

Bianca Steliana PÎRA (BE A)
Bucharest University of Economic Studies,
Department of Economic Informatics and Cybernetics

EUROZONE AND THE LOW INFLATION RISK

Literature
Reviews

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Abstract

The very low inflation in the Eurozone is, probably, the greatest challenge the European Central Bank has been handling since overcoming the 2008 crisis. This study analyses the monetary policies conducted by the ECB and their struggle to lift the inflation rate just below 2%. The paper presents the main causes for the actual situation, the countries where this problem is more persistent and the measures taken in order to raise inflation. It is of great interest to analyze whether the same policies are proper for different member states facing the deflation issue. For this reason, the study shows to what extent the single monetary policy represents an advantage or, on the contrary, a drawback for the Euro Area member states who try to overcome this critical situation.

1. Introduction

According to Lawrence Summers (2014), the nature of macroeconomics has changed dramatically in the last few years, from concerning with minor adjustments to being focused on avoiding secular stagnation.

Eurozone and its low inflation risk is a matter of great interest nowadays, probably a most challenging task for the European Central Bank and for most Eurozone Countries. The low inflation risk is in fact the risk of not being able to raise the inflation level to – eventually – its target. When considering this concept, there is a group of closely related terms which have to be properly understood: the zero lower bound, the liquidity trap and the secular stagnation. The zero lower bound defines a macroeconomic problem that occurs when the short-term nominal interest rate is at or near zero, causing a liquidity trap and limiting the capacity that the central bank has to stimulate economic growth. The liquidity trap is a situation in which prevailing interest rates are low and savings rates are high, making monetary policy ineffective [2]. A liquidity trap is caused when people hold cash because they expect an adverse event such as deflation, insufficient aggregate demand, or war. The secular stagnation is a condition of negligible or no economic growth in a market-based economy. When per capita income stays at relatively high levels, the percentage of savings is likely to start exceeding the percentage of longer-term investments in, for example, infrastructure and education, that are necessary to sustain future economic growth [3]. Persistent low growth, especially in Europe, has been attributed by some to secular stagnation initiated by stronger European economies.

2. State of the art

The Great Depression was the first time the topic raised the interest of some of the most influential economists of those times. After that, the Japanese ten-year period of deflation (1995-2005) generated an abundance of studies on how to prevent and overcome deflation (Miskin et al. – 2004, Svensson – 2006, Clarida – 2010). In 2003, Svensson published a paper sustaining that the zero bound is a foolproof way of escaping from a liquidity trap.

Lately, there have been published a lot of interesting studies on this topic. Most of them define and discuss the economic bubbles and the consequences of their crash (Caballero et al. – 2006, Graham Turner – 2008, Bernanke – 2010, Caballero and Farhi – 2014).

The first to formalize of the secular stagnation are Eggertsson and Mehrotra (2014). Their new Keynesian model is to clarify the conditions under which this can happen, or more to the point, provide a formalization of the popular secular stagnation hypothesis. As they remark, “the main

takeaway from the analysis is not just that a permanent recession is possible, but instead that a liquidity trap can be of arbitrary duration and last as long as the particular dynamics that give rise to it (such as a deleveraging shock and/or rise in inequality and/or population growth slowdown). This would suggest that a passive attitude to a recession of this kind is inappropriate”.

3. Stagflation in the Eurozone

The core problem is that in developed countries, the economic crisis has reduced the natural real interest rate (r^*) on strongly negative levels. For the production to return to its potential level there is either the need to reduce the current real interest rate (r) to lower levels equal to the natural real interest rate or to find measures to increase the natural real interest rate. Once the two rates balance, savings and investments will balance at a level that will lead to economic growth and employment close to their potential levels.

Because of the relatively high level of debt, governments could not increase spending enough to boost aggregate demand in developed economies and to help increase the natural rate of interest. In order to reduce the equilibrium real interest rate to its natural level, the central banks have reduced the nominal interest rates to zero, then switched to quantitative loosening and, recently, have opted for negative nominal interest rates. The major problem in these countries is that, despite all these policies, six years after the financial crisis, production and employment remained below pre-crisis levels. The low natural real interest rate, the low inflation level and the central bank being unable to reduce the nominal interest rate below zero prevents the authorities from maintaining the economic growth rate at its potential level.

From the beginning of 2012 till now the ECB has been facing the crises of not being able to maintain the inflation rate at least close the 2% target rate (Figure no. 1).

The sharp reduction in oil prices and the lower food prices are the main causes for Europe's current deflation. However, prices of most other goods and services have remained fairly steady; therefore people haven't held off on major purchases. More than that, beginning with March 2014, the constant increasing of the dollar against the euro has given a competitive boost to European manufacturers. This should impulse producers to start hiring workers, thus helping increase consumer confidence.

4. Alternative Monetary Policies.

Moderate inflation targeting

First proposed alternative monetary policy is a higher inflation target – that would be an inflation target rate of 3-4%. That would give enough 'space' for the real interest rate to reduce to its natural level.

In his paper, Croitoru (2013) shows how a higher level of inflation at the beginning or during a crisis, generate a raise in the cash-flows. It helps paying the debts accumulated during the period of exuberance, even without increasing government spending in order to support their investments. This is an auto-correcting mechanism that helps the economy recover through stagflation. That means starting with a reduced economic growth and a relatively high level of inflation, but avoiding a prolonged period of economic decline. According to Keen (1995), auto-correcting mechanism leads to a secular trend of decreasing liquidity preference. On the contrary, a low inflation level during crisis does not help cash-flows. Given the debt level, the lower the inflation level is, the greater the imbalance between debt and cash-flows becomes. The greater this imbalance is, more companies where the interest payments outcomes the cash flows will have to sell assets, and would probably choose the protection of a bankruptcy.

