

## **The economic monster called deflation**

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(This is the second in a three-part series.)

In part one of this series, I wrote about the deflation specter that is haunting Europe. Central bankers are so fearful of deflation that they want an inflationary cushion to prevent an economic shock or geopolitical crisis from sending low inflation into negative territory. The Federal Reserve, European Central Bank, Bank of England and Bank of Japan have inflation targets of 2%.

Why is deflation so troubling to central bankers?

First, with chronic deflation, debts rise in real terms. Their nominal value remains fixed, yet nominal incomes and profits — the wherewithal to service those debts — tend to fall. So bankruptcies leap, and lending, the driver of much economic growth, atrophies.

Second, when deflation occurs, economies weaken and central banks lose much of their power. Interest rates fall to zero, and monetary policy becomes asymmetrical (because rates can only be raised, not lowered).

Third, real interest rates are always positive, even with zero nominal rates. That's been the case in Japan for two decades. This means that central banks can't create the negative real rates they desire to encourage borrowing. To be effective, they need to pay borrowers, in real terms, to take money.

Finally, deflation breeds deflationary expectations, which results in a sluggish economy. That's been the case in Japan since the early 1990s. Buyers wait for lower prices before purchasing, so excess capacity and inventories mount, pushing prices down. That confirms prospective buyers' expectations, so they hold off further, creating a self-feeding cycle of buyer hesitation, which spawns excess inventories and capacity that depresses prices and encourages further restraint by purchasers, and so on.

Deflationary pressures are being felt worldwide. The causes include slow growth in developed countries and now in China and other emerging economies. Prices are also falling because of the globalization of labor, leaping worldwide production, excess supply and declining commodities prices.

To make matters worse, global financial deleveraging, which also depresses growth, will probably persist for four more years or so, given that it normally takes a decade to unwind excessive debt after a major financial crisis (as happened in 2008).

Deleveraging has been so profound that it has largely offset the huge fiscal stimulus and monetary easing in the US and elsewhere.

Central bankers, like everyone else, love to blame others for sluggish growth and deflationary pressures. Former Fed chairman Ben Bernanke faulted the gridlocked Congress and the Barack Obama administration for the lack of short-term fiscal stimulus and long-run budget reform. ECB president Mario Draghi blames Europe's inflexible labor policies. "The protracted stagnation," he says, "is pretty severe."

Central bankers also fault their strong currencies. A strong euro retards exports while depressing euro-area import prices and, therefore, the prices of competing domestic products. Japanese prime minister Shinzo Abe is trying to trash the yen, and the ECB is moving rapidly toward measures to depress the euro.

Draghi recently revealed that the ECB has discussed reducing its interest-rate target, introducing negative interest rates on member bank deposits and buying securities on a large scale. "We don't exclude further monetary-policy easing," he said, "and the ECB is resolute to act swiftly if required."

The governing council is "unanimous in its commitment" to use "unconventional instruments" if inflation remains too low for too long, Draghi also said. "A strengthening of the exchange rate requires further monetary stimulus. That is an important dimension for our price stability."

The Organization for Economic Cooperation and Development notes that, among euro-area countries, Greece, Cyprus and Spain already suffer from deflation. It wants the ECB to take "additional non-conventional measures" if the problem escalates.

In the final part of this three-part series, I'll discuss likely ECB actions to depress the euro.

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