

# BRIEFING PAPER

## **Danger of Deflation and Stagflation**

by

**Gustav A. Horn**



Institut für Makroökonomie  
und Konjunkturforschung

Düsseldorf

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## **Executive Summary**

### **Danger of Deflation and Stagflation**

Less than half a year ago the debate was about the danger of inflation and the ECB even raised interest rates in order to suppress seemingly unfolding inflationary expectations. Now, the fear of inflation has turned into a fear of deflation. The inflation impact during last year was almost exclusively caused by oil and raw material prices. Presently headline inflation is declining at an amazing speed. But this is just a dramatic decline of relative and not of aggregate prices. Therefore it would be wrong to call the present situation a deflation.

Scenarios show that the answer to the question whether there will be stagflation or stagdeflation crucially depends on wage developments and expansion exit strategies of economic policy. In the first place economic policy has to stabilise the economy so quickly such that deflationary wage movements are avoided. Secondly the expansionary policy course has to be given up timely and in an appropriate manner as soon as the crisis is over. If that would be the case the crisis could be overcome without initiating future instabilities.

## **1. Introduction**

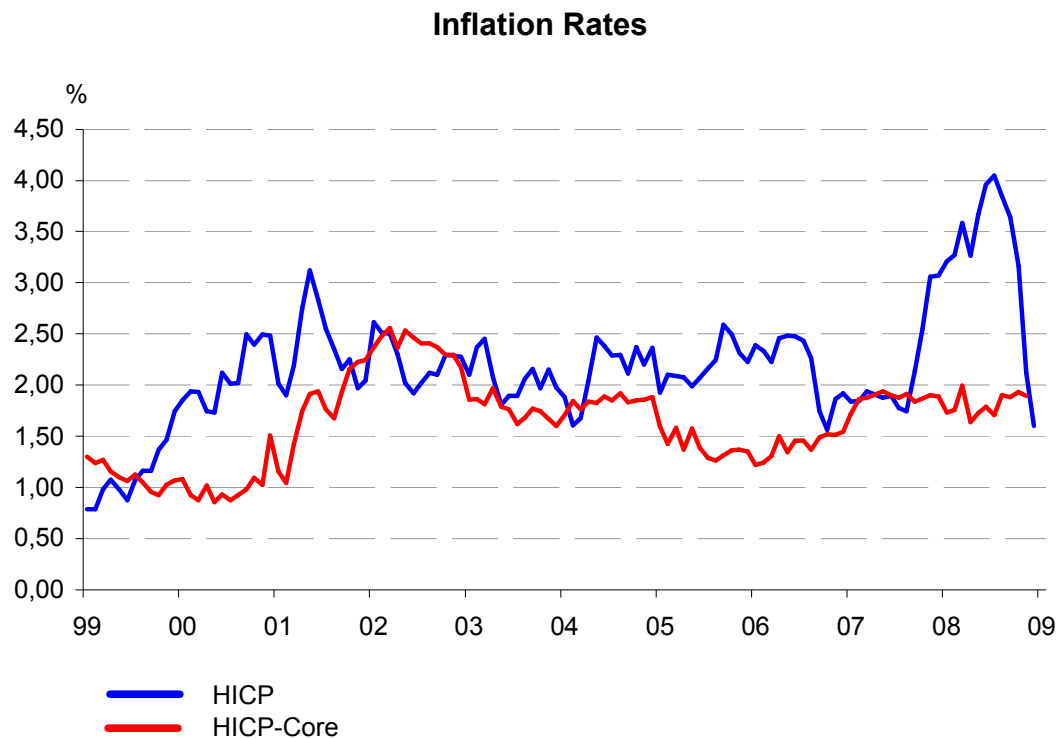
What a change! Less than half a year ago the debate was about the danger of inflation and the ECB even raised interest rates in order to suppress seemingly unfolding inflationary expectations. What a misjudgement! Now concerns have moved to a completely different direction. There is widespread agreement that the world is about to face one of its most severe crisis. Moreover, the fear of inflation has turned into a fear of deflation. Now, there are only debates on how deep the crisis will be and how long it will last. Furthermore there is a discussion whether major economies may even end up with a deflation.

