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## Enabling the ECB to combat the spectre of deflation

By Alessandro Leipold

Over a century and a half ago, Karl Marx opened his Manifesto with the famous image of a "spectre haunting Europe." A similar image is now used by commentators to characterize the main risk confronting the continent: deflation. In contrast to 1848, however, it cannot be said that "all the powers of old Europe" have gathered into an alliance against this menace. On the contrary, all official institutions, at both national and European level (ECB included), have tended to downplay the threat. Yet the phantom of deflation is becoming more tangible with each passing month.

Eurozone inflation has been on a steadily declining path since the end of 2011. This January marked the fourth consecutive month with an inflation rate below 1% (0.7%). As noted by ECB President Mario Draghi, "the longer inflation remains at a low level, the greater the risk of deflation." The transition from "a prolonged period of low inflation" (foreseen by the ECB itself) to actual deflation is a slippery one, with all the attributes of a vicious circle. Hence the term deflationary "spiral" – a process that feeds upon itself and is very difficult to arrest once triggered. Deflation, as Japan has demonstrated, can have devastating effects, braking consumption and growth for years, and – importantly for Italy – making it nigh impossible to reduce public debt. The risk currently facing Europe is clearly asymmetrical: while that of deflation is high, that of overshooting the ECB target is nil. The target's formulation – "an inflation rate below, but close to, 2% over the medium term" – is clearly designed to counter both inflation and its opposite. We are clearly a long way from the 2% ceiling, and there are legitimate doubts that it will be approached even "over the medium term." For the ECB, this is the first real test of a downward deviation from its target – a test so far marked by delays and hesitation. It is safe to assume that the response would have been far more aggressive in the case of an upward deviation from target, i.e. of an inflation rate in excess of 3%.

Why the hesitation? One has to assume that the Eurotower has faith in its own analyses which, for a number of reasons, do not see deflation as imminent. But faced with such a clearly asymmetrical risk, the lack of a more decisive response remains surprising. It is thus most likely motivated by other considerations, of a more political and institutional nature. Draghi himself has reiterated that "the ECB stands ready to act if needed, using all the instruments allowed by the Treaty." The boundaries of the latter are however highly uncertain, especially after the tough words of Germany's Constitutional Court on the legality of OMTs. Frankfurt may well have thought it advisable not to rock the boat on this front until the legal dispute is resolved.

But there is a second factor braking ECB action: it is that of moral hazard, i.e. the concern of lifting pressure for reforms from the countries that sorely need them. The example of Italy in the summer of 2011 is still fresh in European minds. At the time, government bond purchases by the ECB eased market pressures and allowed the government of the day to disregard the letter it had received from Trichet and Draghi. There is but one way to respond to such concerns. It is that of decisively undertaking the long-delayed structural reforms and public debt reduction. If the Renzi government rises to this challenge convincingly, it will not only render a great service to Italy, but also free up room for maneuver for the ECB's monetary policy and for the EU itself in the application of its fiscal rules. May it get to work, then, and swiftly so.