Inflation in Europe: The Price is Wrong

By Antonio Fatas , INSEAD Professor of Economics

The argument that low inflation raises income and boosts demand is not sound.

The Euro area inflation came lower than expected in March and this has raised concerns about deflation (or "lowflation" as labelled by the IMF). In yesterday's **Financial Times**, Jurgen Stark, a former ECB board member argues that deflation or low inflation is not a problem. One of his arguments is that there are benefits for low inflation, in particular:

"It is likely we are living in an extended period of price stability. This is good news. It boosts real disposable income and will eventually support private consumption."

(By the way, Mario Draghi used the same argument in his last press conference).

So low inflation raises real income and it helps boost demand and output. The economic logic behind this statement is at best unclear, at worst completely wrong. Unfortunately, the misconception involved in this sentence is not that uncommon and it reflects the poor understanding of the general public (and public officials) about inflation, nominal and real variables. But it also reflects poorly on academic arguments based on models with price rigidity that, in my view, are not always as clear as they should be when it comes to the dynamics of absolute and relative prices.

Redistribution effect

Let me start with Jurgen Stark's comment: his assumption is that prices are growing at a slower rate than income. But he forgets that income is linked to prices as well. It is possible that as a result of low inflation the real income of some agents is growing but it would be at the expense of the real income of others. For example, if wages are growing at a decent rate but prices are falling (or growing at a lower rate) it means that real wages are increasing. But this is a redistribution effect that shifts income towards workers and away from profits. Total demand can only be affected if we assume some differences in the propensity to consume of different groups. And if this is the model that we have in mind, then let's push for higher wages across the board to get out of a crisis (I doubt Jurgen Stark favours this conclusion).

But what do academic models have to say about the relative price effects of changes in inflation? Not much or, at least, not in a way that is clear enough to drive consensus in policy recommendations.

Let's start with the basic model we teach in macroeconomics: the textbook IS-LM model (investment/saving (IS) and liquidity preference/money supply equilibrium (LM)). In most textbooks this is originally presented as a pure demand-side model. Inflation (or prices) matter: lower prices increase demand. Demand depends on the ratio of nominal money to prices (M/P) and lower prices are associated with increases in output. This is indeed the main mechanism by which lower prices help restore the long-term equilibrium. So in this world, low inflation or deflation are good (i.e. Jurgen Stark is right).

The notion that M/P drives demand and output is not always intuitive for many students so it is very common that when we teach the IS-LM model we also make a reference to the potential role that some relative price can play to generate the same output dynamics. In particular we bring wages into the story. But here is where the logic becomes confusing. By bringing in wages we argue that recessions are periods where nominal wages are rigid and as prices go down, the real wage increases and causes employment and output to contract. The recovery from a recession corresponds to a period where nominal wages are going back to normal (decreasing relative to inflation) and helping employment and output grow. But there are two problems with this logic: this is a supply effect, not anymore a demand effect. Second, if this logic is true, higher prices/inflation is the way to restore the equilibrium (as opposed to lower prices in the first argument). The relative dynamics of different prices are crucial to support the logic of this argument and talking about inflation (as Jurgen Stark does) without making a clear statement on how different prices and wages are moving will be misleading.

But what happened to demand in that story? The real wage argument is a supply-side argument and the assumption is that demand will match supply. But what if we consider the possibility that different agents have different propensity to consume in the short run? Then any change in relative prices might affect demand. In that world, it might be that lower prices help raise real wages (and lower profits) and under the assumption that workers have a higher propensity to consume than capital owners, this could raise demand and output (so Jurgen Stark is right again).

The other effects of low prices

It gets more complicated as real wages are not the only relative price that matter. There are two other arguments that can affect the potential effects of low prices. First, if nominal interest rates are fixed (or stuck at the zero-lower bound), falling prices/inflation will raise real interest rates and reduce demand. In addition, if financial assets and liabilities are denominated in nominal terms, any unexpected fall in prices/inflation will raise the real value of the debt. This is again a redistribution effect (the real value of savings falls so those agents are hurt by inflation) but under the assumption that either borrowers have a higher propensity to consume or simply need more help to restore their damaged balance sheets, there could be a positive effect on demand.

And things get a lot more complicated in an open economy where prices (and wages) play a role determining exports and imports. Typically we teach that lower prices is the right recipe to engineer a real exchange rate devaluation that helps regain competitiveness and improve growth (but when we do so, we ignore the other potential negative effects of low prices or inflation).

Finally, it might be that the effects of low inflation are not at all related to relative prices. The confusion between nominal and real variables has been documented many times and falling inflation, even if all prices and interest rates are moving in sync, could trigger real effects if it is misinterpreted as a real change in income or relative prices.

So we are left with a set of arguments using models with some type of nominal rigidity that are not always consistent in their predictions. They make use of both supply and demand-side arguments and under some scenarios inflation (in some prices) is good, under other scenarios inflation (in some prices) is bad. In this environment, making policy recommendations becomes very difficult.

How to get it just right?

As an example, what do we want to see in the Euro periphery? Lower inflation or higher inflation? Lower inflation sounds good as a way to generate an adjustment in the real exchange rate. But do we want lower price inflation or lower wage inflation or both? How do nominal wage rigidities and potential income distribution effects (from capital to labour or from savers to borrowers) affect demand?

My sense is that the consensus says we want a high enough level of inflation in the Euro area that allows for significant changes in relative prices within countries (this is what the IMF argues in this **blog post**). But exactly which relative price has to move and in which direction might be less obvious. We normally think that the periphery will need lower wage inflation (to be more competitive). But not too low so that we do not run into the fact that wages are unlikely to fall in nominal terms or that potential deflation increases the real value of debt. This all sounds reasonable but implicitly we are assuming that falling real wages in the Euro periphery is good. But are we sure that the redistribution effects of such policies do not affect demand (the same way we argue that the redistribution effects between savers and debtors affects demand)? It would be nice to have more clarity both on the theoretical arguments and the empirical size of each of these effects.

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