In the following it will be analysed in the first section, how price movements we are seeing now and that we have seen during the recent past should be interpreted. Then growth prospects for 2009 and 2010 will be outlined. After that several scenarios will be discussed. In the light of previous results the question will be answered whether the Euro area is on a path to inflation, deflation, stagflation or stagdeflation. By outlining the scenarios it will become clear what economic policy should do.

## **2. Is Inflation followed by Deflation?**

Until summer last year the ECB was very much concerned about inflation. The reasons for these concerns were obvious. Headline inflation was soaring to 4 % for the Euro area, well above the target rate of 2 %. What was increasing the ECBs vigilance was that inflation expectations seem to creep upwards slightly above the target rate as well. In addition to that the ECB was concerned about a minor acceleration of wage bargaining agreements.

Figure 1



All these concerns have proved unfounded and it was foreseeable that matters would go this way. In the first place there never was any inflation at that time. As Figure 1 shows, it was headline inflation that moved upwards so steeply whereas the core rate stayed more or less unchanged. Since the core rate is headline inflation excluding oil, raw material, seasonal food and tobacco, one has to conclude from this finding the increase of prices must have been concentrated in the excluded items of the core price index. Inflation however is defined as a continuous and potentially accelerating increase of general price level. Thus in order to have inflation, prices must go up on very broad scale. That was clearly not the case as the resilience of the core inflation rate shows. On the other hand figures 2 and 3 show where the price rise came from.

Figure 2

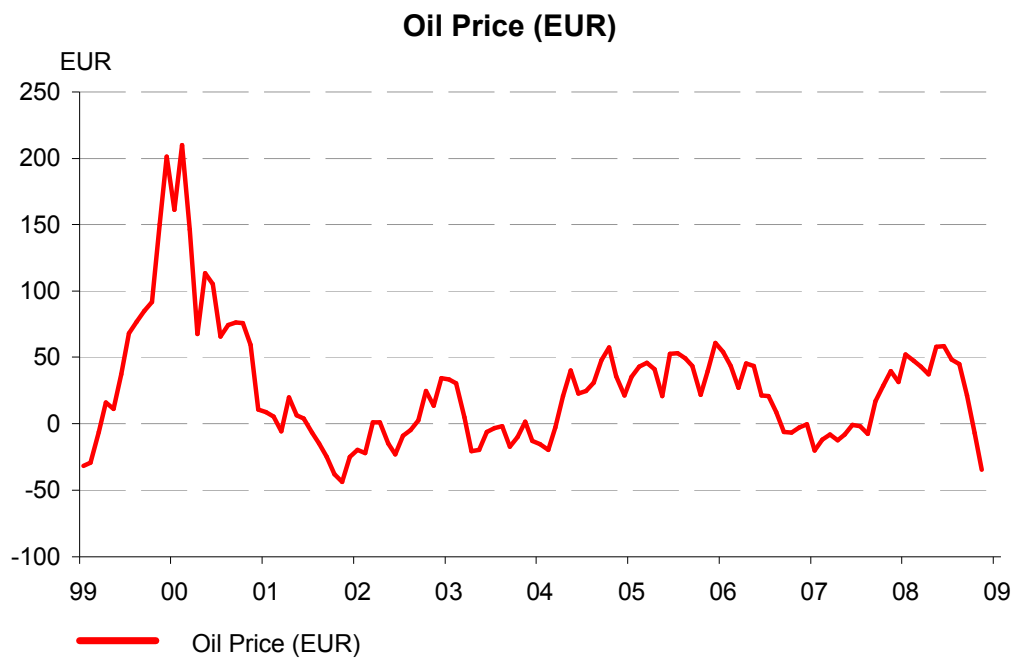
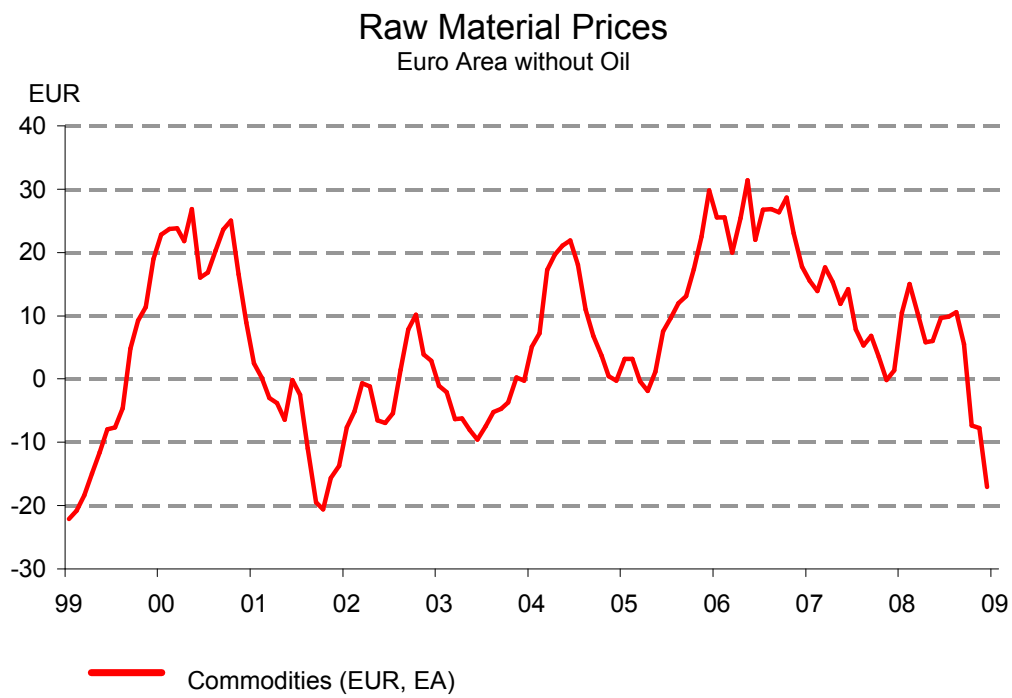


