Deflation

Recent price developments in the euro area demonstrate that deflation is a serious issue of concern. Some euro area countries are already facing a deflation in the usual macroeconomic sense of a “general price decline”. This article discusses the economic consequences of deflation and suggests that the ECB’s expansionary monetary policy was inevitable.

The possible economic consequences of deflation are high-priority issues for most central bankers and economists, but they have never attracted much attention among the general public in Germany. The picture has changed in the last couple of years, as the sustained crisis in many euro area countries has raised concerns about the stability of the euro area as a whole and has stimulated political debates about the fiscal imbalances and redistribution issues among member states. The recent decision by the European Central Bank (ECB) to embark on a massive quantitative easing (QE) programme – for several reasons quite a few years behind the schedule of other large central banks – has led public commentators in Germany to claim that the German tradition of stability-oriented monetary policy has been forsaken by the ECB. This step, it is argued, will possibly result in a sustained softening of the euro, thereby destroying the wealth accumulated by prudent savers, among other adverse effects.

The first purpose of this article is to discuss briefly the economic consequences of deflation. The second objective is to present publicly available empirical facts about recent price developments in the euro area, which demonstrate that deflation is a serious issue of concern. Specifically, we argue that Europe was on the brink of disaster and – given the imposed constraints of austerity obsession and fiscal policy hands-tying – the ECB’s monetary easing was inevitable.

A refresher course in deflation economics

Deflation is defined as “a general decline in prices, with emphasis on the word ‘general’”. Macroeconomists usually are very clear about the distinction between relative price changes versus a general decline in the price level. However, sector-specific price declines might affect the skewness of all relative price changes, which has lasting impacts on the aggregate inflation rate as a consequence of nominal price rigidities. However, a process of self-enforcing deflation only becomes relevant in situations of protracted insufficient aggregate demand. As Ben Bernanke stated several years before the recent financial crisis and subsequent Great Recession:

Deflation is in almost all cases a side effect of a collapse of aggregate demand, a drop in spending so severe that producers must cut prices on an ongoing basis in order to find buyers. Likewise, the economic effects of a deflationary episode, for the most part, are similar to those of any other sharp decline in aggregate spending – namely, recession, rising unemployment, and financial stress.

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1 For long-term trends, see for example Google’s Ngram viewer using the search items “Inflation” and “Deflation” for books published in German.
3 To some extent, the economic policy debate among German economists seems to be de-coupled from international strands of argumentation. See also J. Muellbauer: Combating Eurozone deflation: QE for the people, VoxEU, 23 December 2014.
7 B. Bernanke, op. cit.
At least two channels through which deflation affects economic activity are regularly cited within the deflation literature: the debt-deflation theory arguments dating back to Keynes and Fisher and the aggregate demand/expectations nexus.\(^8\) In short, for debt-deflation theory proponents, deflation is seen as a redistributionary process between debtors and creditors as long as contracts are fixed in nominal terms. This creates a huge burden on creditors, possibly leading to a credit crunch. Pigou argued that such an adverse effect might well be overcompensated by an increasing real value of aggregate wealth, giving rise to a stimulating effect on consumption and aggregate demand as a whole.\(^9\) Such an effect could arise in “modern macroeconomic models” because of inter-temporal consumption behaviour (more wealth over the life cycle, \textit{ceteris paribus}, implies less savings today and more consumption today, given that net wealth exists). This first channel is mainly the concern of financial intermediaries, central bankers and professional investors, but it seems to be of minimal interest to the general public, at least in Germany.

There is a second channel, which could be labelled the “aggregate demand/expectations nexus”, which asserts that deflation, as a process of general price declines driven by insufficient demand, may turn self-reinforcing if persistent expectations of future deflation become strong. In a world with forward-looking consumers and investors, it is reasonable to assume that consumption and investment expenditure is shifted into the future if further price declines are expected, thus reinforcing the deflationary spiral.

Under such circumstances, it is necessary for monetary policy to act fast and, more specifically, to act before expectations are anchored to future deflation. This makes credible, strongly committed and timely monetary policy actions crucial. As Ben Bernanke argued, the deflation-fighting argument is strengthened if it is assumed that deflation is “in almost all cases” a phenomenon of insufficient demand, which according to any macroeconomic school (at least in the short run) can and should be cured by monetary expansion.\(^10\) However, nominal interest rates can only be lowered to the zero bound, unless central banks adopt unconventional measures to pursue their goals. This is what happened with the ECB’s decision to “lift all boats” through unconventional monetary easing. Several observers – most prominently former ECB chief economist Ottmar Issing – argued recently that the ECB was (extremely) overreacting and that deflation was not a big issue.\(^11\) In the following, we present arguments demonstrating why this is not the case.

**Arguments and assessments**

We begin by looking at the development of general price changes. Figure 1 presents inflation rates for several European countries as well as for the euro area as a whole. Year-on-year inflation rates dropped to zero or even turned negative for most euro area member countries during the last several months. This is most pronounced for Greece and Spain. One could argue that this development is to a large extent driven by falling energy and food prices.\(^12\)

This is surely a reasonable argument, given the sustained decline in energy and food prices over the last two years. We therefore calculated price indices excluding food and energy prices (see Figure 2). Clearly, this measure of core inflation did not fall in such a dramatic fashion as the overall inflation rate. Nevertheless, the core inflation rates of Greece, Spain and Portugal have fallen close to or even below the zero bound. Furthermore, one can observe that core inflation rates in the remaining economies are also far below the ECB’s target of below, but close to, two per cent. Looking at the recent historical evidence, one could argue that the current development looks a bit like 2009 – when the ECB escaped a deflationary situation without relying on

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10 B. Bernanke, op. cit.

11 O. Issing, op. cit.; K. Bernoth et al., op. cit.