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How to avert the risk of deflation in Europe: rethinking the policy mix and European economic governance

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Policy recommendations

Two things are needed if Europe – in particular the Eurozone – is to avoid the deflation precipice before which it stands: first, a coordinated fiscal expansion by all but a very few member states; secondly, coordination of wage and price growth with, as the two overriding goals, stimulation to enable actual output production to achieve its sustainable potential, and restoration of the average inflation rate in the area to at least the 2-percent target. More generally, fiscal rules should be reformed to allow for more 'constrained discretion' of national fiscal policies which should target a national relative inflation rate instead of a government budget deficit, while at the same time aiming for long-run sustainability of public finances. This national inflation rate target should be decided for each member state at the EU level with the aim of contributing to stabilising output demand at its sustainable potential level and meeting the 2-percent target for the area as a whole. Collective bargaining institutions with the capacity to coordinate nominal wage and price developments in member states but also transnationally along the lines of a 'Golden rule' should be developed and reinstated as effective complements to national fiscal policies. National-level tripartite institutions and macroeconomic dialogue should be established wherever they do not exist, and reinforced to coordinate developments in these fields at national, transnational and EU level.

Inflation rate in the EU: the current state of affairs[1]

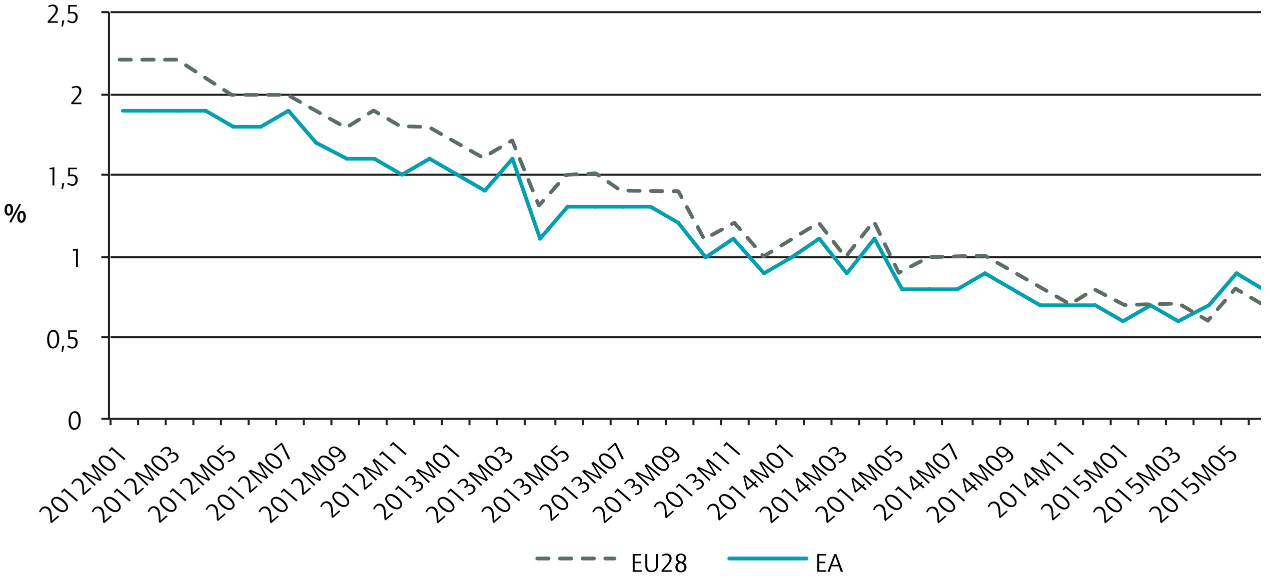
According to Eurostat data, the headline inflation rate (Harmonised Index of Consumer Prices-HICP) in the EU and the euro area turned negative around the end of 2014/first quarter of 2015, having started to decline back in 2013. EU-average core inflation – the overall price index excluding energy and unprocessed food – fluctuated between 0.6 and 0.8 percent between December 2014 and May 2015 (see Fig. 1). In 2014, core inflation was negative or below 1 percent in 15 out of 28 member states, with Bulgaria, Greece, and Spain experiencing core deflation, that is, negative core inflation rates. In early 2015 the vast majority of Eurozone member states had core inflation rates that were positive but well below the ECB's target rate of 2 percent, and in most cases lower than 1 percent (see Fig. 2).

