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

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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.

European Inflation Rates

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.

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. [1]Fernanda Nechio, "Monetary Policy When One Size Does Not Fit All," Federal Reserve Bank of San Francisco, 6/13/11. [2]Source: Trading Economics.

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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.

Euro area's core countries : Austria, Belgium, France, Finland, Germany and the Netherlands.

Euro area's peripheral countries : Greece, Ireland, Portugal and Spain.

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.