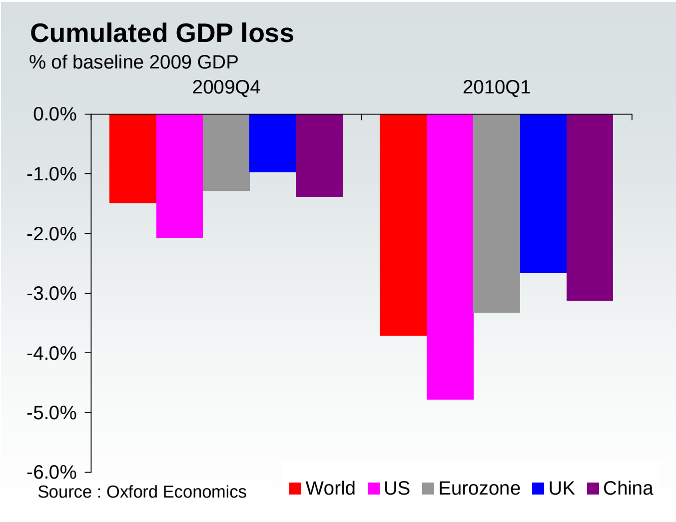
# Could swine flu tip the world into deflation?

Health experts agree that while the current flu epidemic that started in Mexico in April 2009 may weaken during the summer, it could re-appear in the autumn, possibly in a stronger form. Besides the assessment of the likelihood of such a pandemic breaking out that relates to medical and health policy factors, it is useful to evaluate the possible economic impact should a pandemic occur. Using historical benchmarks of previous flu pandemics and of the SARS episode, we have estimated the economic impact of a global flu pandemic.

Under reasonable assumptions about infection and death rates (30% and 0.4% respectively), the duration of the pandemic (six months from October 2009) and responses by households and businesses to the pandemic, we estimate that world GDP would be cut by around US$2.5 trillion in the six months of the pandemic, or 3.5% of 2009 GDP.



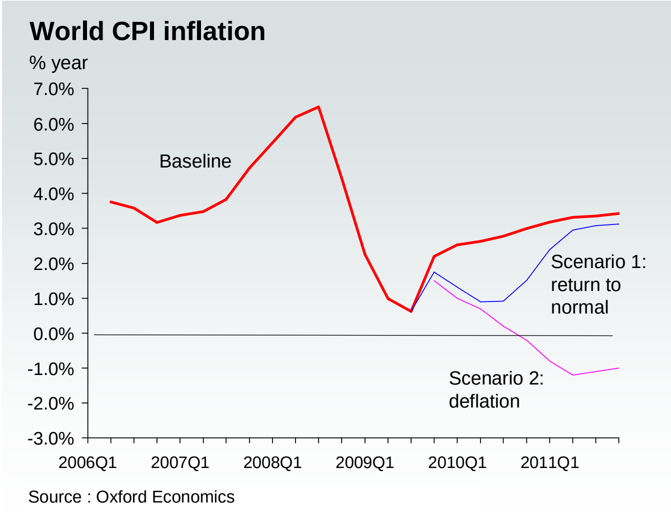

The channels through which a swine flu pandemic would affect the economy are manifold. They include supply effects as employees cannot go to work due to illness or death. They also include demand effects. In particular, consumption of discretionary goods and services such as restaurants or tourism is likely to be cut as consumers (and business travellers) stay away from crowded places in order to avoid infection. In addition, heightened uncertainty about economic developments is likely to make businesses postpone investment. Increased uncertainty would also have a negative impact on financial markets, bringing lower share prices and higher market interest rates than warranted by the economic situation.

Due to the global nature of the pandemic, all countries and regions are affected. Our scenario assumes that the pandemic starts in North America. The US economy is therefore hit relatively harder than other developed economies, with a GDP loss of nearly 5% of 2009 GDP in the six-month pandemic period. However, the Eurozone and the UK would also lose around 3% of 2009 GDP.

