France drifts into deflation as ECB 'pea-shooter' falls short

The Bank of Italy warns that any further falls in prices at this stage could have 'extremely grave consequences for economies with very high public debt levels'

France's price slide is comes at a delicate juncture - as many firms have been going bankrupt over recent months, as occurred during the Lehman crisis Photo: AFP

By Ambrose Evans-Pritchard, International Business Editor

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France is sliding into a deflationary vortex as manufacturers slash prices to keep market share, intensifying pressure on the European Central Bank to take drastic action before it is too late.

The French statistics agency INSEE said core inflation fell to -0.2pc in November from a year earlier, the first time it has turned negative since modern data began.

The measure strips out energy costs and is designed to "observe deeper trends" in the economy. The price goes far beyond falling oil costs and is the clearest evidence to date that the eurozone's second biggest economy is succumbing to powerful deflationary forces.

Headline inflation is still 0.3pc but is expected to plummet over the next three months. French broker Natixis said all key measures were likely to be negative by early next year.

Eurostat data show prices have fallen since April in Germany, France, Italy, Spain, Holland, Belgium, Portugal, Greece and the Baltic states, as well as in Poland, Romania and Bulgaria outside the EMU bloc. Marchel Alexandrovich, from Jefferies, said the number of goods in the eurozone's price basket now falling has reached a record 34pc.

"Eurozone deflation is now inevitable. There is no way around it," said Andrew Roberts, at RBS. "We think yields on German 10-year Bunds will fall to 0.42pc next year."

"The ECB is presiding over a deflationary disaster. They need to act fast and aggressively or else markets will start to attack Italian debt. Italy's nominal GDP is falling faster than their borrowing costs and that is pushing them towards a debt spiral," he added.

The Bank of Italy's governor, Ignazio Visco, said any further falls in prices at this stage could have "extremely grave consequences for economies with very high public debt levels, such as Italy".

Consumer price index (IPC) and Core inflation (ISJ) – year-on-year changes

Source : Insee - Consumer Price Indexes

The trade-weighted exchange rate of the euro has risen by 2pc over the past two months as the rouble plummets and currencies buckle across the emerging market nexus, despite the ECB's efforts to talk it down. This is a form of monetary tightening.

The German-led hawks at the ECB are running out of excuses for opposing quantitative easing after demand for the ECB's second auction of cheap four-year loans (TLTROs) fell short of expectations. "The TLTRO is a peashooter rather than a bazooka," said Nick Kounis, at ABN Amro.

Lenders took up just €129.8bn of fresh credit, far less than €270bn of old loans due to be repaid. This means that the ECB's balance will continue to contract – rather than expanding by €1 trillion as intended - unless it embraces full-blown QE. Alasdair Cavalla, at the Centre for Economics and Business Research, said QE was "all but inevitable" at this stage.

Mario Draghi, the ECB's president, vowed to pull out all the stops to head off deflation. "Let me be absolutely clear. We won't tolerate prolonged deviation from price stability," he said last week.

Yet the ECB council continues to insist that it will expand its asset purchases only "if needed", without explaining what the threshold is. Critics say it should already be obvious that full QE is needed immediately.

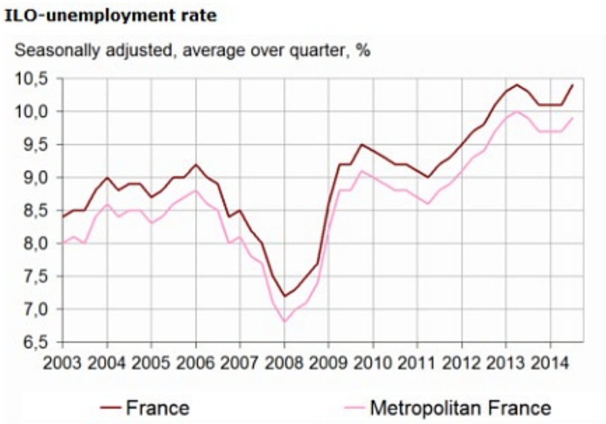
Mr Draghi faces stiff opposition from Germany's members, Jens Weidmann and Sabine Lautenschlager. He has to navigate a legal minefield involving one case at the European Court, and another likely case at Germany's top court against any QE.

Yet the hawks are becoming isolated. Their suggestions that QE will not work because rates are already low are hard to square with orthodox monetary theory. "The interest rate is totally irrelevant. What matters is the quantity of money," said Tim Congdon, at International Monetary Research. "Large scale money creation is a very powerful weapon and can always create inflation."

The tide is clearly moving in favour of sovereign bond purchases. Several ECB governors have given hints of strong action over recent days. Peter Praet, the ECB's chief economist, suggested this week that the latest oil price shock is a further reason for stimulus.

"Normally, any central bank would prefer to look through a positive supply shock. After all, lower oil prices boost real incomes. But we may not have that luxury at present. Shocks can change: in certain circumstances supply shocks can morph into demand shocks via second-round effects," he said

France's price slide is comes at a delicate juncture - as many firms have been going bankrupt over recent months as occurred during the Lehman crisis. The jobless rate has remained stuck at 10.4pc with a record 3.4m workers in "category A" unemployment. This spells political disaster for President Francois Holland, who asked voters to judge him on creating jobs.



The biggest price falls in France were in photographic, audio and information equipment (-7.3pc), medical goods (-3pc), household appliances (-2.5pc) and toys (-2.2pc). Even services fell slightly. "The struggle against deflation must be our absolute priority; at a national and a European level," said Karine Berger, a French economist and Socialist MP.

Mathieu Plane, at the French Observatoire, said a "dangerous dynamic" is setting in where high unemployment is sapping demand, causing companies to cut prices to hold on to market share. This in turn leads to further pay cuts in a vicious cycle. It is exactly what happened in Japan.

How we moderate

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