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EUROPE NEWS

# Euro-Zone Consumer Prices Weaken to Five-Year Low

*Consumer Prices in Euro Zone Grew 0.3% in August Year-Over-Year*

By BRIAN BLACKSTONE

Updated Aug. 29, 2014 6:11 p.m. ET

The European Central Bank gets back to work after the summer next week with inflation in the euro zone now down to 0.3%. That may not prove enough for them to bring in new policy measures. But it and investors will watch the latest economic data from Germany closely. Elsewhere, the Bank of England meets, while U.S. nonfarm payrolls data are expected to show the country adding a healthy number of jobs again.

FRANKFURT—Europe's struggle to prevent [ultralow inflation](#) from discouraging business investment and undermining the continent's fragile economy deepened as consumer prices dropped in August to a five-year low.

The data released Friday keeps pressure on the European Central Bank to take more dramatic stimulus measures to boost demand and inflation, and comes just days after ECB President [Mario Draghi warned of the risks of investors' falling expectations](#) for consumer-price growth. His remarks were seen as suggesting the ECB is moving closer to large-scale purchases of public and private debt, known as quantitative easing, at a time when the U.S. Federal Reserve is nearing an end of its stimulus program.

Most analysts expect the ECB to refrain from taking that step when it meets on Thursday, but some

economists expect smaller easing measures, such as rate cuts, to underscore the ECB's resolve to act.

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Consumer prices in the euro zone grew 0.3% in August from the previous year, the European Union's statistics office said Friday, down from 0.4% in July and far below the ECB's target of inflation just below 2%. Much of the decline reflected falling energy prices. Prices grew 0.9% when food, energy and other volatile items were excluded, up a bit from

July. That removes some of the urgency for the ECB to respond as soon as next week.

Still, "the euro zone is one big shock away from deflation," said Stephen Cecchetti, professor at Brandeis University.

Deflation refers to persistent declines in prices that lead to a vicious cycle of weak profits and declining levels of business investment. The effects have already started to hit several euro zone members, particularly in southern Europe. Spain's consumer-price drop deepened to 0.5%. Italy on Friday reported its first annual decline in consumer prices since 1959, by 0.1%, based on its national measure. Five of the euro zone's 18 countries have falling prices, according to BNP Paribas.

"Deflation is a serious threat for our business," said Giovanni Ferrero, chief executive of Ferrero International SA, the Italy-based maker of Nutella, Tic Tac and other candies and chocolates.

"We're not only in a situation of low inflation. In some markets, distributors are asking us for deflation," he said, referring to price cuts. Although this can be a positive for consumers' pocketbooks, the trend "in reality destroys value," he said. "The cost of production is constantly on the rise. It's unthinkable to expect that prices couldn't recover costs without cutting cash-flow generation, investments and jobs."

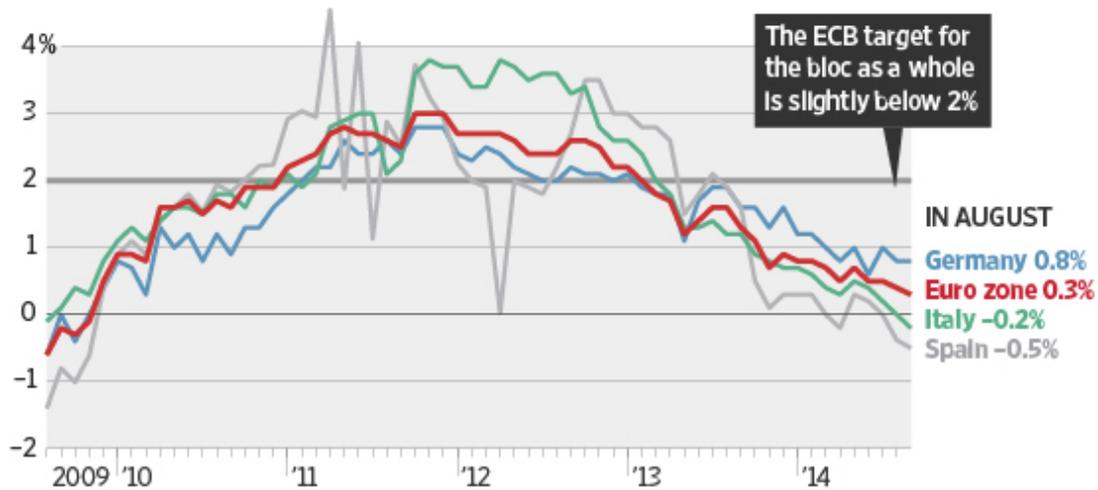
The threat of deflation is more pronounced in Spain, which has a public and private debt load equal to about three times the size of its gross domestic product. Weak or falling prices make it harder for households, businesses and governments to service debts that are typically paid off at fixed interest rates, since incomes and revenues stagnate in a deflationary environment.

Though the danger of too-weak prices was once limited to Greece and other struggling economies, it has spread to healthier economies, too.