Different industries would be affected differently. Those selling non-essential goods and services would probably be hardest hit. In particular, as the SARS experience showed, travel and tourism is likely to fall sharply (international travel to Asia was down by around 60% during the SARS outbreak).

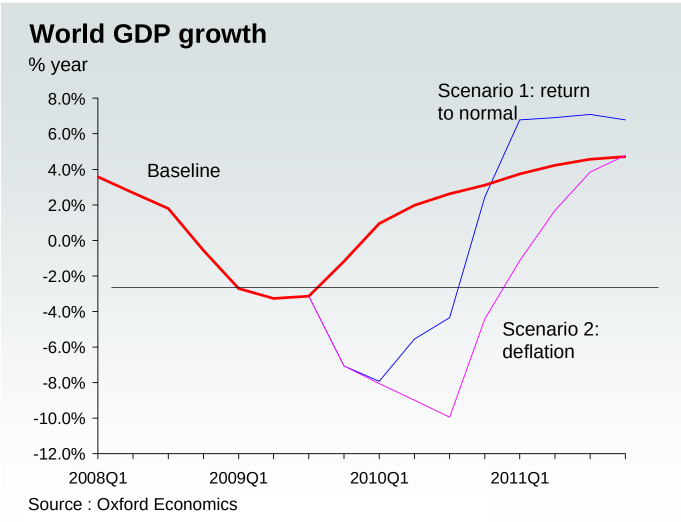
Weaker demand would keep inflation rates lower for longer. At first, the drop in inflation is limited due to fixed wage contracts. By 2010Q1, world consumer price inflation is around ½% below the baseline. But the disinflationary trend continues and deepens as rising unemployment and lower demand exert downward pressure on prices and wages. By the end of 2010, world CPI inflation is around 1.5% below baseline, just above 1%. In this scenario, Japan is in deflation and Chinese inflation falls to zero.

The lower inflation environment would allow monetary policy authorities to postpone planned interest rises. However, in many countries, policy setters would have no room to support the economy as interest rates are at or very close to the lower bound. For instance, in our baseline forecast, US official rates are at 0.25% in 2010Q1 and the ECB and the Bank of England rates are unchanged from now at 1% and 0.5% respectively. With fiscal balances already recording very large deficits (around 9% of GDP in the US, more than 5% in the Eurozone and nearly 12% in the UK in 2009), there is also very little room for fiscal support.




Once the pandemic wears off, the world economy may gradually recover. At least some of the pent-up demand that builds up during the pandemic would be realised, pushing 2011 GDP growth above our baseline forecast.

However, there is a significant risk that the world economy does not return to normal. The fact that the pandemic would occur just when the economy starts to recover could mean that the impact is longer-lasting than suggested above. Rather than catching up on postponed spending, households may raise savings for a longer time. In addition, companies that are already fragile after the recession may succumb to this new shock. Another factor that makes a worse scenario quite likely is the fact that the pandemic would occur around Christmas, when a lot of discretionary spending takes place.




In this case, consumer spending would remain lower for longer as households prefer to keep higher savings rates. Travel and tourism would remain depressed for longer. As unemployment rates keep rising well past previous peaks, downward pressure on wages would build. And financial markets would experience another bout of protracted malfunctioning.

We estimate that under such a scenario the world economy would fall into deflation. CPI inflation would fall to -1% in 2011. World GDP would be down nearly 8% in 2010 and growth would only return to positive quarter-on-quarter rates at the end of 2010.

In conclusion, while the world economy should in principle be able to cope with a swine flu pandemic, there is a significant risk that the pandemic might trigger a set of unfavourable behavioural changes that tip the world into deflation. A flu outbreak in the autumn would hit the world economy just as it starts to recover from the credit crunch. It would prolong the rise in inflation, threaten already fragile businesses and put further strains on financial markets and fiscal balances. This could generate a vicious cycle that postpones the recovery for another couple of years.