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The Upside of Europe's Ebbing Inflation

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The fall in the prices of oil and various other commodities is set to push Eurozone inflation further towards zero in coming months. This will create enormous political pressure on the European Central Bank (ECB) to reinforce its efforts to avoid deflationary territory. The ECB itself has contributed to the expectation that it can and will bring inflation back to its close-to-2%-benchmark soon. That is why there is a general expectation that further quantitative easing (QE) is around the corner.

But such policies have major spillover effects. They encourage risk taking among investors searching for yield; they affect the distribution of income and wealth between the less affluent, who are most affected by the lack of interest paid on their bank and savings accounts, and the wealthier, who tend to benefit most from rising share prices; finally, perhaps most importantly, ultralow interest rates depress the overall return on savings, discourage badly needed savings for retirement and slow down the growth of existing pension assets. For these reasons, it is essential to examine how big the risk of deflation really is.

Besides the weakness in demand during the past two years of Eurozone recession, there are other important, but presumably temporary factors that have dampened inflation. First, the fall in the prices of oil and other commodities since 2011 has directly translated into lower consumer price inflation through lower prices for petrol, other oil products as well as foodstuffs. . Moreover, falling commodity prices also affect broader producer prices, as lower costs for energy and other inputs are passed through into sales prices in manufacturing and other sectors of the economy. In well-functioning markets, a prolonged downward trend in commodity prices, therefore, also lowers so-called core inflation, which excludes energy and unprocessed food.

The second reason why Eurozone inflation is so low is that those Euro countries that went through excessive price and cost increases before 2009 are in the process of correcting them. Lower inflation or slight deflation in Spain, Portugal, Greece and Ireland are not a sign of malicious deflation. They are necessary to restore the purchasing power of people whose

wages and incomes have declined and to improve these economies' competitiveness on international markets. Once these countries recover – based on growing exports and a revival of consumer demand increasingly channeled into domestic production – downward price pressures will disappear. Lower commodity prices, meanwhile, should also help to boost growth (some argue that falling commodities indicate an imminent economic downturn, but experience shows that they are more likely to help weak economies to stabilize and recover).

It is difficult, of course, to quantify the impact these two developments have had on inflation. But let us assume for a moment that commodity prices in 2014 stayed at their average 2013 levels and that inflation in the periphery countries remained at 2%. The combined inflation impact of stable commodity prices and a lack of rebalancing in the periphery could easily be around 1%. In other words, inflation would today stand not at 0.4% but at 1.4% -- far from the alleged dangers of deflation.

But what about inflation expectations? Aren't they much too low, signaling deflationary risks. Central banks rightly argue that it is their primary objective to provide an anchor for expectations. Inflation expectations should be above 0%. Otherwise, any negative economic shock to the Euro economy could quickly lead to deflation, especially since interest rates are already at rock bottom (or what economists call the zero lower bound).

Having declined somewhat in recent months, Eurozone inflation expectations for the five-year horizon are currently somewhere between 0.7 % (as indicated by bond prices) and 1.8% (as reported by surveys among forecasters). Inflation expectations among financial market participants do seem to be worryingly low. They are, however, themselves influenced by volatile oil and commodity prices. When oil prices drive down inflation rates, they also drive down inflationary expectations. There is a high correlation between actual inflation and inflationary expectations for the next two to five years. Inflationary expectations, in other words, are a dependent variable: recent developments shape future expectations. Therefore, inflation expectations are also subject to temporary influences; they are not a straightforward indicator of future inflation nor an easy guide for monetary policy.

What does all this mean for the ECB? First, central bankers should make it very clear that monetary policy has an impact on the price level only in the medium term; changes in policy can take two to five years to feed through into inflation. Therefore, short-term volatility in inflation and inflation expectations, which is caused by commodity prices or structural adjustments in some recessionary countries, has to be tolerated. It is no indication that

the central bank is not doing its job. This, however, is exactly what many market participants and commentators are criticizing.

Second, recent developments raise the question whether the ECB's inflation targeting needs recalibrating. Growing calls for an ever more activist monetary policy result from the fact that present inflation is far below the aspired to 2% stability norm. It may therefore make sense to return to the stability definition the ECB used before it reassessed its strategy in 2003, which was to define price stability as inflation "below 2%". That could be interpreted as a band between 0% and 2%, which leaves central banks with room for discretionary policies, for example reacting to the volatility of commodity prices. However, central banks need room for maneuver in both directions. For example, when commodity prices rose in 2011, Eurozone inflation peaked at 3.0 %. The ECB, rightly, did not react by tightening significantly. It quickly reversed two small interest rises and then cut rates while inflation was still above target.

If the ECB reverted to its previous, broader definition of price stability under present circumstances, it might create additional uncertainty, and markets might get worried even more about the ECB's commitment to keep inflation above zero. As a first step therefore, the ECB should become more explicit about which deviations from its close-to-2% target are worrisome and which are not only tolerable, but potentially positive for the economy. For example, if oil and commodity prices continued to fall in 2015 (unlikely, given the prospects for economic recovery) the result could be an inflation rate below 0.5%. This, however, would help the recovery – it would not signify a failure on the part of the ECB. It is the ECB's job to explain this. Otherwise, analysts and investors will continue to demand that it counteract falling commodity prices and economic rebalancing by launching another QE program.

The ECB already has some flexibility by not pursuing a fixed inflation target, but seeing the close-to-2% value as a benchmark. But it should be much more explicit about this in communicating with the markets. Otherwise it will fall into an expectations trap – any decision by the ECB not to act will cause adverse reactions, irrespective of how justified it is.