Briefing Paper “Risk of Deflation or Stagflation?”

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Risk of deflation is not zero, but it is low

I. When do we speak of deflation?

The term deflation is used when the general price level falls over several years. The situation is characterised by excess supply on the goods and factor markets. Experience shows that deflation is accompanied by a reduction in money supply.

II. Deflation periods in the past

1. <u>Global Deflation 1929-1932</u>

The global deflation can be characterized by the following points:

- Huge slump of the economy. In the US, GDP fell by 27% from 1929 to 1932
- Sharp rise in unemployment. With the slump of the economy, the number of unemployed soared. In the USA, the unemployment rate rose from 3% to 25%
- Drastic fall in consumer prices. The sharp rise in unemployment led to a fall in wages and therefore also the prices of goods and services. In the US, the consumer price index slumped by 25% between 1929 and 1932
- Strong decline in the money supply

<u>The trigger</u>
The bubble burst on Wall Street. The Dow Jones Index shed 48% within two months starting from its peak in September 1929. Up to the trough in July 1932, the index lost 88%. From today’s perspective, it was the wrong reaction of monetary and financial policy that made a global crisis out of the crash on the stock market. Governments bound to the gold standard enforced an extremely restrictive fiscal policy. Many studies suggest that bank failures and the refusal of the Fed to raise central bank money caused money supply in the US to dramatically decline. This lack of money is often regarded as the main reason for the Great depression in the US.

2. Japan in the 1990's

   The Japanese deflation of the 1990s can be characterized by the following points:

   - Weak economic growth
   - Rise in unemployment
   - Moderate decline in consumer prices

   The trigger

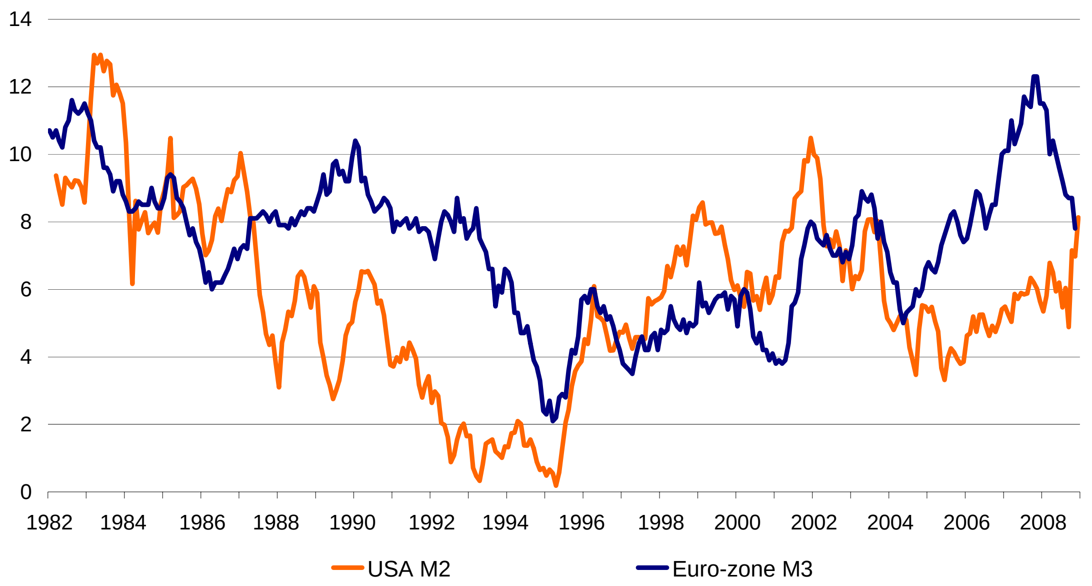
   The burst of the bubbles on the equity and housing markets caused private households to raise their savings. Consumer restraint led to an under-utilisation of production capacities, rising unemployment and falling prices. In the 1990's, the Japanese state reacted late with an expansive monetary and financial policy. They started to solve the crisis only The crisis was only overcome, though, when the government started to buy up bad loans from the banks in 1998 and to restructure the banking sector in 1999.

III. How is the current situation different?

There are a lot of differences between the current situation and the deflations of the past.

