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Chart of the week: Deflation risk as Eurozone inflation falls to 4-year low [1]

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Summary: Euro area inflation is at a 4-year low; a bout of falling prices in 2014 is possible

What the chart shows: The chart shows the twelve-month per cent euro area inflation, headline and core,

Why the chart is important: Deflation, like rapid inflation, is bad for countries. This is even more the case when there is a debt overhang, as there currently is in many euro area countries. A number of factors highlight the risk of falling prices in the EA in 2014. Broad money growth is once again slowing. There are large and persistent negative output gaps in all EA countries, showing substantial slack in the economy. The euro is now more likely to rise than to fall. And, finally, the scope for further increases in taxes and administered prices is limited. In theory, the ECB could easily avert deflation by boosting broad money growth. But technical problems and a disinflationary bias mean that this is unlikely to happen. The most we are likely to see are, in order of likelihood, a cut in the policy interest rate; the introduction of negative interest rates for bank reserves held with central banks; and attempts to talk down the euro. The first and the third will have little effect, the second may prove somewhat useful.

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