The risks of deflation/lowflation

Low inflation can be the outcome of weak demand or of supply-side developments. On the supply side, falling production input costs, such as the oil price, an exchange rate appreciation, or faster productivity growth, can lead to falling prices. The appreciation of the euro in 2013 and the negative oil price shock underway since the summer of 2014 have accelerated these inflation developments from the supply side by reducing some of the costs of production in oil-importing European countries. In such cases, falling inflation or deflation can be a positive development spurring economic growth and incomes, as it allows, among other things, monetary policy authorities to lower interest rates. Lower oil prices could also offset the higher share of debt servicing for households, firms and/or the government; by lowering production costs, they could, what is more, allow for improvements in cost competitiveness without the need for further adjustment of nominal wages.

1 I am indebted to Christophe Degryse, Maria Jepsen, Philippe Pochet and Andrew Watt for their useful comments on an earlier draft of this Policy Brief. Any remaining errors are my own.

Figure 1 **Monthly Core Inflation Rate (Harmonised Index of Consumer Prices excluding energy and unprocessed food prices), EU and Euro area, 2012M1-2015M6**



Source: Eurostat, prc_hicp_manr series

On the demand side, however, inflation significantly below the 2-percent target, or deflation, is the sign of persistently weak demand and below-potential output. Such a situation presents three risks.

First, and perhaps most worrying in policy terms, very low or negative inflation over a period of time combined with very low nominal interest rates can result in inappropriately high real interest rates, thus rendering monetary policy incapable of stimulating demand in an economy. This is because an inflation rate that is persistently lower than the target is likely to generate lower inflation expectations among economic agents. Lower expected inflation tends to increase real interest rates[22]; high real interest rates adversely affect real expenditure decisions, such as investment, that are crucial for stimulating demand.

One indicator used by the ECB to gauge inflation expectations, the Survey of Professional Forecasters, has been showing that expectations in the short-to-medium term (1-2 years), have remained below the 2 percent target during the first three quarters of 2015, with a slight increase from the second to the third quarter. The long-term expectations (5 years ahead) seem to fall slightly short of the 2 percent target. Whether this should be reassuring, however, is questionable, as in Japan long-term inflation expectations of professional forecasters were close to 1 percent between 1999 and 2013, while real actual inflation was negative. Should something similar happen, it would be particularly difficult, as the experience of the Bank of Japan has shown, for the ECB to generate expectations of stronger demand and higher inflation in the medium term, at least by using its conventional interest rate instrument.