1. Since the outbreak of the current crisis in the middle of 2007, central banks and governments have intervened quickly and firmly. While it was not possible to prevent banks from restricting their lending to some extent, there can be no talk of a broad-based credit rationing in the euro-zone. The money supply on both sides of the Atlantic is still rising (**Chart 1**). This is in sharp contrast to the deflation periods of the past.

Money supply is still rising sharply by past standards
% change, year-on-year

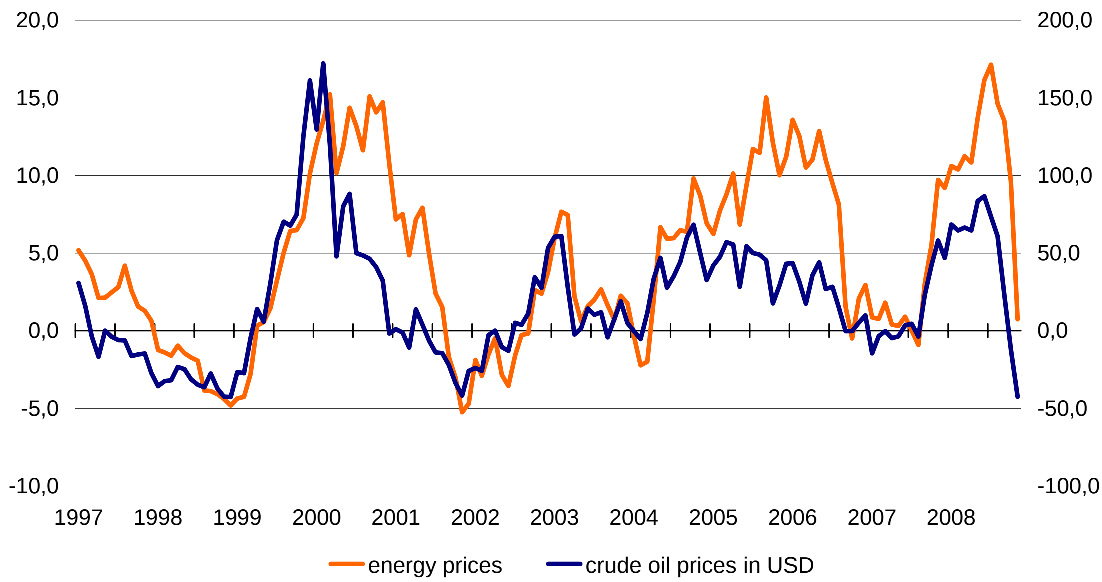


- Chart 1 -

2. Unlike the global economic crisis when governments pursued a strongly restrictive fiscal policy, governments have reacted to weaker demand very quickly this time with huge economic stimulus programmes.

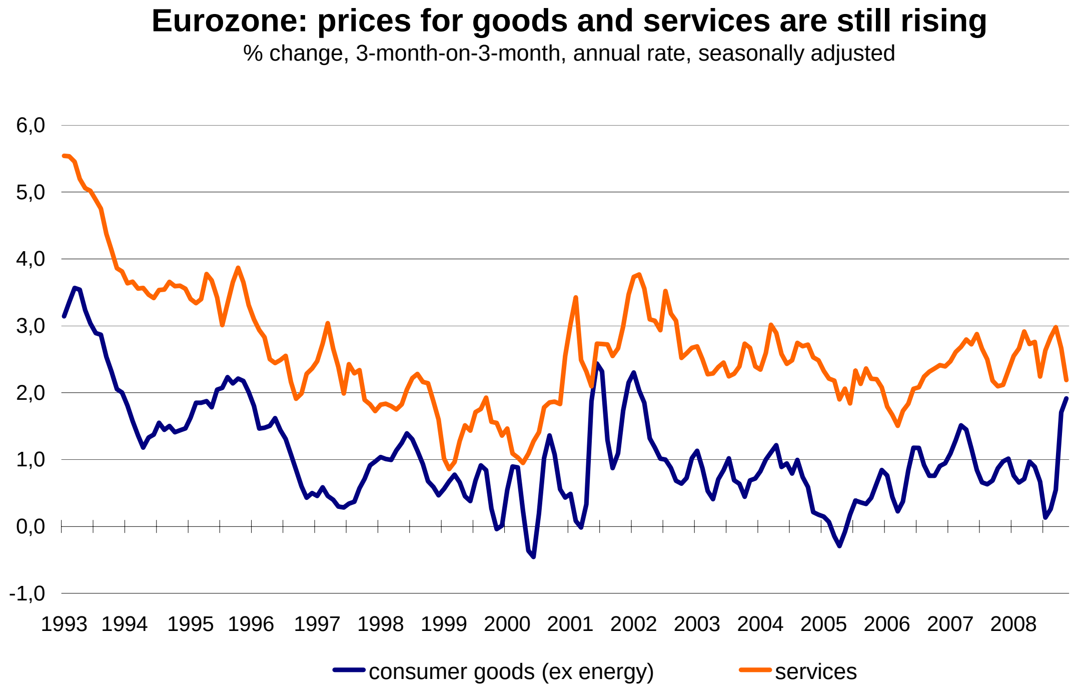
3. The current significant fall in inflation is solely attributable to the bubble bursting on the crude oil market. At the start of 2009, crude oil prices at around 45 dollars for a barrel of Brent are about 100 dollars lower than the peak of mid July. This has allowed the rise in energy prices in the euro-zone to fall by 15 percentage points since the peak in mid 2008 (**Chart 2**).

