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Deflation in the euro zone

The euro zone needs a history lesson

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Rounding off the contributions to our round-table discussion of the risk of deflation in Europe is Kevin O'Rourke, professor of economic history at Oxford University.

In a recent column (http://www.ft.com/cms/s/0/73b623d8-73e0-11e3-a0c0-00144feabdc0.html#axzz2qb40DNRI) in the Financial Times, Wolfgang Münchau discussed the set of choices that appear, as of now, to have been made by Europe's policy-making elite. These are: to preclude any form of debt mutualisation; to have individual debtor countries pay off their existing debts; and to have them adjust macroeconomically via austerity and deflation. In Münchau's words, "If you look at this with a knowledge of economic history, this is an awe-inspiring set of choices, to put it mildly."

He's right.

When economic historians teach the history of international monetary relations they often start with the classical gold standard of the pre-1914 period. Under this system, periodic deflation was a feature, not a bug. Deficit countries were supposed to adjust by following the "rules of the game", raising interest rates and reducing the money supply, thus lowering price levels, depreciating real exchange rates, and improving trade balances. (Alternatively, Humean gold flows could have sparked the same adjustment process automatically.) If such an adjustment mechanism was suitable to any period, it was the decades before World War I. Relatively flexible wages and prices meant that deflation was more feasible than it would become subsequently, and involved fewer unemployment costs. The limited franchise meant that any unemployment that did result would incur lower political costs than would subsequently be the case. The net effect was that deficit countries could in principle depreciate their real exchange rates, even though nominal exchange rates were fixed, and surplus countries had no incentive to permit inflation, via deflation.

Strikingly, however, even before 1914 adjustment in many cases did not follow this textbook picture. Leave aside the fact that interest-rate-setters did not in general follow the "rules of the game", and recall that many countries adhered to the gold standard only sporadically, if at all. This meant that nominal exchange rates did a lot of the heavy lifting in real-exchange adjustment even during this period, and especially in those countries in the periphery (southern Europe, Asia, and Latin America) where such adjustment was needed the most.

Furthermore, the overall stability of the gold-standard "system" depended on whether the "gold zone" was experiencing inflation or deflation. As is well known, the period from the early 1870s to the mid-1890s was one of deflation, as a growing world economy ran up against limited gold supplies. Deflation was then succeeded by inflation from the mid-1890s onwards. In an article (http://www.cepr.org/PRESS/EP26FZPR.htm) published in 1998, Marc Flandreau, Jacques Le Cacheux and Frédéric Zumer point out that the period of deflation was one of rising public debt in the periphery, whereas debt-to-GDP ratios tended to fall after 1895. They also point out that peripheral adherence to gold was limited in the earlier period, but became more common after 1900 or so. Messrs Flandreau, Le Cacheux and Zumer conclude that the

> gold standard turned out to be hostage to the exogenous evolution of prices. Over the period 1873-96, the declining price trend exacerbated the public finance problems of the periphery to breaking point. After 1896, by contrast, inflation made convergence and steady participation in the gold zone much more attractive. Governments became more eager to conform to the discipline that markets require. The clear implication for EMU is that its stability will hinge on the ECB's policy not being too restrictive.

The pernicious effects of deflation on debt sustainability were further in evidence in the interwar period. As the IMF pointed out (http://books.google.co.uk/books?id=JeHDKIIzPt0C&pg=PT165&lpg=PT165&dq=The+U.K.+interwar+episode+is+an+important+reminder+of+the+challenges+of+pursuing+a+tight+fiscal+and+monetary+policy+mix,+especially+when+the+external+sector+is+constrained+by+a+high+exchange+rate&source=bl&ots=yc_LYqHwvf&sig=_gjD8ynk-38HFr07F0OE70KmQho&hl=en&sa=X&ei=l0bYUq_3HI-f7gaD2YHgDg&ved=0CDIQ6AEwAA#v=onepage&q=The%20U.K.%20interwar%20episode%20is%20an%20important%20reminder%20of%20the%20challenges%20of%20pursuing%20a%20tight%20fiscal%20and%20monetary%20policy%20mix%2C%20especially%20when%20the%20external%20sector%20is%20constrained%20by%20a%20high%20exchange%20rate&f=false) recently, interwar Britain was what current euro-orthodoxy would regard as a model pupil. It ran a primary surplus equivalent to about 7% of GDP throughout the 1920s, it was committed to repaying its war debts, and it experienced "internal devaluation", which is what deflation is called nowadays in the context of individual euro-zone member states. And yet the net effect of all this virtue was a substantial increase in the British debt-to-GDP ratio, largely as a result of deflation. As the IMF drily notes, "The U.K. interwar episode is an important reminder of the challenges of pursuing a tight fiscal and monetary policy mix, especially when the external sector is constrained by a high exchange rate."

An adjustment strategy based on the expectation that already over-indebted countries will pay back what they owe in an environment of falling prices seems doomed to failure; all the more so if "internal devaluation" at the level of individual member-states is replaced by euro-zone-wide deflation. But outright deflation would be much more costly than that. If economic historians have learned anything from the Great Depression, it is that deflation is dangerous. First, nominal wages are sticky downward: as Ben Bernanke and Kevin Carey showed (http://qje.oxfordjournals.org/content/111/3/853.short) for the interwar period, this implies that price deflation, if achieved at all, leads to higher real wages and unemployment. Second, deflation is harmful in other ways, increasing the real value of private as well as public debt, raising real interest rates, and leading agents to postpone expensive purchases. And interwar deflation ultimately had terrible political consequences, as well as economic ones.

The euro zone really shouldn't want to go there.