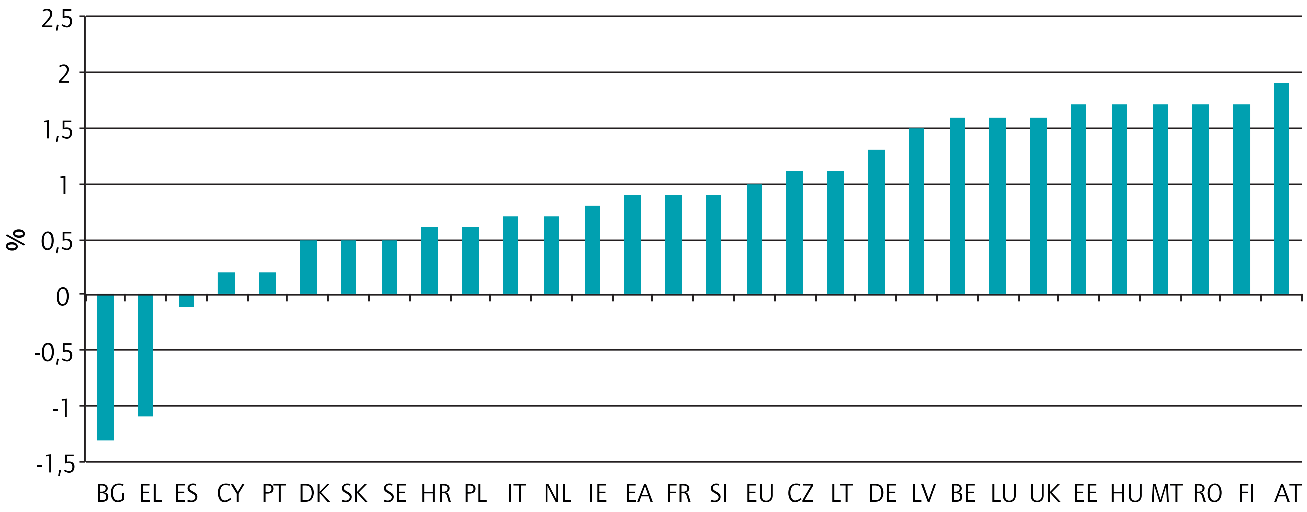
Secondly, deflation or very low inflation due to weak demand increases the debt-servicing burden, whether in the public or the private sector. This happens because debts are denominated in nominal terms and paid off according to nominally fixed pay instalments. The fact that the debt remains constant whereas wages, prices and tax revenues fall in the context of deflation means that servicing the debt takes up an ever increasing part of the nominal revenues of households, firms and governments; it squeezes their consumption or investment demand further, thereby fuelling the negative spiral. This is an important challenge in Europe where public debt has increased substantially since the beginning of the crisis in several countries while in others the private sector too has been trying to deleverage by paying back its debt.

Thirdly, very low inflation or deflation makes the adjustment of relative wages more difficult and painful, insofar as, in the presence of lowflation/deflation, a relative wage reduction, which could normally be achieved via higher inflation rates, will now require cutting nominal wages, a practice to which both workers and employers are notoriously resistant (Bewley 1999). This is especially relevant for the Eurozone where a process of substantial relative price/cost adjustment has been taking place since the crisis began and current account deficits in several member states had to be redressed.

All in all, demand-driven very low or negative inflation represents a threat to the European economy. It risks perpetuating the already protracted recession, which has been so damaging to many countries and regions, by depriving the economy of effective stabilisation policy instruments and trapping it in a so-called 'liquidity trap', as well as by making deleveraging and relative price/cost adjustments – which have had a bearing on recovery – even harder. We will focus here on the demand drivers as these are more directly applicable in the context of the economic policy choices currently followed – as the outcome of economic governance – in the EU.

2 As per Fisher's equation, real interest rates are the difference between nominal interest rates and expected inflation. When interest rates are close to zero, and as long as expected inflation is low but higher than the interest rates or negative, then we have negative real interest rates.

Figure 2 **Annual Core Inflation Rate (Harmonised Index of Consumer Prices excluding energy and unprocessed food prices), EU member states, 2014**



Source: Eurostat, prc_hicp_aind series

How did we get here? Economic policy responses to the crisis and economic governance

The EU economy and in particular the Eurozone have experienced a double deep recession since the outbreak, in 2008, of the global financial crisis, recovery from which has yet to take off in the Eurozone. The EU economy grew in average real terms by only 0.1 percent per annum between 2008 and 2014, whereas the Euro Area (EA18) shrunk by an annual average of 0.1 percent during the same period. The gap between actual and potential GDP became negative in 2009 for both the EU and the Eurozone and remained so until 2014, ranging between -3.5 in the EU in 2009 (-3.4 in the Eurozone) and -1.3 in 2011 (-1.1. in the Eurozone). At the same time, the EU's – and particularly the Eurozone's – current account balance with the rest of the world has steadily increased since 2009, reaching for the Eurozone a surplus of 3 percent of GDP and expected to grow further in 2015. These figures suggest that demand in Europe has remained subdued since 2009.

The shock of the global financial crisis led to the first recession in 2008. However, from 2010 onwards, weak demand has been the outcome of policies conducted in the EU, the course of which has been inextricably linked to the economic governance institutions of the EU and in particular the Eurozone.

