

ECB interest rate cut could kill the wrong guy

By Michael Heise

Eurozone deflation is a welcome sign of improving productivity

Eurozone inflation is falling and many observers are sounding the alarm. Is the region teetering on the brink of Japanese-style deflation and was the European Central Bank right to react with its surprise rate cut in early November, they ask?

The answer depends on whether the eurozone is experiencing “good” or “bad” deflation. The stubborn deflation seen in Japan was the bad type as it arose from a persistent weakness in aggregate demand rather than an increase in the supply of goods and services.

The situation in the eurozone looks similar. It started with the bursting of a credit bubble, which forced overleveraged households and companies to trim their expenditure. Bad debts led to a loss of confidence in banks, many of them kept alive only by exceptional liquidity measures by the ECB. Nonetheless, bank lending has been on the retreat, bankruptcies have soared and disposable incomes have fallen. This is the kind of demand shock that fosters bad deflation: a financial crisis causes aggregate demand to shrink faster than supply, resulting in falling prices.

However, looking through the lens of aggregate supply, the difficulties of the eurozone’s periphery bear only a superficial resemblance to those plaguing Japan. In this case, falling prices are the result of a supply shock, through improved productivity or real wage reduction.

Low inflation or even deflation is testament to the fact that (painful) adjustment through structural reforms is finally working. The eurozone periphery is regaining competitiveness via internal devaluation. This could even be called “good deflation”, and is a world away from Japan, which slipped into deflation because it was able to duck structural reforms for too long with the help of expansionary fiscal policies.

Interaction

In the eurozone, both reasons for deflation – good and bad – interact. On the one hand, low inflation or deflation is a welcome reaction to structural reforms as they accelerate the restoration of (cost) competitiveness; on the other, it is a troubling sign of economic depression as it aggravates the problem of excessive debt.

It is not at all clear whether the ECB’s response addresses the good or bad sort of deflation. The ECB could easily end up killing the wrong guy. In such a situation, it may be better not to shoot at all. The rate cut will not help the peripheral economies but only fuel the already riotous equity boom.

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But this is not to say that nothing should be done. Measures should aim straight at the demand shock, directly tackling its cause – the private debt overhang. While this is a long-term task, it will be much easier within a sound banking system.

At the bottom of the debt pyramid sits the moribund banking sector. Despite the ultra-loose policy of the ECB, credit is still not flowing properly. We are left with banks that are unable (and unwilling) to clean up their loan books but are practising debt forbearance on a grand scale. This also undermines reform efforts: although labour and product markets have been freed from red tape, without new credit there are too few young and innovative companies that can exploit the new opportunities.

Banking test

This diagnosis leads directly to the comprehensive banking test the ECB is due to undertake during the course of 2014 in preparation for its new role as the main bank supervisor in the eurozone.

It is vital the ECB does not fudge the asset quality review but helps banks to write down their bad debts. Banks would be less reluctant to lend to new businesses if their pile of dud loans is reduced, while households and companies would be more likely to start spending again if their debt burden is eased.

The US experience shows that a “tough love approach” towards banks can work, placing the necessary deleveraging on fast forward and limiting the demand shock. The ECB’s banking test may be the last chance to restore confidence in the eurozone’s banking system as a whole. It would be a pity if this opportunity was squandered due to petty quarrels about sources of backstop capital to fill banks’ capital holes; or due to the almost mythical belief in the power of monetary policy to solve all problems by pumping in ever more liquidity.

In reality, monetary policy has its limits, and the price fall in the wake of structural reforms cannot – and should not – be stopped. With a clean-up of the banking system we could at least be sure we are not seeing the bad sort of deflation that afflicted Japan, but rather “good deflation” triggered by internal devaluation. In the end, there is nothing to fear about deflation if it is signalling improved productivity and competitiveness.

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