Usually countries with a higher inflation rate would use depreciation in their exchange rate to restore competitiveness. However, in the Eurozone this cannot happen. Countries cannot rely on depreciation to make their exports competitive and this can lead to large current account deficits, lower exports and lower growth. Therefore, countries who have become less competitive (Spain, Italy, Portugal, Greece) need to cut their costs to improve their competitiveness. Nonetheless, their debt burdens become unsustainable and such a strategy leads to economic stagnation and deflation. Even though the actual inflation target under 2% seems to be appropriate for Germany, it is not so well-suited for other countries in the Eurozone.

Having a higher inflation rate would help to plan out economic growth and probably diminish unemployment. Higher inflation would also help to contain and reduce government debt to GDP ratios – without excessive austerity. Among the advantages of having a moderate inflation target is the ability of making adjustments in wages and relative prices. It would be much more difficult (or even impossible) to cut nominal wages than to adjust them with their productiveness or, in case of unproductive workers, to have them frozen. These measures would enable a boost in the economic growth

In case of a higher inflation target in the Eurozone, less competitive countries could restore economic growth with low inflation – rather than outright deflation.

On the other hand, not all economists agree with targeting a higher inflation rate, as inflation is usually considered to be a problem then its rate raises above the 2% level. The main argument in favor of maintaining a low inflation target is that an inflationary growth is usually unsustainable and leads to periods of boom in the economic bubbles. Other reasons for not supporting a higher inflation

level are the fact that inflation is usually associated with uncertainty and confusion which tends to discourage investment and long term economic growth; it may reduce the value of savings and generates menu costs – as during higher inflation the changes of prices is more frequent. However, considering the Eurozone (a group of developed countries), its credibility and its experience with handling inflation targeting, these issues could probably be overcome by using the appropriate policies and a much-sustained public information campaign.

Probably the most difficult task when considering raising inflation is finding a way of to higher it. According to Goodhart (2013), having nominal interest rates already at the lower bound, it cannot be clear what monetary policies would be able to higher future inflation. In the absence of such policies, the higher inflation target may not be credible. The Bank of Japan stated the same idea.

Price level targeting

The second alternative monetary policy is the price level targeting

A monetary policy goal of keeping overall price levels stable, or meeting a pre-determined price level targeting. The price level used as a barometer is usually Consumer Price Index (CPI), -- or some similarly broad measure of cost inputs.

A central bank or monetary authority operating under a price level targeting system raises or lowers interest rates in order to keep the index level consistent from year to year.

Price level targeting is similar to inflation targeting in that both establish targets for a price index like the CPI. However, if inflation targeting only looks forward (i.e., a 2% inflation target per year), price level targeting actually takes past years into account when conducting open market operations. So, if the price level rose by 2% in the previous year (from a theoretical base of 100 to 102), the price level would have to drop the next year in order to bring the price level back down to the 100 target level.

According to Cournede and Moccero (2009), the main benefits of price level targeting are:

- A price-level targeting regime can act as a built-in stabilizer by reducing the need for large moves in policy interest rates in response to shocks. For instance, if the price level falls, agents would expect inflation to rise in order to bring the price level back to its target path, this should reduce the long-term real interest rate, support activity and pushing up prices.
- As the need for large shifts in policy interest rates is reduced, it is less likely that the economy would fall into a liquidity trap.
- A credible price-level targeting mechanism can have a positive effect on capital accumulation and steady-state growth insofar as it reduces the cost of

long-run nominal contracts by protecting the long-run purchasing power of money.

The same paper identifies the possible risks of adopting a price-level targeting regime. Main costs would be: Inflation targeting is better at protecting against welfare losses than price-level targeting when there is strong uncertainty about the presence of a sufficient minimum degree of forward-looking behaviour of economic agents., the self-regulating capacity of price-level targeting may be undermined if central banks are not fully credible.

Under the actual circumstances with very low interest rates, the monetary policy regime is limited to the zero lower bound on nominal interest rates. In this case, a change to a price-level targeting regime can help avoiding the liquidity trap, as suggested by Svensson (2001) .

5. Conclusions

This paper shows the benefits and costs of both the moderate inflation targeting regime and the price level targeting regime as an alternative monetary policy for this actual situation in Eurozone. Having both policies analyzed and compared, a higher inflation target seems to be the appropriate solution. Some of the reasons for finding it a better choice are that it is easier to implement, it is a very well documented theory which has been applied and tested in numerous countries, in comparison to the price level targeting which was only applied in Sweden in the early 1930s. Consequently, it is less risky than the price-level targeting option; more practical experience would be needed before one could conclude that price level targeting constitutes a worthy alternative to current monetary frameworks. Moreover, the Eurozone has been known for being not so opened when it comes to shifting to new monetary policies.

Nonetheless, a more complex analysis is needed before opting for a solution among the two regimes. Unfortunately, this paper does not provide simulations for the two regimes. It would be very interesting to model the two policies by creating two DSGE models and, after using them to simulate the economic progress in Eurozone, choose the one which better helps overcoming the stagflation the Eurozone is facing.

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Figure



Figure no. 1 Inflation rate – Annual percentage changes 200801-201412

Source: Eurostat