Europe’s political leaders cannot afford to be complacent about deflation in the Eurozone

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Figures released on 7 January by Eurostat indicate that inflation in the Eurozone turned negative in December. But should we be concerned about deflation? As **Gerhard Illing** *notes, some economists have made the case that falling prices could have positive consequences, with the recent fall in oil prices in particular constituting a positive supply shock. He argues however that there are very real risks associated with persistent low inflation and that a complacent policy response could set the Eurozone on a path toward long term stagnation.*

In December 2014, headline inflation (technically the change in the ‘harmonised consumer price index’ or HPCI) in the Eurozone became negative – the rate was 0.2 per cent lower than in December 2013. After a peak at 3 per cent at the end of 2011, inflation has been falling steadily. Since 2013, the European Central Bank has persistently undershot its target rate for inflation of below, but close to 2 per cent. In some periphery countries, deflation seems to have become the new normal.

Part of the recent decline in inflation across the Eurozone is a temporary phenomenon – mainly the result of falling energy prices. But core inflation (excluding energy and food) shows a similar trend, falling from 2 per cent at the end of 2011 to 0.8 per cent in December 2014. More worryingly, inflation expectations (as measured according to the ECB survey of professional forecasts) have also been falling recently: In Q2 2014, the two year ahead mean forecast is now just 1.4 per cent (compared to 1.9 per cent in 2011). Even the 5 year forecast, which for a long time has been well anchored at 2 per cent, recently declined to 1.8 per cent.

Should we be concerned about deflation in the Eurozone?

Some argue that falling prices are a good thing, allowing us simply to buy more stuff. They see no evidence for a risk of a sustained self- reinforcing deflationary spiral provided that long term inflation expectations stay positive. Quite the contrary, they see the spectacular collapse of oil prices as a positive supply shock, boosting real income across the whole Eurozone. Such complacency, however, ignores that slowing prices and stagnant wages are mainly the result of a lack of demand due to a deep recession in large parts of the Eurozone. With unemployment and real debt rising steadily, people in these regions simply cannot afford to buy more stuff. When investors reduce their long-term growth expectations and start to adapt to weak growth and low inflation, growth pessimism is likely to trigger adverse hysteresis effects.

Certainly, in some parts of the Eurozone, the economy is booming. In Germany, the unemployment rate has come down to a record low level not seen since the unification boom in 1991. There is no sign that German workers postpone purchase of durable consumption goods, expecting a steady decline of prices. So right now, the risk of a sustained deflationary spiral is still low. Even in Japan, with inflation rates hovering around 0 per cent for more than 20 years such a devastating spiral has not been triggered. But this is not good news. In Japan well anchored long-term inflation expectations (between 1999 and 2013, they stayed consistently more than one percentage point above the actual average rate of inflation) did not help to prevent the Japanese economy from suffering over two lost decades.

Persistently low rates of inflation are a reason to be seriously worried. What we really need to be concerned about is the fact that despite fairly good times in the core countries, the target rate of 2 per cent across the Eurozone has been missed for two years, with no visible sign of a reversal of the negative trend. Even in the boom areas, both overall and core inflation have stayed significantly below 2 per cent and are further declining (with 0.5 per cent HCPI and 0.9 per cent core inflation in November 2014 in Germany). As long as overall Eurozone wide inflation stays too low, monetary policy is simply too tight to help smooth the internal adjustment process urgently needed within the Euro area. Instead, it severely hampers adjustment and recovery. With output below potential since the start of the financial crisis, complacency with falling rates of inflation would be a dangerous guide towards secular stagnation, with the risk of one or even more lost decades.

