

FOR MARIO DRAGHI AND THE ECB, DEFLATION IS A MOVING TARGET

Luciano Siracusano — Chief Investment Strategist

11/30/2015

The euro area and the United States are comparable in numerous ways, including population and relative economic size. Since the financial crisis, they have also shared a common goal of escaping from the jaws of a [balance sheet](#) recession, as [deleveraging](#) has posed a headwind to economic growth on both continents. One shorthand metric to judge progress is the [inflation](#) rate, which today rests at zero in both regions. Currently, both central banks are targeting an inflation rate of close to 2 percent. In the States, the [Federal Reserve \(Fed\)](#) has delayed raising [interest rates](#) largely because of the lack of inflation in the U.S. as measured by the [Consumer Price Index](#) or the [personal consumption expenditure](#). Meanwhile, the European Central Bank's (ECB) president, Mario Draghi, recently signaled that he may take more aggressive action when the ECB convenes again on December 3. [His statement on October 22](#) signaled that [deflation](#) remains a problem in Europe. As a result, investors are surmising that this could mean the ECB might further ease [monetary policy](#) or even boost its [quantitative easing \(QE\)](#) efforts, which were announced in January 2015. Yet even though both the ECB and the [Federal Open Market Committee](#) have similar monetary tools, the Fed has the benefit of a unified country, where key economic data points reflect national averages and thus are more easily targeted by federal [fiscal](#) and monetary policy. In Europe, the ECB is making policy for an entire region, but it is a region consisting of 19 sovereign states. Borrowing a term from Japan's prime minister, Shinzo Abe, the ECB is left trying to hit an inflation target with only one arrow (monetary policy). Moreover, in Europe, deflation is a moving target, as some countries show price inflation, while the largest countries—Germany, France, Italy and Spain—still struggle to free themselves from the specter of falling prices.

Country	GDP(\$B)	% Weight of Euro Area GDP	Annual Inflation Rate, 1/15	Annual Inflation Rate, 9/15
Euro Area	13403		-0.60%	-0.10%
Germany	3853	29%	-0.50%	-0.20%
France	2829	21%	-0.40%	0.10%
Italy	2144	16%	-0.50%	0.20%
Spain	1404	10%	-1.50%	-1.10%
Netherlands	870	6%	-0.70%	0.30%
Belgium	533	4%	-0.60%	0.90%
Austria	436	3%	0.50%	0.60%
Finland	271	2%	-0.10%	-0.70%
Ireland	246	2%	-0.40%	0.00%
Portugal	230	2%	-0.40%	0.90%

Sources: Eurostat, Trading Economics, as of 11/9/15. The table displays the Western European countries in the euro area.

European Inflation Rates

Since January, Belgium has seen a 1.3 percentage point increase in its inflation rate. Yet Spain, a country that was experiencing severe deflation, has only reduced the rate of deflation by less than half a percentage point. Likewise, Finland has actually seen prices fall 0.6% since the start of European QE. So when the ECB shoots, what is it aiming for? "The ECB's definition of price stability makes clear that the focus of its monetary policy is on the euro area as a whole," according to the ECB's website. But in 2011, Fernanda Nechio of the Federal Reserve Bank of San Francisco found that by using the Taylor rule, "a policy guideline that generates recommendations for a monetary authority's interest rate response to the paths of inflation and economic activity," the euro area's [core countries](#) and [peripheral countries](#) do not fall in line with the ECB's one-size-fits-all target rate.¹ Essentially, the pieces work when pulled together, but when viewed separately, they tend to fall short of the ECB's target (especially in the case of the peripheral countries). Currently, all the countries on this list are falling short of the "close to 2%" target. This makes the possibility of additional ECB action in December likely. The larger question will be how the ECB will react when a majority of its members are closing in on the target but many of the "peripheral" countries, such as Spain, are left far away from the bull's eye. If history tends to repeat itself, it seems the ECB will continue to focus on the euro area as a whole and leave the less fortunate countries to fend for themselves. Presently, the euro area as a whole is still far from its inflation goal. Even excluding the impact of falling food and energy prices, [core inflation](#) across the continent is only 1.1 percent.² The euro has weakened

in the last few weeks in response to Draghi's public musings. Further euro weakness and additional [credit](#) easing in Europe would, in our view, be [bullish](#) for the local recovery now taking shape across the region. That could provide another leg up for the European equity rally, particularly for U.S. investors who make the effort to mitigate the impact of a depreciating euro to their stock portfolios. ¹Fernanda Nechio, "Monetary Policy When One Size Does Not Fit All," Federal Reserve Bank of San Francisco, 6/13/11. ²Source: Trading Economics.

Important Risks Related to this Article

Investments focused in Europe increase the impact of events and developments associated with the region, which can adversely affect performance.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

Deleverage : Bring down levels of debt.

Inflation : Characterized by rising price levels.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Consumer Price Index (CPI) : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Personal Consumption Expenditure (PCE) Price Index : measure of price changes in consumer goods and services in the U.S. economy.

Deflation : The opposite of inflation, characterized by falling price levels.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Fiscal Policy : Government spending policies that influence macroeconomic conditions. These policies affect tax rates, interest rates and government spending, in an effort to control the economy.

Core inflation : Inflation excluding the impact of food and energy.

Credit : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.

Bullish : a position that benefits when asset prices rise.