Eurozone: crude oil prices determine energy prices
% change, year-on-year



- Chart 2 -

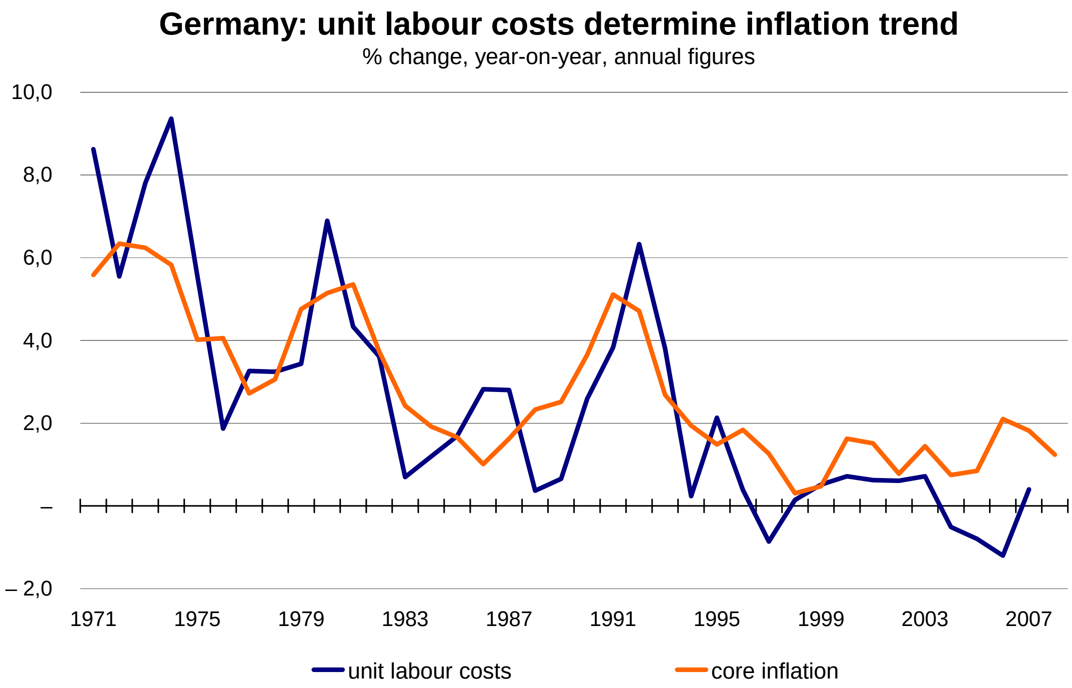
Excluding energy, consumer prices for goods and services are rising at about the same rate as in past years (**Chart 3**).



