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PRESS RELEASE

Deflation, a demon from the distant past or a real danger in 2009?

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During the summer of 2009, Belgium and the euro area, as well as numerous other industrialised countries, recorded negative inflation rates. Although they were the direct result of sharply falling commodity prices in the second half of 2008, the question arose whether this would be the start of a deflationary spiral. Indeed, parallels with the Great Depression in the 1930s - which was also characterised by an asset price boom-bust cycle and banking stress - were drawn.

This article explains under which conditions deflation can have dramatic consequences for the economy, gauges the current deflationary risks and discusses what the policy options are in a deflationary environment.

In past centuries, deflation - when defined in a broad sense as a decline in the general price level - was a frequent phenomenon and was not always accompanied by economic hardship. When deflation is defined more narrowly as a sustained decline in the general price level caused by a negative demand shock and moreover gives rise to further expected price level decreases, it is no innocent phenomenon, however. Indeed, it then confronts an economy with a number of nominal rigidities which can trigger a deflationary spiral. One such rigidity is the lower bound on nominal interest rates at zero which can limit the central bank's potential to stimulate the economy as interest rates cannot fall any further. Second, the real burden of outstanding debt increases when prices fall, leading to a redistribution of wealth towards lenders who generally have a lower propensity to consume than borrowers. Third, it appears to be difficult to decrease nominal wages, implying that real wages adjust not sufficiently to the worsened economic situation, which leads to more unemployment and worsening economic activity.

Today, the risk of deflation in the euro area and Belgium seems limited. The negative inflation rates recorded in the summer of 2009 can entirely be explained by declining energy and food prices and are not a sign of widespread price falls. Also, inflation expectations remain well anchored although inflation is expected to return only gradually to levels consistent with price stability. That is reflected in predictions from professional forecasters and international institutions, financial market-based measures of inflation expectations and the Eurosystem's staff macroeconomic projections. Taking a broader view, the IMF deflation vulnerability indicator, which combines a range of macroeconomic indicators, points to an increased *ex ante* risk of deflation in all industrialised countries. However, prompt, accurate assessment of this increased risk of deflation has led the policymakers to conduct a decidedly expansionary policy. The measures to support the banks, the recovery plans of the various governments, and the interest rate cuts supplemented by unconventional measures on the part of central banks throughout the world have significantly reduced the *ex post* deflation risk. Such a resolute policy response is in stark contrast to what happened at the time of the Great Depression.

As regards the policy options, it should be pointed out that having a quantitative definition of price stability that defines the latter as a low, but strictly positive rate of inflation - the Eurosystem, for instance, aims at an inflation rate below, but close to, 2 pct in the medium term -, helps to prevent that the economy enters a deflationary spiral. On top, when nevertheless confronted with a deflationary threat, monetary policy has a range of tools to limit deflationary risks. First, nominal policy rates can be lowered pro-actively - in other words, more forcefully than in normal conditions -, until they hit the lower bound. If further stimulus is warranted, central banks can resort to unconventional monetary policies, as they have done in previous months. These policies can consist of ample liquidity provision, quantitative easing, credit easing, communicating that interest rates will remain low for an extended period of time, foreign exchange market intervention or changing the definition of price stability to a price level target instead of a target for the annual inflation rate. Also fiscal policies can help to contain deflationary risks, in first instance to tackle banks' solvency problems if they threaten financial stability. At the same time, it should be borne in mind that expansionary fiscal policy can only resort to stimulating effects when the longer-term sustainability of public finances remains intact.

Finally, it must be emphasised that policy-makers have to decide on appropriate policies to deal with deflationary risks in so-called real time - i.e. on the basis of information available at the time -, making "prevention is better than cure" advice all the more complex. Looking ahead, policy makers do indeed have to weigh the risk of reversing macroeconomic impulses too early - and hence the re-emergence of deflationary risks -, against the risk of too late a normalisation which would lead to higher inflation or the emergence of a new bubble.