# The Euro Zone Flirts With Deflation

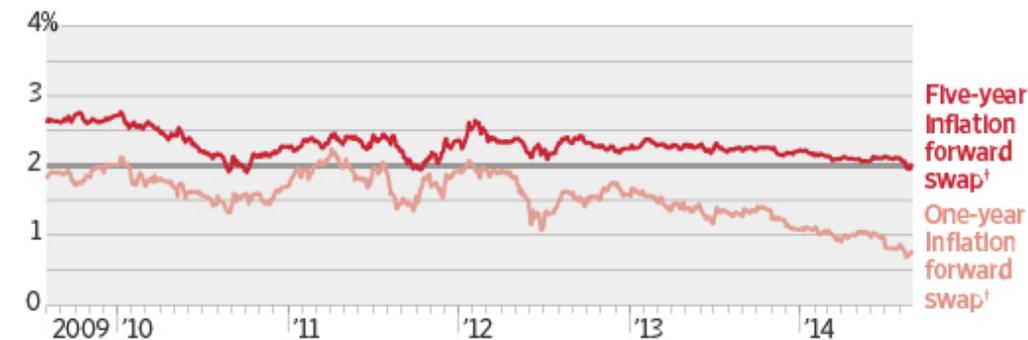
## Slowing, Stalling and Falling

Inflation slowed in August in the euro zone and was unchanged in Germany. Prices fell in Italy and Spain. Change from a year earlier in consumer-price indexes\*



## Anchors Away

Financial-market measures of how investors expect consumer prices will evolve, once firmly anchored, now show that investors expect inflation to weaken.



\*Note: national consumer-price indexes for Spain and Germany; harmonized indexes for Italy and the euro zone

†Market expectations of annual inflation rates that will prevail beginning one year and five years in the future.

Sources: national statistics offices via Thomson Reuters (Germany, Spain); IStat (Italy); Eurostat (euro zone); Royal Bank of Scotland (inflation forward swap rates)

The Wall Street Journal

"The environment in terms of pricing is very challenging," said Alexandre Ricard, deputy chief executive of French drinks maker Pernod Ricard SA, which sells drinks ranging from Absolut vodka to Martell cognac.

Pernod Ricard on Thursday said that despite the pressure on prices amid low inflation in Europe, the company was [able to increase prices for its drinks](#) on average by 2% in its fiscal year, which ended June 30. Mr. Ricard predicted that in the 2014-2015 year, the company won't be able to push through price hikes as high as that.

It isn't just business leaders who struggle with weak prices. They are a headache for central bankers, too. Fighting high inflation typically requires growth-draining rate increases, but it is easier for central bankers to explain what they are doing. People feel the pain when prices rise.

It is harder to explain using unusual tools such as negative interest rates or asset purchases to fight the opposite problem: when inflation is too weak. After all, central banks strive for low—albeit positive—

inflation. And households benefit from lower prices, particularly for items that make up a big chunk of their budgets like food and energy. Businesses are helped when the prices for supplies and raw materials fall.

"Due to the fact that raw material prices did not increase as expected, we see an additional positive effect [of] around €80 million (\$105 million) for this year," said Wolfgang Schaefer, chief financial officer of German tire and auto-parts maker Continental AG.

But in the longer term, very low prices tend to damp business investments and hiring. The key question facing Europe, analysts said, is how long inflation stays near zero. In the most recent worrying development, the euro-zone economy stalled last quarter.

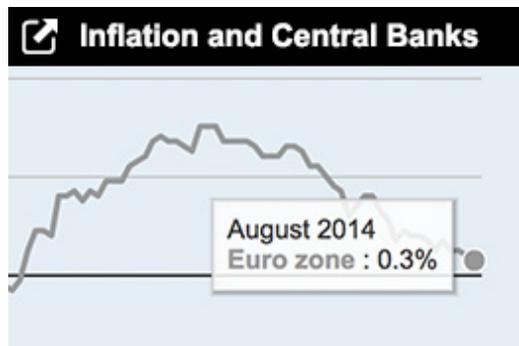
U.S. Federal Reserve officials worried about deflation threats earlier in the economic recovery, leading them to purchase trillions of dollars of bonds in an effort to boost the economy and guard against deflation. Now the central bankers face inflation that remains subdued, but at more comfortable levels.

A key U.S. inflation gauge released Friday by the Commerce Department showed prices up just 1.6% in July from a year earlier. That was below the Fed's 2% inflation target for the 27th straight month, giving Fed officials plenty of latitude to move cautiously in raising interest rates from near zero.

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### Central Bank Watch >

Here is how the central banks in four major advanced economies have moved two key levers of monetary policy in recent years, and how two important economic indicators have responded. [View the interactive.](#)



The ECB has said quantitative easing is an option, but has resisted it on the expectation that inflation will gradually rise. The policy is unpopular in Germany, where it stirs deep-rooted fears of politically captive central banks financing governments by printing money.

But Mr. Draghi appeared to change course earlier this month when he said: "Over the month of August financial markets have indicated that inflation expectations exhibited significant declines at all horizons."

Inflation expectations are key to whether temporary, and sometimes beneficial, price declines morph into more pernicious deflation. Financial measures of how inflation will look starting in five years fell in August, as did consumer-based expectations.

Yet with the ECB having waited so long to try bold steps like bond buying, the question may arise "whether it is already too late," warned analysts at BNP Paribas.

—Manuela Mesco, Ruth Bender and Neetha Mahadevan contributed to this article.

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