- Chart 3 -

4. Lasting retreat of consumer prices in eurozone is unlikely. A negative inflation rate in the eurozone cannot be ruled out in the course of 2009. Should oil prices stay at the current level in the first half of the year, the inflation rate will have a minus sign in front of it in the summer. But the period when prices are below last year's level will not last long. The correction on the crude oil market is already well advanced. Based on the fundamental factors, the price of crude oil is even likely to have already plunged too far. With the stabilisation of crude oil prices, energy prices will not drop any further either.

Another slump in the price level means therefore that prices for goods and services have to drop. This is not very likely, however, as pay growth has tended to increase recently, and this is the main determining factor for core inflation (**Chart 4**).



- Chart 4 -

The recession and the resulting rise in unemployment will not be anywhere near as serious as in the global economic crisis of 1929-32. Central banks and governments have reacted to the crisis very swiftly and in a coordinated manner. Central banks have made huge rate cuts. And even with a key interest rate close to zero, a central bank still has instruments (open-market policies) to increase the demand for money.

A further positive factor is that states have supported demand through job creation and infrastructure programmes. This is a further means of overcoming the situation where the demand for money no longer rises, described by Keynes as a liquidity trap.

It is therefore unlikely that we will see a downwards spiral of falling employment, falling wages, falling demand, further falling employment etc. wages and therefore the underlying price momentum will generally point upwards in the euro-zone also in 2009.

IV. Inflation risks are more likely in the long term

1. ECB on stability course so far
   Ever since the monetary union was founded, the ECB has steered a stability-driven course in its monetary policy. With our estimated Taylor Rule it is possible to show that the ECB has set interest rates in line with forecasts for growth and inflation. Only in the 2004 phase was the refi rate significantly lower than the Taylor interest rate. In this phase, the ECB considered its own growth predictions as too optimistic, which proved right in retrospect.

2. Fundamentally favourable inflation climate
   The contraction of the euro-zone economy is resulting in significant under-utilisation of the economy. This means, firstly, that companies have less pricing scope and, secondly, that rising unemployment is curbing pay growth.

In the longer term, though, inflation risks appear to have increased

- Demographic distribution conflicts: Germany and many other Western countries face demographic distribution conflicts as less employees have to feed a rising number of old age pensioner. Governments could defuse such conflicts in the short term by increasing their debt. This in turn increases the temptation to reduce the debt burden though inflation. An extreme example of this is the periods after the First and the Second World War. The debt that had risen because of the war was discharged in inflation – not only by Germany as the loser of the war but also in the USA as the victor. Distribution conflicts also fuelled inflation in the 1970s: in 1973, the dramatic rise in oil prices diminished distributed income

- The ECB's independence is not set in stone: In principle, an independent central bank can prevent conflicts ending in inflation. But the ECB has always had to defend itself against attacks on its independence. In 2005, for example, it only just managed to prevent a passus in the EU draft constitution that would have made it easy for state and government leaders to change the regulations of the ECB and encroach upon its independence

- High liquidity: Since 2001, the ECB has allowed the money supply to rise more sharply than intended. Under former chief Greenspan, the Fed quickly slashed the fed funding rates in times of crisis and was hesitant to raise them again in times of upswing. The excess liquidity has not inflationised the prices of goods but rather of assets – first equities and then, in the last few years, housing and corporate bonds. The marauding liquidity has barely left out a single asset class, and the risk that the prices of goods will rise more sharply in the next ten years has therefore increased.

V. Conclusions for ECB monetary policy

In order to tackle the economic crisis, a very expansive course in monetary policy is justified. The primary objective must be to prevent a liquidity squeeze and ensure that the economy receives the necessary credit. Even after a rate cut close to zero, the ECB can expand the money supply via open-market transactions. It could, for example, buy up loans from banks.

However, there will be a point in the future where the ECB will have solved the risk of deflation. Then, the medium to long-term inflation outlook will depend on whether the ECB is able to reduce high liquidity before this inflationises the prices of goods and/or assets. This could prove difficult. Given the delayed effect of monetary policy, central banks must raise interest rates before the economy reaches normal levels of utilisation again, meaning before unemployment falls again to the starting point before the crisis. Experience in the past has shown that such a change in course in monetary policy will encounter substantial political resistance.