Monetary policy

Unlike its counterparts in the US and the UK, the ECB's monetary policy reactions to the demand shocks have been slow and modest – if not at times misguided (e.g. in 2011 when it raised interest rates) – but in line with its asymmetric approach to pursuit of its inflation target, whereby it is more likely to take action if actual inflation overshoots the target than if it undershoots it. It has been argued that these preferences, combined with the rather low target inflation rate of only 2 percent (cf. Blanchard *et al.* 2010) chosen by the ECB, create high deflation risks for the percent euro area. Nevertheless, the ECB's main interest rate dropped as low as 0.25 in November 2013 and declined further to virtually zero in 2014, while in June of that year the interest rate offered for its deposit facilities actually turned negative. Not even this, however, was enough to prevent inflation from decelerating further.

In spite of the fact that inflation began its steady decline below its target rate in the Eurozone early in 2013, reaching below 1 percent in October 2013, it was not until March 2015 that the ECB launched its programme of quantitative easing, an unconventional monetary policy whereby the central bank creates money to buy financial assets (mostly government bonds) that may prove useful when nominal interest rates have reached the lower zero bound. The programme is due to last for at least 18 months or until there are indications that inflation is firmly on a return path to its target rate. The capacity of monetary policy alone to avert the threat of deflation by means of quantitative easing should not, however, be overestimated. It is hard to ascertain the extent to which quantitative easing has been responsible for any effects, for lack of counterfactuals. Yet the indications have been hardly encouraging for the Eurozone.

Fiscal policy

Between 2010 and 2013, the average structural primary government deficit, an indicator of discretionary fiscal policy stance in the EU28, shrunk by around 2.9 p.p., whereas between 2010 and 2014 the respective balance increased by 3.1 p.p. in the Euro area (EA18); both developments indicate contractionary policy stances for these periods. However, as the output gap in the area remained negative and the monetary policy of the ECB has reached the limits of its effectiveness in steering inflation to target, even a neutral fiscal policy stance is too little to support recovery.

The inappropriately tight fiscal policy stance is not surprising. Following the onset of the sovereign debt crisis in Greece, a series of legislative initiatives (the 'Six-Pack', the 'Two-Pack' and the Fiscal Compact) have reformed the economic governance of the EU and the Eurozone, in particular the fiscal rules. Of these, the most comprehensive, the so-called 'Six-Pack', came into force at the end of 2011, while the others saw the light in 2013. All of these instruments aim at tighter national government budget monitoring and fiscal rules on both the preventive and the corrective arms. These reforms of the fiscal rules have followed from the diagnosis that it was lack of fiscal discipline that lay at the root of higher public deficits and debt as a share of GDP, when in fact it was the ineffectiveness of adjustment mechanisms – most notably the consequences of diverging national inflation rates for real interest and exchange rates – for keeping domestic demand developments in check in the different member states, that eventually led to the macroeconomic imbalances that unleashed the European crisis.

Rather than inducing confidence among households, firms and investors and bringing forward the recovery, fiscal austerity led to much deeper than expected recession, especially in the Eurozone and those member states in receipt of financial support from the EU and the IMF. The new measures also placed a much greater burden of adjustment to country-specific shocks on the intra-Eurozone real exchange rates, that is, relative prices and unit labour costs. What is more, the new rules, although advertised as enhancing fiscal coordination in the Eurozone, effectively failed to coordinate national fiscal policies towards an appropriate aggregate fiscal stance, given that the monetary fiscal policy had lost its effectiveness due to very low nominal interest rates and inflation.

Real exchange rate adjustment and structural reforms

In parallel with fiscal austerity, internal devaluation, that is, a devaluation of the real exchange rate based mostly on lower nominal wages and prices relative to the other member states, has been pursued in several Eurozone members, mostly in the periphery. These countries experienced, after 2008, several episodes of 'sudden stop' in the private financing of their large current account deficits and subsequent dramatic drops in demand. Up until the onset of the crisis, prices and unit labour costs in these member states had been growing faster than in others. The pressing need to rebalance these deficits meant that the member states that incurred them were forced to undergo a combination of recession and real exchange rate adjustment (devaluation).

