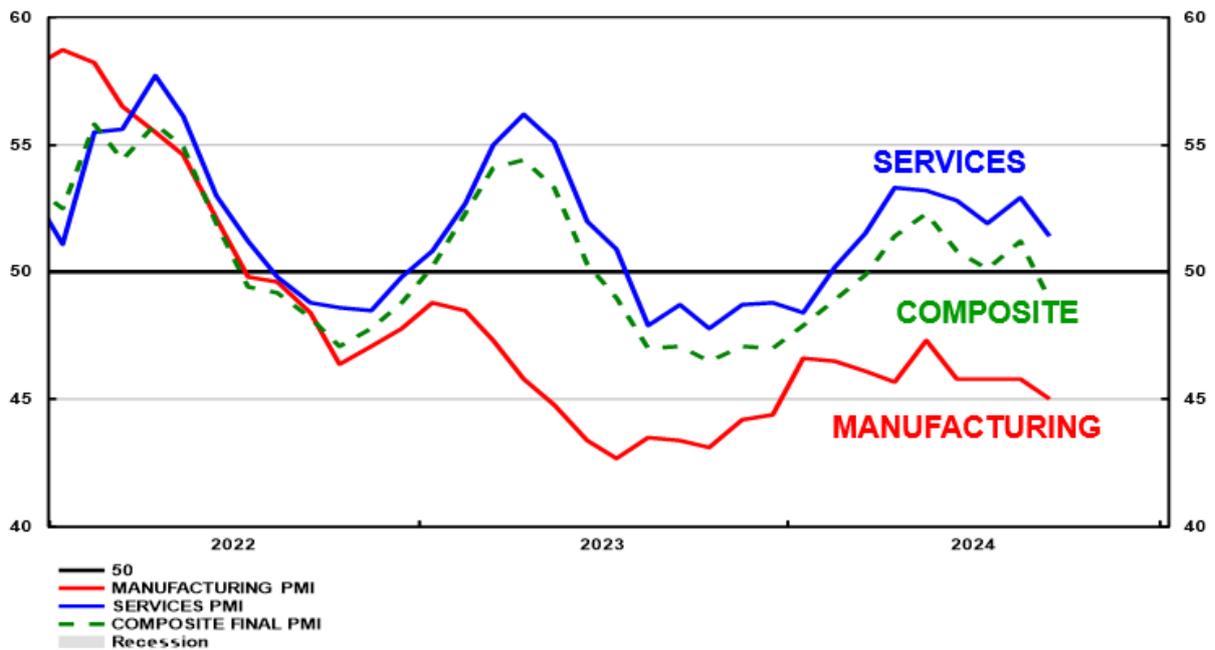


Focusing on the recent data only, due to the slump in M3 growth, nominal GDP growth (in red) will continue to decline for several more quarters, squeezing both real growth and inflation. Just as the negative growth of M3 in 2010-11 was followed by very weak

growth of nominal GDP, we should also expect very weak growth in the eurozone in 2025-26.

Figure 5. Eurozone Growth Weakness Already Apparent in PMI Indicators

EUROZONE: MANUFACTURING, SERVICES & COMPOSITE PMI (LEVELS)

