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Deflation in Europe: curse, ogre or benign?

Benjamin Fox

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Prices across the eurozone fell by 0.6 percent year-on-year in January, according to figures released by Eurostat on Wednesday (4 February).
The data published by Eurostat demonstrates that the 0.2 percent drop in prices in December was no one off. The eurozone economy last saw falling prices in 2009 but it has never experienced a protracted period of deflation.

But that is what is facing the bloc now. The eurozone's largest economy Germany reported last week that it had slipped into deflation to the tune of 0.5 percent in January, making it likely that further price falls can be expected in the coming months.

In its Winter Economic forecasts, also published on Thursday, Economics commissioner Pierre Moscovici revealed that prices would not start to increase until the second half of 2015.

All of which has got a number of economists and policy-makers very hot under the collar.

The Economist has described deflation as "the world's biggest problem". IMF boss Christine Lagarde has compared it to an "ogre" which "could prove disastrous" for the eurozone's recovery during a speech in Washington last month. And last month, the European Central Bank launched a €1.1 trillion bond-buying programme, in part, to prevent it.

In her Washington speech Lagarde commented that "if inflation is the genie, then deflation is the ogre that must be fought decisively".

Lagarde's remarks made her the first high-profile policy-maker to warn that extremely low inflation in the eurozone could result in the kind of falling prices that have dogged Japan's economy for two decades.

At first glance, the statistics do not appear to justify such bleak language.

Most of the recent fall in prices has been attributed by the EU's statistical agency to the recent slump in oil prices, resulting in an 8.9 percent fall in energy prices in January. If food and energy are stripped out of the calculations, eurozone prices were still rising at an inflation rate of 0.5%, down from 0.7% the month before. However, this is still well below the ECB’s target rate of 2 percent.

Announcing its €1.1 trillion money-printing programme last month, ECB president Mario Draghi said that the programme would remain in place “until we see a sustained adjustment in the path of inflation which is consistent with our aim of achieving inflation rates below, but close to, 2%”.

Why does it matter?

Like most things in economics, inflation and deflation is about public confidence.

Prices fall when consumers and businesses delay purchases and consumption - usually because they are nervous about their personal economic prospects, which in turn reduces overall economic activity and can lead to a so-called 'deflationary spiral'.

Meanwhile, lower-than-expected inflation also increases the real burden of pre-existing debts. Lenders benefit, but because they are more likely to save than borrowers, demand is sapped overall.

Deflation also increases rigidity in the labour market. Workers are resistant to wage cuts in cash terms, but inflation lets firms cut real wages by freezing pay in nominal terms. Deflation, by contrast, makes this problem worse.

That, at least, is the theory, and the experience of Japan, which has suffered more than 20 years of near stagnation since a financial crash in the 1990s, partly as a result of very low inflation, is a fate which the EU is anxious to avoid.

But economists are far from united in viewing a mild fall in prices as disastrous.

Charles Prosser, the President of the Philadelphia Federal Reserve Bank, has argued that despite the fear mongers, the historical record and recent experience - aside from the Great Depression in the 1930s - show that most periods of mild deflation have led to economic growth rather than stagnation.

Others have argued that deflation can be ‘benign’ or even a good thing.

In a paper for the Cato Institute, a conservative think tank, George Selgin, says that “a little deflation can be a good thing, provided that it is the right kind of deflation.”

“Benign deflation.. is a result of improvements in productivity, that is, occasions when changes in technology or in management techniques allow greater real quantities of finished goods and services to be produced from a given quantity of land, labor, and capital.”

Speaking with EUobserver last month, Franziska Ohnsorge, author of the World Bank’s Economic Prospects report, was relatively sanguine about the deflation threat.

“We could see several months of negative inflation…but this would not be that big a problem,” Ohnsorge contends. The real risk, she says, is that long-term inflation expectations become ‘de-anchored’ from the 2 percent rate targeted by the ECB.

Arguments about the dangers of inflation and deflation are a fact of life for students of the ‘dismal science’.

For the moment, however, the combination of almost non-existent economic growth and stubbornly high levels of unemployment make comparisons between the eurozone economy and Japan’s twenty year deflationary experience since the 1990s irresistible.

If not an ogre or a catastrophe, six months or longer of deflation will just serve as another delay to the eurozone's recovery. And that is hardly benign.