Figure 3



The inflation impact was almost exclusively caused by oil and raw material prices. Both prices are shown here in Euro. That diminishes the price level change, since the Euro appreciated during that time. At its peak the oil price raised by 50 % compared to the previous year despite the appreciation of the Euro and the price of raw materials was 30 % higher. That is a dramatic rise of relative prices rather than a general increase of the aggregate price level. The reason was the buoyant growth of the global economy that obviously influenced expectations on the limited resources of oil and raw materials. People seemed to believe that these resources were too limited to go along with the relative strong growth at that time. These considerations influenced their investment behaviour on financial markets and people expected these prices to increase in the future. Hence financial markets made them rise already in the present.

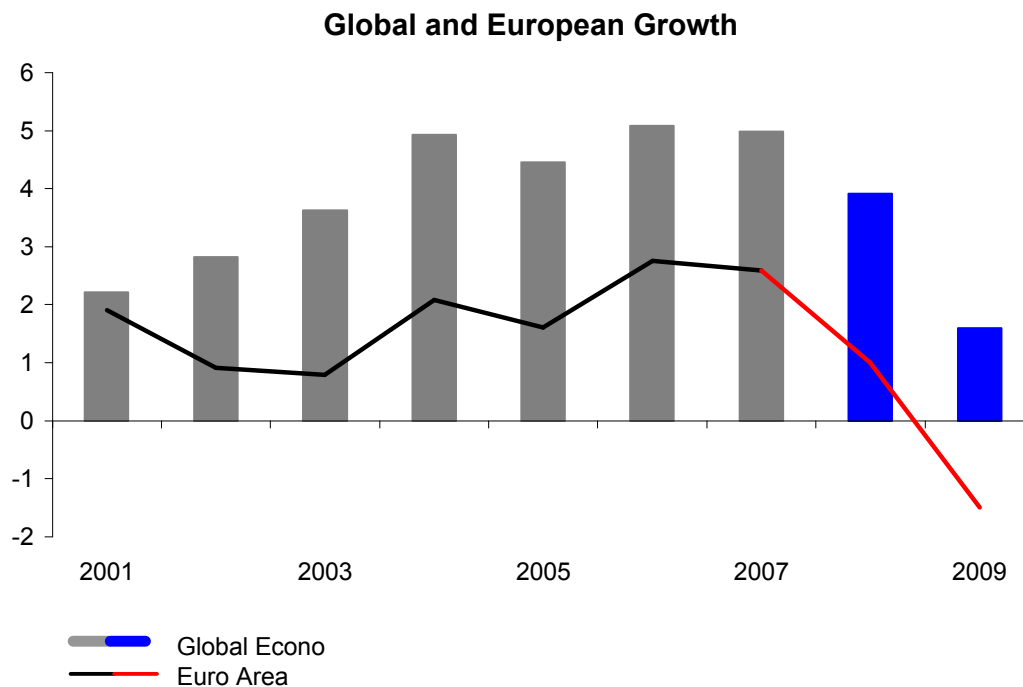
Now, with a global decline of growth rates expectations have also changed dramatically to the opposite direction. And this again is reflected in the respective price indices shown in figures 2 and 3. Accordingly headline inflation presently is also declining at an amazing speed (figure 1). This is just a dramatic decline of relative and not of aggregate prices. Therefore it would be wrong to call the present situation a deflation. The argument is completely symmetrically to the above one only with respect to inflation. The core inflation rate is still staying constant. Therefore in general, price stability is preserved.