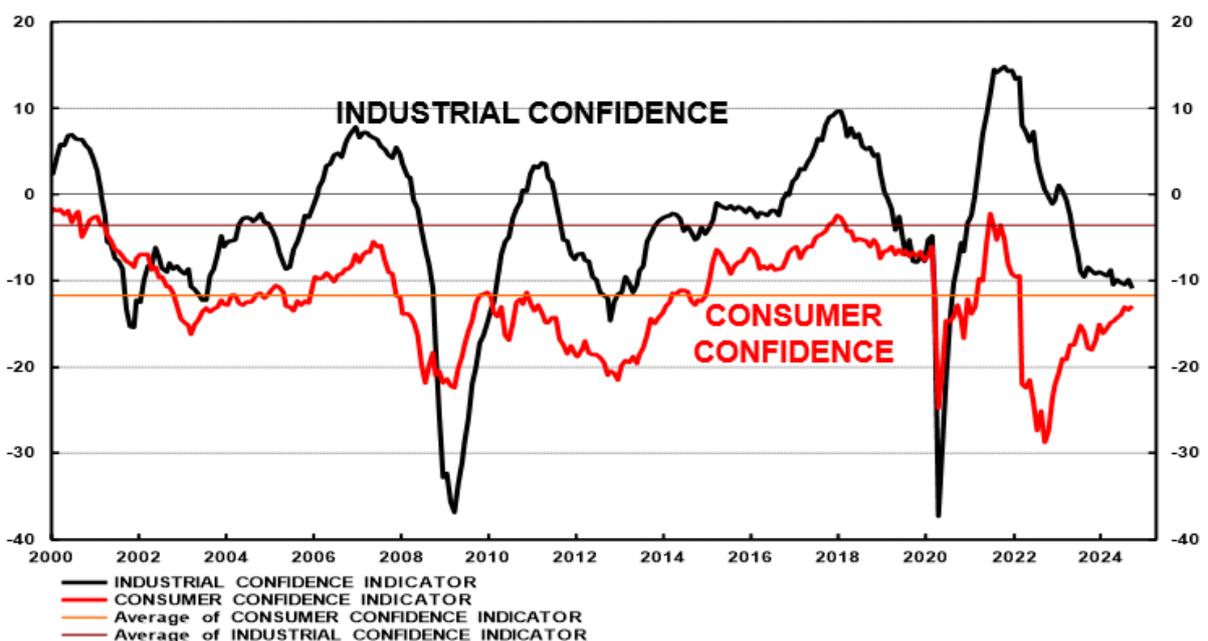


Source: I SFG Datastream

Signs of such potential weakness are already becoming evident in the PMI indicators shown in Figure 5, especially in manufacturing. It should also be noted that the composite indicator has fallen below the 50-mark which separates expansion from contraction in this diffusion index.

Figure 6. Business and Consumer Confidence Levels Deeply Depressed.

EUROZONE: BUSINESS & CONSUMER CONFIDENCE INDICATORS



Source: LSEG Datastream

Confidence indicators for the eurozone, shown in Figure 6, are already very weak. Industrial confidence (in black) surged strongly (though briefly) after the Covid lockdowns but has since fallen continuously from +14.8 in the second half of 2021 to -10.9 in September 2024. The current level stands well below the 25-year long-term average level of -3.5.

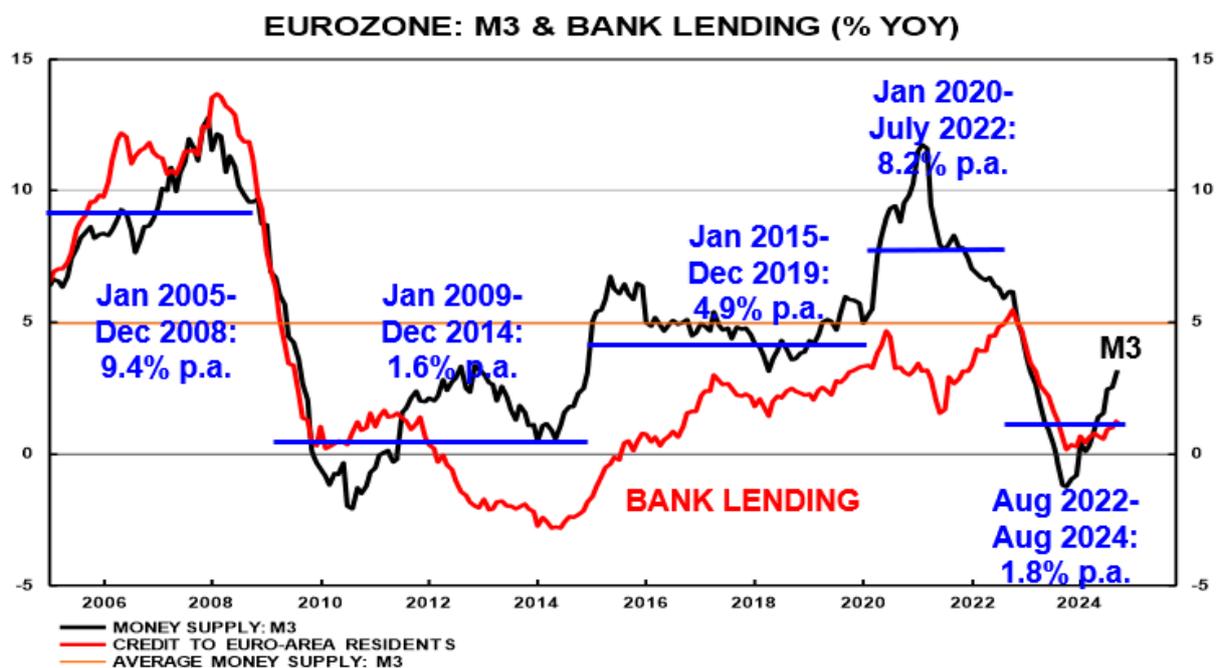
Consumer confidence (in red in Figure 6) has followed a slightly different trajectory, rising steeply until the June-September period of 2021, but then falling very abruptly on the outbreak of war in Ukraine in February-March 2022 until September 2022 and subsequently making a steady if unspectacular recovery. Like industrial confidence it still lies below its long-term average of -11.7.

