

{ DEFLATION }

# JEREMY WARNER

Lower prices can feed a depressing downward spiral in demand

Ever since the financial crisis first erupted, commentators, and indeed policymakers, have found it hard to figure out what poses the greater threat – deflation or inflation.

With a collapsing banking system and economy, it was deflation that everyone worried about most at the start of the crisis. But then along came central bank money printing, and the possibility of runaway inflation, or even hyperinflation, seemed to become the greater concern. We were about to become Weimar, or Zimbabwe, some warned.

This was, in truth, never very likely, but it didn't stop some pretty garish headlines every time the consumer price index showed a slight uptick. Well, now the inflation risk has receded anew, we are back to worrying about deflation, particularly in the economically depressed eurozone, where the headline inflation rate in January sunk to 0.7%. Not since the immediate aftermath of the Lehman Brothers collapse has it been so far beneath target.

At the World Economic Forum in January, Christine Lagarde, MD of the International Monetary Fund (IMF), said the IMF assigned a “low” 15-20% probability to deflation taking hold in Europe. I would say that's a worryingly high risk, and in any case, she went on to opine that economies already at very low rates of inflation were just one shock away from falling into outright deflation. Such



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a shock – think Russia and Ukraine, or China and Japan – is only too possible.

But before assessing the deflation threat in more detail, why do economists worry about falling prices? We've had dramatic price deflation in consumer electronics and communications for decades now, and this has plainly been a positive for most economies. Likewise, falling energy and food prices, which tend to put more money into people's pockets and allow them to increase their spending on other things. What's not to like about lower prices?

In answering this question, it is important to distinguish between price falls caused by rising productivity and innovation – overwhelmingly positive – and a generalised fall in the price of goods and

services prompted by absent demand – deeply negative.

For countries with very high levels of debt, this latter phenomenon is likely to be utterly disastrous, since its effect is to increase the real value of the debt, making it even more difficult to pay down. Fully fledged deflation is also highly likely to reduce spending and investment in the economy. Why buy today when the price will be cheaper tomorrow?

Eventually, a self-feeding, downward spiral in demand takes hold, as has occurred in Japan, which has had no growth in nominal GDP for more than 10 years now. The jury is still very much out on whether Shinzō Abe's 'three arrows' policy initiative will succeed in extracting Japan from its economic funk. There is good reason for scepticism.

Deflation may be as much about the demographics of ageing societies as subdued money growth and structural deficiencies. Whatever. Once in deflation, it's extremely difficult to get out of it.

In any case, you'll be pleased to know that, according to the European Central Bank (ECB), there is no such threat in Europe. If deflation is defined as a broad-based fall in prices with a self-feeding expectation of further falls, says Mario Draghi, president of the ECB, “we don't have that in Europe”.

Much of the disinflationary pressure in the eurozone is coming from its distressed countries, he insists. This is not deflation as such, but “a relative price adjustment”, which in time will restore competitiveness with more economically healthy currency countries. Believe it if you will.

The more worrying truth is that some countries in Europe already have many of the characteristics associated with prolonged periods of price deflation – depressed internal demand, high unemployment, ageing demographics and intractably high debt burdens. I hope Draghi is right, but I wouldn't bet on it. He will come to regret not taking the threat more seriously. ♥



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