The pursuit of internal devaluation has been painful and costly, in terms of recession and unemployment, not least because it has not been matched by any policies which could lead to internal revaluation in those member states whose relative prices and unit labour costs had been growing below the target inflation, most notably Germany. The fiscal rules have merely been steering national policies towards balance or surpluses rather than towards an expansion that could help spur a rise in inflation and a revaluation in some member states. Continuous parallel fiscal austerity in states with current account deficits has exacerbated the adverse effects of internal devaluation.

The newly established Macroeconomic Imbalances Procedure has been treating current account deficits more cautiously than current account surpluses, calling for stronger – and earlier – corrective action in case of the former than in case of the latter, thereby placing, in conjunction with the fiscal rules, a greater burden of real exchange rate adjustment on member states with deficits. The combination of devaluation and the fact that core inflation in Germany has remained significantly below 2 percent every year since 2009 meant that the adjustment in real exchange rates in troubled member states required very low inflation rates, with all the risks that this entails.

As part of the effort to precipitate internal devaluation by making wages and prices more flexible, structural reforms – most notably in labour but also in product markets – have been undertaken or recommended (Coeure 2014). However, rather than strengthening institutions like collective wage bargaining and fostering coordination practices that could steer nominal wages and prices towards the required adjustment at minimised costs, reforms have instead promoted deregulation and decentralisation of collective bargaining. This is at least ironic, given that member states like Germany, Austria, the Netherlands and Finland, whose unit labour costs and prices evolved moderately (if not excessively moderately) prior to the crisis have been benefiting from coordinated practices.

It has been argued (ibid.) that structural reforms, if fully implemented, would lead to expectations of higher growth in the future which would in turn prompt households and firms to bring forward their consumption and investment, thereby stimulating short-term demand and thus fuelling recovery. However, for any positive effects on demand to materialise, households and firms should not be liquidity constrained; they would need to have either funds or readily available credit in order to finance higher consumption and investment in the run-up to the expected future higher growth in output. This is a far-fetched assumption as incomes have fallen and credit flows from financial institutions have not been restored to normal levels in most of the member states that have had to pursue internal devaluation. This delay is due not least to the damage to the balance sheets of credit institutions caused by the crisis and recession and the ongoing private sector deleverage process in countries with high private debt. Moreover, the pressure on nominal wages has been greater than on prices, leading in several countries to stagnant or negative real wage growth which has been exacerbating the problem of low demand.

Therefore, under the current circumstances in the Eurozone, structural reforms that might increase flexibility would be unlikely to help in the fight against deflation. Instead, as various studies have suggested, their negative short-term effects on demand will in fact push further towards lowflation/deflation and lower demand, especially as nominal interest rates have begun to approach the zero lower bound (e.g. Eggertsson *et al.* 2014).

To sum up, not only have the policy responses – on both the demand and the supply side – to the combination of recession and rising public deficits since 2010 in Europe not helped; they have in fact precipitated the slide towards deflation. What then can be done?

How can we pull the European economy away from deflation/lowflation and avoid it in the future?

One option, on which there is an ongoing debate among macroeconomists, is the use of the 'helicopter money' version of quantitative easing. This is, essentially, a fiscal stimulus financed by money newly created by the central bank. It has been suggested also that an upward revision of the target inflation rate would reduce the risks of deflation (cf. Blanchard *et al.* 2010). Under the current circumstances of very low nominal interest rates (the so called 'liquidity trap') and the political opposition that is likely to be raised against the use of the helicopter money version of quantitative easing and/or a higher target inflation rate, other elements of the policy mix – that is, fiscal policy and collective wage bargaining – will have to be used to stop low or negative inflation from becoming entrenched.

