The Professor *of* Passivity

BY DESMOND LACHMAN

Three lessons for Mario Draghi.

History is bound to judge harshly the European Central Bank's current maintenance of a passive monetary policy stance in the face of markedly decelerating inflation. This is more so the case since the ECB is maintaining this stance despite the fact that eurozone inflation is now running at less than half of the ECB's inflation target. It is also doing so despite the fact that European unemployment remains at record-high levels and Europe remains in the grip of a crippling credit crunch.

While low inflation levels by historic standards characterize most of the world's advanced economies, the eurozone stands out as the economic area where inflation has been decelerating at the fastest pace and where inflation is now at the lowest level of the world's major economies. Over the past two years, eurozone inflation, excluding volatile items like food and energy, has declined by around one-half from 1.5 percent to 0.8 percent. This takes eurozone core inflation to its lowest level in the euro's fifteen-year history and to less than half the ECB's inflation target of "below but close to 2 percent." It also puts inflation into what economists generally consider to be the danger zone, which necessitates resorting to aggressive policy action to forestall the risk of outright deflation.

Desmond Lachman is a resident fellow at the American Enterprise Institute. He was formerly a deputy director in the International Monetary Fund's Policy Development and Review Department and the chief emerging market economic strategist at Salomon Smith Barney.

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220 I Street, N.E., Suite 200
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Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

A particularly troubling aspect of recent eurozone inflation performance has been the marked divergence of inflation performance between the zone's northern and southern member countries. While inflation in the more buoyant Austrian, Dutch, Finnish, and German economies has been not very far below the ECB's inflation target, the same is hardly true of the countries in Europe's troubled economic periphery. Indeed, Cyprus and Greece are now experiencing outright deflation, while Ireland, Portugal, and Spain are all on the cusp of deflation. Regretfully, these countries are the ones most in need of higher inflation to help them cope with their very heavy public and private sector debt burdens.

The deflation risk associated with European inflation falling into the danger zone has not escaped IMF Managing Director Christine Lagarde's notice. In recent weeks, she has called on the ECB to be much more proactive in its policies to avoid the risk of deflation. However, Madame Lagarde's concerns are not shared by ECB President Mario Draghi. Indeed, he has been stridently dismissive of any notion that Europe might be on its way to experiencing anything like Japan's deflation over the past two decades. By the same token, he has been dismissive of any further resort to unorthodox monetary policy measures by the ECB to help boost eurozone inflation.

What, Me Worry?

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Similarly, although the ECB is forecasting that there will somehow be a pickup in inflation despite the eurozone's large output and labor market gaps, it is still projecting that inflation will increase to only 1.3 percent by 2015, leaving it well below the ECB's 2 percent inflation target.

The ECB's relative monetary policy passivity also seems surprising considering the euro's relative strength. The last thing any struggling European economy needs right now is a strong currency. Yet that is exactly what Europe now faces, in large measure because of the ECB's relative passivity at a time when both the Federal Reserve and the Bank of Japan's massive expansion of their bal-

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ance sheets has been weakening the U.S. dollar and the Japanese yen.

In allowing the ECB to fall behind the monetary policy curve, it would seem that Draghi has forgotten three basic monetary policy lessons that one would have thought that he must have learned during his doctoral stint at the Massachusetts Institute of Technology. The first lesson, which was famously expounded by Milton Friedman, is that monetary policy generally operates with long and variable lags. An important implication of this lesson is that it is very dangerous for a central bank to allow inflation to get too low since it generally takes a very long time for corrective monetary policy to work its magic. Until monetary policy does begin to work, there is the very real danger that inflation expectations could become unanchored at an unhealthily low level by persistently low realized inflation.

The second lesson that Draghi seems to have forgotten is that large gaps in the labor and product markets are generally associated with decelerating price inflation. Had he remembered this lesson, he should not have been surprised when core eurozone price inflation declined markedly over the past two years, for eurozone inflation would seem to have only been responding to a rise in overall European unemployment to record levels and to the opening up of very large output gaps, especially in countries like Italy and Spain. Had he remembered this lesson, he also would not have been quite as dismissive as he now seems to be about the risks of Japanese-style deflation taking hold in Europe. This is particularly the case considering that the ECB itself is forecasting the persistence of very large output and labor market gaps over the next two years.

The third monetary policy lesson that Draghi seems to have forgotten is that deflation has a high cost, especially when countries have very high public and private sector debt levels. For, as economist Irving Fisher taught us, deflation raises the real burden of any given debt level, which for highly indebted countries heightens the risk of a deflationary trap. One would have hoped that this lesson would not have been lost on Draghi, especially since many countries in the European economic periphery have extraordinarily high public and private debt levels at the very time when they are already either experiencing or about to experience deflation.

It is certainly true that the ECB's founding treaty legally constrains its room for policy maneuver. In particular, unlike the Federal Reserve or the Bank of Japan, the ECB is prohibited from buying sovereign bonds in the primary market. However, this would not seem to exonerate the ECB from its relative passivity in the face of a real deflation risk. There would seem to be nothing to stop the ECB from moving more quickly to cut its policy rate to the zero bound, from charging interest on ECB deposits, from buying private sector asset-backed securities, and from subsidizing bank lending to the countries in the European periphery.

To put the ECB's current decision to eschew the further resort to unorthodox monetary policy measures in perspective, it is well to consider how the U.S. Federal Reserve might have reacted under similar circumstances. In September 2012, when the United States was faced with a deflation risk, Ben Bernanke's Federal Reserve responded by setting out on a third round of quantitative easing that expanded the Fed's balance sheet by around an additional $1 trillion over the past year. By contrast, when faced with a similar deflation threat, Draghi's ECB frets over whether or not it should cut interest rates by a mere 25 basis points. This inaction only heightens the likelihood that the ECB is now in the process of repeating the Bank of Japan's past mistakes of doing too little too late to ward off deflation and to prevent a lost economic decade. ◆

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