

Schroders

Global Economic Outlook

No need to feel deflated...



In summary:

- Deflation is back on the agenda
- We do not believe that deflation is a long-term problem – it could even benefit some areas of the economy
- Core inflation is expected to fall to 1% by 2010 – but promises to rise again, driven by emerging markets and the build-up of government borrowing

By Keith Wade, Chief Economist

After an absence of five years, the d-word seems, once more, to be the hot talking point for economic spectators. Having previously focused on inflation, attention has now shifted to the prospect of a global recession and falling commodity prices pushing the global economy into deflation in 2009.

Deflation – the opposite of inflation – describes downward pressure on the price of goods and services in an economy. It can be caused by a lack of supply of money or credit – clearly something we've witnessed in the last few months – and can have negative connotations for demand. This is because spending will often be delayed when consumers can see a clear downward shift in prices; when is something cheap enough? In previous periods of deflation this curtailing of growth has also, unsurprisingly, led to a rise in unemployment.

The Great Depression of the 1930s and the Japanese financial crisis of the 1990s are both often referred to as deflationary eras. No wonder then that the term arouses such fear in financial circles.

However, we believe it is important to distinguish between two types of deflation; the deflation caused by a fall in commodity prices and that characterized by a general fall in price levels. The former can be seen as a clear benefit to consumers: as household bills cheapen, individuals have more capital available for other spending which, in turn, could be viewed as a benefit to economic growth – depending on how that excess is used. It is also beneficial in decreasing the strain on those economies dependent on importing their commodities i.e. the OECD¹ and Asia. The latter is the type of deflation witnessed during the American and Japanese crises mentioned above, and the type that is truly to be feared.

We believe that the deflation that is likely to affect the economy next year will be of the favourable sort and that it should not be a dominant theme in the long run. That said, it is important to note that core inflation (a measure of inflation that excludes prices that are naturally subject to volatility e.g. food and energy) is expected to fall to 1% by 2010 – so, getting close to tipping over into negative

¹ OECD: Organisation for Economic Co-operation and Development. An international organization of thirty countries that accept the principles of representative democracy and a free market economy. Most members are high income economies and are regarded as developed countries.



territory. However, further out, inflation is likely to rise again as pressure from emerging markets and the build-up of government borrowing begin to take effect once more.

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