POLICY VIEWPOINT

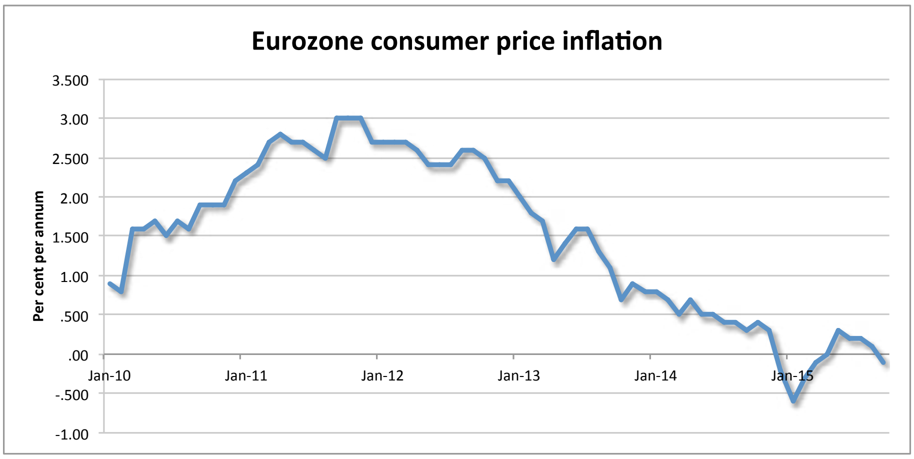
OCTOBER 2015

Eurozone policy-makers should heed deflation warning

Written by
Jo Michell , Senior Lecturer in Economics, Bristol Business School, UWE

The eurozone is once more on the brink of deflation. As of September, the official estimate of annual price inflation was -0.1 per cent (see Figure 1). Inflation has declined steadily from a peak of around three per cent in late 2011.

FIGURE 1: EURO CONSUMER PRICE INFLATION



Economists are divided on the potential dangers posed by deflation. Falling prices driven by large drops in the prices of commodities, such as oil, increase the purchasing power of consumers. If consumers spend these windfall gains on domestically produced goods and services, the increase in demand may act as a stimulus to growth.

This was the prevailing view when, in the first quarter of 2015, Europe briefly tipped into outright deflation. It was then widely argued that there was little cause for concern since retail sales growth was strong and manufacturing and services output were expanding. Furthermore, with the introduction of quantitive easing by the European Central Bank, it was expected that higher lending alongside devaluation of the currency would further strengthen demand.

The positive signals from retail sales growth and private sector economic activity appear to be fading. The eurozone is almost entirely reliant on German growth – France is on the verge of tipping back into recession – while Germany is ever more reliant on demand for exports. Such imbalances cannot last indefinitely (See FEPS Economic Policy Viewpoint No. 11).

The implication is that the probability of a 'bad deflation' scenario is rising. While falling prices may increase the value of the money in consumers' pockets, they may also induce consumers to postpone purchases in the expectation that prices will fall further. Perhaps more significantly, given the level of indebtedness of eurozone periphery, deflation increases the real burden of debt and requires a greater share of income to be spent in servicing that debt.

At the global level, falls in commodity prices may reflect weakening demand, particularly from China. There are clear indicators that the economic recovery in the US is faltering. Declining global demand will more than offset any positive impact from exchange rate devalution.

How should European policy-makers respond to the situation? Mario Draghi has made clear that the ECB stands ready to increase the scale of monetary stimulus in the event that deflationary tendencies strengthen. But the effectiveness of such stimulus, especially when implemented in isolation from other measures, is increasingly open to question. The US Federal Reserve and Bank of England embarked earlier than the ECB on large programmes of quantitative easing, yet both the US and the UK are also on the verge of outright deflation. While such programmes were effective in re-inflating asset prices, capital investment - vital for sustained economic growth - continues to languish at historically low levels. Private debt levels and current account deficits continue to deteriorate.

Despite mounting evidence that quantitative easing is a flawed policy tool it remains the only approach to macroeconomic stabilisation acceptable to the political orthodoxy. But recourse to yet more electronic money printing will do nothing to overcome the structural problems of the eurozone - problems which the European political class appear as determined as ever not to address.

Foremost among these problems is the chronic lack of demand across the monetary union. While the deflationary effects of high saving in

AE ECONOMIC COUNCIL OF THE LABOUR MOVEMENT
CDPR CENTRE FOR DEVELOPMENT POLICY AND RESEARCH
FOUNDATION FOR EUROPEAN PROGRESSIVE STUDIES
FONDATION EUROPÉENNE D'ÉTUDES PROGRESSISTES

Germany and the Netherlands remain as strong as ever, the imposition of austerity across the periphery implies that these deflationary tendencies in the core can no longer be offset by spending elsewhere. As a result, the eurozone is entirely reliant on external demand for exports.

Figure 2 shows the eurozone current account balance, disaggregated into the major sub-components. Since the start of 2010, when the zone as a whole was in external balance, the current account surplus has risen steadily, driven entirely by a rising trade surplus – matched by massive excess savings in Germany and the Netherlands. The ballooning trade surplus is driven almost entirely by rising exports – imports have barely changed over the last five years. As a consequence, the eurozone is enormously exposed to a fall in global aggregate demand – a fall which looks increasingly likely as the chaos in commodity markets intensifies.

In order to escape deflation and recession, the eurozone is banking on the US and the UK continuing to play their role as global consumers-of-last-resort. This is a high-risk strategy. It is also unneccessary: the blueprint for an alternative Europe is clear – it requires an end to austerity, a sustained increase in investment spending in the periphery, wage rises in the core and a fiscal mechanism to recycle surpluses back to deficit areas. Detailed macroeconomic modelling of such a programme was presented in a recent FEPS Policy Brief.

The likelihood of a shift towards this kind of rational macroeconomic strategy is slim. The efficiency with which European policy-makers subdued the attempt by the Greek SYRIZA government to re-orient eurozone policy-making was sobering.

Instead, the eurozone is focused – in the form of the capital markets union – on removing barriers between regional financial markets. It is hard to imagine a policy more expressly designed to ensure deeper financial contagion when the next crisis hits. Aside from that, the eurozone appears content to sit and wait.

FIGURE 2: EUROZONE CURRENT ACCOUNT