ECB President Mario Draghi, Credit: European Central Bank (CC-BY-SA-3.0)

The reasons are straightforward. Relative prices and wages within the Eurozone need to adjust to make periphery countries more competitive. Let's try a simple thought experiment and assume that the weight of both core and periphery countries is one half for the whole area. With wages and prices falling by 2 per cent in periphery countries, wage and price inflation in the core countries need to rise to 6 per cent in order to achieve the overall target of 2 per cent inflation. As long as even in the core countries average inflation is stuck below 1 per cent, this puts severe additional pressure on wages and prices to fall in the crisis countries. There have already been dramatic cuts in real wages implemented in the public sector in many periphery countries. But ample evidence suggests that negative nominal wage adjustments in the private sector are extremely hard to enforce. It is much easier to implement adjustments in real wages via inflation, while keeping nominal wages constant. But as growth in the Eurozone is stagnating, the lower the overall rate of inflation, the longer the adjustment will take, threatening to reinforce a process of long run stagnation.

Alas, challenges in the Eurozone are even more dramatic. Stagnant or falling wages and prices aggravate the real burden of debt, resulting in severe losses for debtors. High real rates make it increasingly difficult to service the debt – the more so since most private loans and interest rates were locked in at a time when inflation expectations were well anchored around 2 per cent. In many crisis countries like Ireland, Spain and Portugal, indebtedness of private households exceeds those of the public sector. Debt deflation puts enormous strains on consumption in these countries at a time when unemployment rates are soaring. Of course, unexpectedly low rates of inflation may result in gains for creditors. But that is true only as long as the debt is likely to be repaid. As the rising real debt burden increases the risk of defaults in the periphery, creditors in the core countries may also turn out to be losers from this development.

How can low inflation be addressed?

So there are good (or rather bad) reasons to be concerned about inflation being on the wrong track in the Eurozone. The tricky part is how to fight low inflation. With interest rates already close to zero, standard monetary policy virtually ceases to be effective. During the last months, the ECB tried hard to ease financial conditions using some non-standard monetary policy measures, both by providing ultra-cheap loans targeted to those banks lending to small and medium-sized enterprises and by purchasing private sector assets (covered bonds and asset backed securities). Up to now, however, the success has been fairly limited.

Even though borrowing rates for households and businesses are falling also in stressed economies, lending activity to non-financials is still depressed and inflation outlook steadily deteriorating**.** TheECB's balance sheet has contracted further – an unfortunate feature of "passive tightening". Since 2007, other central banks (the Fed, the Bank of England, the Swiss National Bank and recently even the Bank of Japan) have expanded their balance sheet much more forcefully than the ECB. In all these countries, unconventional monetary policy via massive quantitative easing (mainly by purchasing government bonds) helped to stabilise inflation without triggering inflationary spirals.

Apart from political resistance to such measures, the specific structure in the Eurozone (the lack of a central fiscal counterpart for the ECB and the resulting absence of “safe assets” – government debt issued by a central fiscal agency a central bank can buy and sell without any credit risk) imposes tough limits on the feasibility of unconventional policy measures. Given this structure, there are strong incentives for the ECB to avoid potential fiscal risks. This creates a natural tendency to act too cautiously. Unfortunately, however, not acting is likely to impose fiscal risks that are even larger. For that reason, decisive actions are needed to combat the risk of inflation being too low.

Aiming to expand its balance sheet by 1 trillion, the ECB most likely will launch a massive quantitative easing programme on 22 January, with outright purchases of government bonds, despite strong resistance from the Bundesbank. At the same time, the ECB is likely to try to stick to “pure” monetary policy operation in order to avoid taking on Euro area fiscal tail risk. So presumably credit risk of sovereign debt purchases will remain on the balance sheets of national central banks. By attempting to minimise real sharing of risk, the likely impact of such unconventional measures is bound to be rather limited.

In the absence of debt mutualisation, spreads on peripheral market debt may even increase, thus reinforcing the fragmentation of monetary policy. The most obvious recipe for success at the Zero Lower Bound is one that requires coordination between the monetary and fiscal authorities. For example, at the start of its quantitative easing programme the Bank of England was assured that any potential losses it may incur will be indemnified by the UK Treasury. As long as policymakers in the Eurozone are reluctant to take similar urgent action, effectiveness of monetary policy is bound to be severely hampered.

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Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.

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