# The Spectre Haunting Europe

**By Bob Hancké, LSE**

With inflation dipping significantly below 1% in the euro zone, we have now entered dangerous territory, and it is far from obvious how to get out. The basics first: an average inflation rate of 0.7-0.8% is far below the already tight target that the ECB has set itself of ‘below but close to 2%’ (in the medium run). The economies in the euro zone that are doing well, such as Germany and most of its neighbours, are, by any measure, not experiencing particularly high inflation: most estimates are around 1.5-2% for those. Because of the low inflation in the core, a large number of EMU member states are now experiencing deflation or something very close to that. The inflation rate in the single currency bloc is the GDP-weighted average of all, and that means that the low inflation in the core is mirrored in even lower inflation c.q. deflation in the periphery.

One way out would be for the core to start running inflationary wage policies. If German wages grew at, say, 3 or 4%, and its neighbours would also have an expansionary policy, then countries such as Portugal and Spain could easily have a inflation rate of about 1-1.5% without endangering the ECB’s target. Those are hardly excessive inflation rates to begin with, but they would make adjustment in terms of current accounts easier by encouraging exports to the fast-growing north of the continent, and they would erode public and private debt considerably faster than an inflation rate of around 0% would. But it is in fact very hard to imagine Germany and the rest of north-western Europe doing so: their economies are too dependent on exports as a source of demand, and the entire wage-setting system is organised around the need to keep export prices under control. Considering the large number of jobs directly and indirectly dependent on exports in the north west of the continent, it is not entirely clear what exactly the incentives are to drop wage moderation.

The other way out is the one that the north should have adopted a few years ago already, but it is never too late: an expansive fiscal policy, based on the notion that many of the governments in the north, but especially Germany, can now borrow money at extremely low real interest rates. If the northern economies used the low-cost funds to invest in infrastructure, from roads via schools to broadband, the demand thus created would suck in exports from the struggling countries in the periphery – and, as a bonus, better prepare the northern economies for the future. Alas, the clamours of austerity emanating from the northern capitals make that option problematic as well.

That EMU was misconceived is now pretty much obvious to anyone willing to cast a critical glance. It produced massive imbalances because of the flows of hot money as a result of what is in essence a pro-cyclical monetary policy (low inflation countries face higher real interest rates than high inflation ones and vice versa); when a country faces adjustment problems, as half the continent does today, they are left on their own, since the ECB is not really their central bank (which means that they have borrow in a – hard – currency which is not their own); and if the neighbours interfere, in the guise of the troika, they impose draconian austerity policies that fail to address the issue, since they lower GDP growth and thus increase the debt and deficit over GDP ratios regardless of the actual adjustment efforts in the debtor countries.

This deadlock is not stable. Eventually something will have give. Either the core countries accept their responsibility in reorganizing EMU in the direction of a mutual insurance mechanism, thus lifting the periphery out of its misery, or EMU becomes economically and politically unsustainable. The extremely low inflation on the continent is only the tip of the iceberg.

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