An interesting question is why the core rate stays so unabated from these otherwise dramatic developments. The main reason is that wages neither did pick up the previous price hike nor up to now the decline the very same prices. Therefore these price shocks could not spread all over the economy, where they would have triggered a detrimental wage - price spiral. Such a spiral indeed would have led to inflation and for the very same reason the present situation is not a deflation. Presently the still rising wages ensure price stability. The decisive question is whether this is also the case for the near future. That is the question whether the probability of a deflationary scenario is high. The answer to this question depends on the economic prospects of the Euro area and will be outlined in the following scenarios.

### 3. Economic Prospects of the Euro area

Present data show a dramatic fall of economic activity on a global scale. The Euro area will also be hit by this global shock ( figure 4).

Figure 4



Sources: IMF; Eurostat; from 2008 IMK-Forcast.

Primarily exports and private investment will suffer from these developments. In addition to that there are a few countries in particular Spain and Ireland where the bursting of speculative bubbles in the real estate sector and the banking sector will require structural adjustments. Therefore these economies will be particularly hard hit. But also those economies where growth during the past years was rather unbalanced towards exports will suffer more than others. In this respect Germany must be mentioned. There domestic demand still is so weak that it cannot compensate by far the expected losses from foreign trade. All major forecasting institutions predict that the Euro area will show

negative growth and a low but positive inflation rate in 2009. This scenario means there will be a deep recession, but neither stagflation nor stagdeflation not to speak of inflation.

Table 1

**Total Growth Prospects**  
Percentage Change

	GDP			Inflation			Unemployment Rate		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Euro Area	2,6	1,0	-1,5	2,1 <sup>2</sup>	3,3 <sup>2</sup>	1,4 <sup>2</sup>	7,4	7,5	8,4
USA	2,0	1,3	-1,1	2,9	4,0	1,2	4,6	5,7	8,8
Asian Emerging Markets	5,9	4,4	3,3	2,4	5,5	3,7	-	-	-
China	11,4	9,6	7,5	4,8	6,3	4,0	-	-	-
Japan	2,1	0,3	-1,2	0,1	1,5	0,2	3,9	3,9	4,4
Central and Eastern Europe <sup>4</sup>	6,1	4,8	2,7	5,1	7,6	4,6	-	-	-
Total	3,1	1,5	-0,7	-	-	-	-	-	-
<sup>2</sup> HICP. <sup>3</sup> South Korea, Taiwan, Hongkong, Singapur, Malaysia, Thailand, Indonesia. <sup>4</sup> Poland, Russia, Czech Republic, Hungary. Source: IMK-Forecast.									

But this can only be a preliminary answer to the central question of this paper. The year 2009 could be an intermediate phase on the road to one of above mentioned scenarios. Whether this is the case crucially depends on the economic policy answer on these forecasts. In the following several scenarios will be outlined.

The first scenario is one of doing nothing. There it is assumed that – what is from a present point of view highly unlikely - there would be no further policy reaction to the



crisis in the Euro area. Then there will be no economic turn around. The dramatic fall of economic should fade, because stimulus packages elsewhere in the world especially in the US, the UK and Asia will have some positive impact on global trade. In addition to that also monetary policy will work to some extent. From all this Europe would benefit, but only to a minor extent since the domestic market is very dominant for the Euro area. In such an environment unemployment would still rise putting trade unions under pressure. With a diminishing bargaining power of employees and a still looming crisis, wages would tend to grow less and less. Wage cuts will spread in due time. Then a negative wage price spiral is triggered leading to deflation and thus a long lasting depression in the Euro area. This scenario shows that there is an urgent necessity for economic policy action.