These examples could be replicated with data from retail sales, industrial production, consumer spending, and no doubt other indicators. But the key attribute of the Quantity Theory is that it captures all these trends in the relationship between broad money growth and nominal GDP. The stability of that relationship is one of the underlying principles that forecasters and investors can usually rely upon.

2.4 Inflation

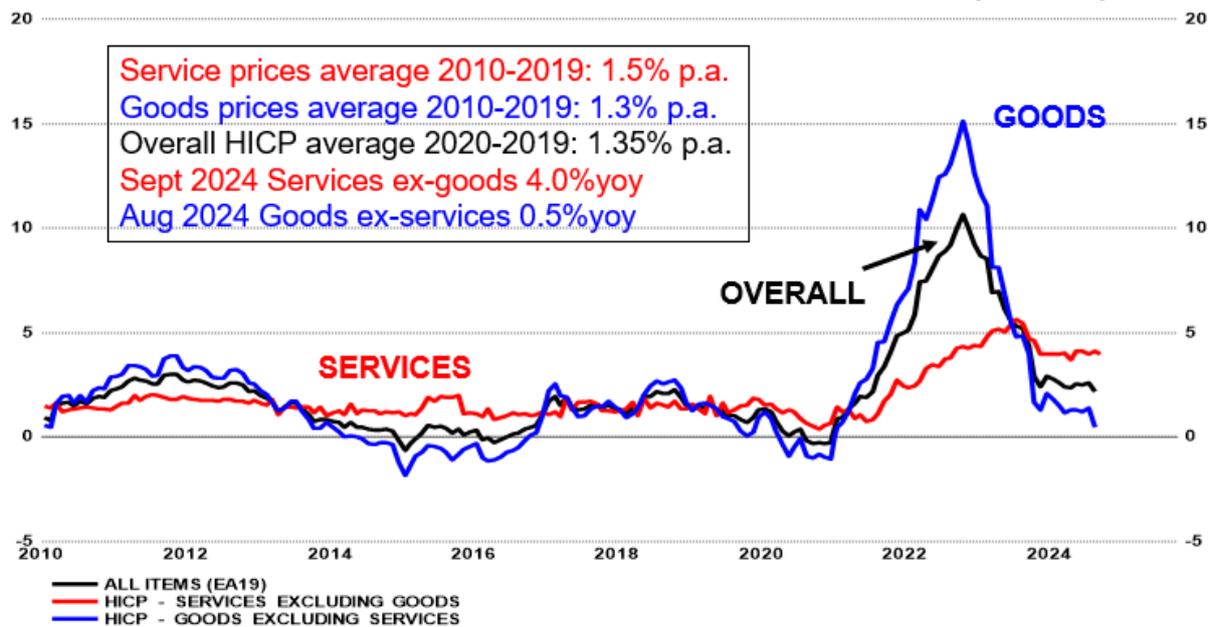
The account above shows that since mid-2022 each of the links in the transmission chain between a slowdown of eurozone broad money growth (M3) and the expected outcomes for the euro-area economy have, by and large, been fulfilled for asset prices, economic activity and confidence indicators. This leaves us with the question of what will happen to the HICP (harmonised index of consumer prices) inflation and its components.