National fiscal policies need to assume a greater than hitherto assumed role in stabilising national economies facing country-specific shocks, while simultaneously aiming for public finances sustainability in the long run. For this purpose a reform of the current fiscal rules to allow for more 'constrained discretion' (cf. Allsop and Vines 2008) will be required. Under current circumstances, the overriding goal should be to stimulate demand so as to close the gap between actual and potential output, especially in the Eurozone economy as a whole. Given the risks of deflation explained earlier, this is the safest way of keeping national public debt/GDP ratios on a sustainable path in the medium to long run (cf. Wren-Lewis 2015).

To this end, national fiscal policies should be aimed at achievement of a real exchange rate that is compatible with sustainable full employment in an economy over the medium term. In the national fiscal policy context, this could be done by stimulating (contracting) demand to result in higher (lower) national inflation relative to the average which would lead to a real exchange rate appreciation (depreciation). The fiscal stance for each member state would be determined as a function of the necessary aggregate fiscal stance and the appropriate alignment of real exchange rates: those with relatively higher price competitiveness (that is relatively lower inflation rates over a period) not justified by relative productivity differentials vis-à-vis other member states would be required to expand their fiscal policies even more than those with relatively lower price competitiveness (that is, relatively higher inflation rates). This need would also give rise to different national inflation rate targets, which taken together should, however, aim at averaging at least the 2-percent-inflation target of the ECB. The recently proposed European Fiscal Board would be in a position to provide analysis that would allow for the determination at the EU level of the appropriate national inflation rate targets.

Collective wage bargaining institutions in a position to coordinate pay outcomes across the economy that will work in the same direction with national fiscal policies in steering the European economies away from deflation and towards the real exchange rate that is compatible with sustainable full employment in the medium term and sustainable public finances in the long-run will be required. Collective bargaining should aim to deliver nominal wages in accordance with the so-called Golden Rule which states that nominal wages should on average increase by the medium-term national productivity growth rate plus the target inflation for the member state, adjusted for a price competitiveness component, which will be positive (negative) for economies with current account surpluses (deficits).

Under the current deflation threat, collective bargaining should thus engineer nominal wage increases that can re-ignite inflationary pressures in the Eurozone, especially in those member states where relative unit labour costs/inflation have been growing for some time at rates below the ECB inflation target. Insofar as bargained pay outcomes lead to higher real wages, stronger consumption demand will also boost aggregate demand, especially in those economies with high output gaps.

Yet for such developments to take place, macro-coordination of collective bargaining and a wide coverage of bargained pay agreements across a national economy will be necessary to avoid free-riding problems and to arrive at the national inflation rate that will deliver the appropriate real exchange rate. This would suggest at least some reversal of recent reforms in collective bargaining systems in several member states which have undermined macro-coordination and encouraged the closer linking of wage developments to local or firm-level productivity growth. Moreover, some coordination across member states would also be necessary to ensure that the real exchange rate adjustments designed to deliver the 2-percent average inflation rate in the euro area are as symmetrically distributed as possible.

This proposed 'constrained discretion' of national fiscal policies could benefit from the existence of the independent national fiscal councils that member states are currently required to establish under the 'Two-Pack' legislation. These councils can help determine the appropriate real exchange rate to be targeted, taking into account developments in the economy, such as productivity growth, the output gap, unemployment, and so on.

Fiscal policies typically include measures that affect variables such as the tax wedge between compensation and take-home pay – but also productivity growth, either through public investment in infrastructure, R&D, and human capital or/and tax incentives to firms that organise training programmes that can help productivity growth (cf. Hancke and Soskice 2003).

For such an assignment of functions across the various fields of the policy mix to succeed and bear fruit, it will be necessary to set up at the national level – or to strengthen in cases where they already exist – institutions able to foster dialogue between the social partners and national governments over the broad range of areas that required to contribute to determining the appropriate real exchange rate while simultaneously promoting higher and more equally distributed living standards. At the EU and especially the Eurozone level the role of the Macroeconomic Dialogue should be strengthened to coordinate the network of national institutions (cf. Allsop and Watt 2003). Such an arrangement could indeed form an alternative to establishment of the independent competitiveness boards recently recommended by the European Commission.

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