A second scenario assumes – what seems to be very likely – there is an economic policy reaction. But the reaction is uncoordinated as far as fiscal policy is concerned and comes very hesitantly and late as far as monetary policy is concerned. In this case there will be no turn around in 2009. The effects of monetary policy always come slow. It takes about a year after interest rate changes when the main impact is being felt. Under the present circumstances a further delay must be expected. First the banking system will have to be consolidated. Only then firms and private customers will benefit from lower interest rates. The uncoordinated fiscal stimulus also leads to a diminished effectiveness. In particular, those economies that are the first to start with a package, will achieve at best only modestly positive results. A lot of the stimulus will get lost by higher imports. This undermines confidence in these economies making a recovery much more difficult to achieve. In this case a turnaround will not happen before mid 2010. Then monetary policy should become effective and fiscal stimuli should finally work to some extent. But until then wages have come under increasing pressure and deflationary dangers have risen. Monetary policy then has to do more to avoid this and possibly has to follow the quantitative easing approach of the US- Fed. In other words a relatively slow approach enhances dangers and makes it more difficult to achieve stabilisation. In addition to that confidence in public finances of some countries within the EU like Greece or Italy will have decreased more and more. As a consequence governments have to pay higher interest on their fiscal policy actions. This risk premium too makes it

more costly to stabilise their economies. In particular the danger of deflation then will have become much higher. This could end up in a stagdeflation.

After a still possible turn around, economic policy must follow appropriate expansion exit strategies that also avoid instabilities. The expansionary fiscal policy of governments then should be reversed as fast as possible by cutting the extra expenditure immediately and then fiscal policy should enter a smoother consolidation path. Monetary policy should then take back all the quantitative easing immediately by starting appropriate open market operations. Interest rates then should be increased only slowly as long as the upturn is not steady. Wages will then possibly return to a productivity oriented path and inflation can be avoided.

The ideal scenario would be that all member countries would have attacked the crisis in a co-ordinated approach at the beginning of 2009. Co- ordination means that the stimulus has about the same size in each country and becomes effective simultaneously in each country. According to IMK calculations, this would increase the effectiveness of e.g. a German stimulus package by 30- 40 %. In other countries in particular small and very open economies the effect should even be larger. However in particular because of the German resilience with respect to a European stimulus package this timeframe is no longer feasible. The best one could achieve now is that Germany acts swiftly and with a stimulus larger than on average in the Euro area. That means it should about 2.5 % of German GDP. Doing so Germany may have only a minor recession. Therefore German imports would not go down as much as in the other scenarios. That would help all other member countries, especially those countries like Spain where domestic demand is very difficult to stimulate because of the crisis in the construction sector. Furthermore the ECB swiftly reduces interest rates, potentially down to zero. Under this assumptions a turn around may occur already towards the end of 2009. Until then pressure on wages may not have become so strong that a deflation is likely. They have rather served to achieve more or less price stability. Therefore an additional quantitative easing on behalf of the ECB may not be necessary.

As soon as the turn around is achieved, expansion exit strategies should be applied too. Fiscal policy should proceed as in above scenario. Monetary policy should increase interest rates until the real rate is about zero. That could be as high as 1.5 to 2 pc When the upturn is steady it should continue to raise rates to avoid inflation. Otherwise an inflation scenario could come true.

The scenarios show that the answer to the basic question of this paper whether there will stagflation or stagdeflation crucially depends on wage developments and expansion exit strategies of economic policy. .In the first place economic policy has to stabilise the economy so quickly such that deflationary wage movements are avoided. Secondly the expansionary policy course has to be given up timely and in an appropriate manner as soon as the crisis is over. If that would be the case the crisis could be overcome without initiating future instabilities.

Despite the actual very critical circumstances, economic policy still has the option to avoid many dangers. But action has to take place as soon as possible .and Germany as the leading economy has to take a leading role in that. In addition to that monetary policy has to ease its course further to provide an opportunity for the financial market sector to recover.