Deflation in Greece!? What do they (not) know?

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The latest Interim Forecast by the European Commission makes some gloomy predictions for the Greek economy in 2012 but, interestingly, on the issue of inflation it states:

Constant-tax inflation in 2011 was 1.2% in 2011. However, for an economy in deep recession, the inflation rate reveals deep inflexibility in product and services markets. In 2012 the price rise trend is expected to be reversed, resulting in slight deflation of 0.5%. The main driving force stems from anticipated falls in disposable income and consumer spending due to wage cuts in the private sector.

(added emphasis is mine; the repetition is theirs!)

It is of course a positive sign, that the economists at the Commission have come to realise what 'any fule kno' in Greece: that downward price rigidities in the country are immense. Perhaps in the future they may make the additional step and come to realise that, by implication and given the sizeable reduction in nominal wages in 2011, inflation in the country is not (predominantly) driven by wage pressures.

But what is more startling in the text quoted above is the anticipation of deflation in 2012. This is based on a very simple principle of (neoclassical micro-)economics: the decline in disposable incomes shifts the demand curve to the left and the economy adjusts reaching a new equilibrium at lower prices (and lower consumption). So prices fall. And this is deflation! [Add to this the market deregulation measures (licensed professions, wage bargaining, and all that) and we get an extra fall of prices, through the outward shift of the supply curve – although the Commission report does not seem to make much of this (just a quick comment on "medium-term" effects).]

So, there you have it: deflation in Greece. Is it possible!? In a country that manages to have simultaneously the deepest recession and the highest inflation rate in the Eurozone, is it really possible to experience deflation – especially at a point in time when economic sentiment is hoped to be improving? I am very sceptical. Although research on the topic is not exactly in excess supply, there seem to be some peculiar determinants of price rigidity in Greece that are very persistent. Some of these are structural but some are behavioural – and as such, they are only remotely affected by the level of incomes (or, for that matter, by deregulation policy such as the liberalisation of closed professions and wage bargaining). This is why, despite the Single Market, despite the much lower incomes and purchasing power of Greek households, despite the country's much lower labour (and other) costs, and despite the fact that the country is entering its fourth year of recession, a German fridge is more expensive in Greece than in Germany (the comparison is for the KGN39H76 Bosch model, but you can play around with others; milk is actually a better – or, should that read 'worse'? – example).

Let me highlight five of these determinants: import-push inflation, production inefficiencies, price collusion, the revenue-income conflation and consumer attitudes.

Import-push inflation. In a country where imports of goods are twice as high as manufacturing GVA, it is not difficult to see how the reduction in domestic labour costs and the fall in demand will have very little effect on actual consumer prices. The impact of international energy prices is a big part of the story here, but it is not the only one.

Production inefficiencies. Greece is a small country, with low (and declining) domestic demand and relatively poor accessibility. All these characteristics, as any textbook will tell you, contribute to raising distribution and operational costs – and thus final prices. Add to these the fragmentation of production, bureaucratic rigidities, and the absence of economies of scale, and you already have a good part of the explanation of high – and fast-growing – prices.

Price collusion. Another part of the explanation is the pricing policies of retailers in Greece –including the infamous supermarkets. In a small market, with too few providers and too much concentration of capital, competition doesn't work as nicely as in the textbooks. Prices are determined more on the basis of the 'ability to extract surplus' and less so on the basis of some full-competition profit maximisation condition.

Revenue-income conflation. But it is not only aggressive pricing by avid supermarket-owners that does the job. In Greece 40% of employment is accounted for by the self-employed. 96% of all businesses are small or medium size. While a large part of retail trade is conducted by single-person or family owned businesses. For all of them, sales revenues equate automatically and categorically to household income. (Forget about capital depreciation, profit reinvestment, etc.) For them, unlike in 'perfect markets', the optimal strategy in response to a reduction in demand is to increase their prices: this is the first and only strategy for maintaining their income levels intact. The option to reduce prices in order to attract more custom is not in the logic of the small retailer of Greece.

Consumer attitudes. But this is not the end of the story. Nor does it explain why the logic of the Greek retailer remains such, despite the continuous fall in her household income. Greeks like to show-off (I need to acknowledge here, and warn the reader about, the ills of over-generalisation and stereotyping: not all Greeks, not always, and not in all things), they like to buy expensive stuff, they don't like the 'cheap', they enjoy 'spend big' even if they have to reduce other aspects of their consumption to the bare minimum. Consumer behaviour in Greece has many of the characteristics of the 'bandwagon effect' and 'conspicuous consumption' that Veblen so elegantly talked about over 100 years ago. Blame it to the residuals of past sufferings («κατοχικό σύνδρομο»), blame it to the years of affluence since the 1980s and after the 'cheap money' of the Euro, the fact of the matter is that the Greek consumer has (decreasingly so, but still) an attitude of 'price-tag quality', where perceived quality and use-value are determined by the price of a good – and not the other way around. This makes price- and income-elasticities in Greece somewhat 'peculiar' and not compliant to the rules of economic theory which produce the downward price adjustments that the Commission economists are hoping for.

What does all this mean for the anticipation of deflation in 2012? To me, it shows that there is still a lot of wishful thinking about, and very little understanding of the conditions of, the Greek economy. The economists of the Commission should know that Greece's persistent inflation does not simply "reveal deep inflexibility in product and services markets", but things that are more structural and more difficult to shoo-away with the reduction of the minimum (basic) salary and the compression of incomes. Sure, the squeezing of incomes does reduce demand – and it is changing consumer attitudes. But Greece's price rigidity problem is too complex and too embedded in society and in the structure of production to allow this income squeeze to translate into deflation. And one should not forget that deflation is not a blessing, it is often a problem. More importantly, even with deflation, real household incomes can continue to be eroded owing to the substantial differences in the rate of change between the prices of basic and more price-elastic goods. And so, the prediction about deflation in 2012 is neither a happy nor a very plausible scenario…