Figure 7. After Creating Too Much Money during Covid, the ECB is Now Creating too Little



Given that Eurozone M3 growth is already so low (averaging just 1.8% p.a. over the past two years since August 2022, as in Figure 7), we must expect overall HICP inflation to fall to near-record low levels.

Figure 8. In HICP, Expect Service Prices to Fall to pre-Covid Average
EUROZONE CONSUMER PRICE INFLATION (%YOY)



As shown in Figure 8, the HICP inflation measure currently breaks down into 0.5% inflation for goods (ex-services) and 4.0% inflation for services (ex-goods). ECB officials and others are concerned that the higher level of service inflation may be sustained or even increase (e.g., due to wage-push), threatening another round of inflation. But monetary analysis tells us that there is little such risk.

If we consider the pre-Covid period 2010-2019 when M3 growth averaged 3.1% p.a., service prices averaged just 1.5% p.a. while goods prices averaged 1.3% p.a. (which included two periods of deflation), giving an overall average of the HICP of 1.35% p.a. (See box in Figure 8.) With M3 growth lower now than it was during the period 2010-19, the inflation outlook for the next two years must be for a return to inflation rates close to those pre-Covid averages.

Conclusions

This analysis has shown that many of the economic phenomena that we are seeing in the eurozone – the pause in house price appreciation, the weakness of nominal GDP and economic activity, and the slowdown of inflation – are all consistent with the prior deceleration of broad money (M3) growth. The monetary framework provided by Quantity Theory explains all these changes.

Further, they clearly suggest that euro-area inflation will slow further in 2024 and 2025 on account of the extremely low recent growth of M3. A period of deflation is



even possible if M3 weakens further. Of course, there may be shocks to the system – such as a jump in oil prices due the crisis in the Middle East – which would temporarily raise measured prices, but these relative price increases could not be sustained at the overall price level if the underlying monetary weakness persisted.

Summary and Investment Implications

- Having generated inflation through excess M3 growth in 2020-21, it now looks as though the ECB will administer a dose of **deflation** to the eurozone as forecast in IMM#24, “Europe’s Coming Deflation” (August 2023).
- Broad money growth (M3) has slowed from 11.8% year-on-year in January 2021 to a low of -1.2% in August and September 2023.
- Although the pace of M3 growth has picked up since then, it has averaged only 1.8% p.a. over the two years since August 2022.
- The analysis considered the outlook for inflation by checking that all the elements of the monetary transmission mechanism were in place.
- We observed that despite cutting rates, the ECB’s balance sheet is shrinking, putting downward pressure on the amount of money in the banking system.
- Initially tighter money (M3) growth hit asset prices (equities and house prices). House prices have been more adversely affected than share prices due to the on-going bull market in America.
- Nominal GDP and economic activity have been the next dominoes to fall, with manufacturing production especially badly hit.
- Goods and service price inflation, as always, will be the last symptom of the monetary squeeze to show up.
- Currently policymakers are still worrying about the possibility of a rebound of inflation from so-called “second round” effects (i.e. wage settlements etc.), which, earlier this year, was delaying rate cuts and monetary easing by the ECB.
- However, ECB balance sheet policies, Basel bank regulations, and the response of consumers and business to the current levels of interest rates all suggest that slow money growth will persist.
- In turn this means not only that inflation will be lower than most people expect – i.e. below the 2% target – but also that sub-target inflation will persist for longer. So much for expectations of “higher for longer”!
- Looking forward, given the typical 18- to 24-month time lag between broad money growth and inflation, CPI inflation will stay very low through 2025 and into 2026.
- As far as the investment implications are concerned, lower inflation is generally favourable for both bonds and equities, but if economic activity is so weak as to precipitate a recession and declines in corporate earnings, then a bear market in equities cannot be ruled out.
- Against this backdrop the ECB will need to continue cutting interest rates until M3 growth and economic activity have recovered. Depending on the timing of these additional rate cuts, equities could enjoy a temporary recovery.

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