Christian Noyer: The ECB is ready to fight deflation

Opinion piece by Mr Christian Noyer, Governor of the Bank of France and Chairman of the Board of Directors of the Bank for International Settlements, in Wall Street Journal, 21 November 2013.

* * *

There is a lot of talk nowadays about the risk of a "lost decade" in the euro zone, with a conjunction of no growth and deflation. Current forecasts point to very low inflation in the foreseeable future. For the euro area as a whole, inflation is projected to remain at around 1.5% in the coming year.

However, low inflation is very different from deflation. Deflation is a cumulative process of decreasing prices, wages and output fueled by negative expectations. Deflation is a pernicious spiral. It increases the burden of debt and creates an incentive to defer consumption and investment. Deflation is especially dangerous because once the process becomes entrenched, it becomes very difficult to stop.

At the moment there are no signs of general deflation in the euro area and most indicators point to a very low risk. Inflation expectations in particular remain firmly anchored in positive territory and, for the long term, stand at levels close to the European Central Bank's definition of price stability.

As usual, inflation rates vary in the different economies of the euro area. In some peripheral countries, inflation is particularly low. This, in a way, is a good thing, as it contributes to restoring their competitiveness, as witnessed by their strong export growth. However, the lower inflation is, the greater the risk that unexpected shocks could push the economy into deflationary territory. Since this could, in turn, have consequences for overall euro-area inflation, it is perfectly justified to ask what should be done to minimize that risk.

The best protection and the first line of defense against the risk of a lost decade is structural reform. Structural reforms stimulate private consumption and make investment more profitable. In particular, they increase the return on capital and, as a consequence, the economy spontaneously moves towards an equilibrium with higher interest rates. In turn, higher equilibrium interest rates would make it easier for the European Central Bank to set its own policy rate at levels consistent with those needed by the economy. The chances that monetary policy becomes constrained by the lower bound of 0% interest rates are reduced. Higher equilibrium rates also benefit savers, a legitimate concern in many countries. Basically, savers have a claim on future output. They are best protected when growth is sustained and widespread, allowing them to earn high returns and diversify their risks.

That said, deflation, like inflation, is ultimately a monetary phenomenon. And central banks must fight all risks to price stability with determination. Under the Eurosystem mandate, which is the cornerstone of all our actions, price stability is our priority objective. The definition of price stability is therefore an essential feature of our monetary framework. Originally, when the euro was created, price stability was defined as a "less than 2%" increase in the overall price index. That would theoretically allow for zero or even negative inflation.

The definition was described as "asymmetric," meaning that the Eurosystem would react to excess inflation but would be indifferent to low inflation or even deflation. But that was never the intention. In 2003 the definition was adjusted in order to eliminate any ambiguity. Price stability is now defined as "less than but close to 2%." The current definition is therefore fully symmetric. It makes it clear that the central bank is equally concerned by inflation that is too low or too high.

This is not only a question of semantics. Central banks' perceived objectives determine expectations and the behavior of private agents. If a central bank is seen as equally intolerant of both high and low inflation, the economy will more easily stabilize within the acceptable inflation range. Stability of inflation expectations has improved the capacity of euro-area economies to absorb the post-Lehman shock: While inflation became negative for a few months in 2009, expectations did not change and deflation was never a threat. This episode illustrates the credibility achieved by the Eurosystem in approaching price stability in a symmetric fashion.

Together with the definition of price stability, the “two pillars” approach is another important feature of the Eurosystem’s framework. In parallel to assessing future economic prospects, the European Central Bank’s governing council looks independently at the dynamics of money and credit aggregates. This has proved very useful in the past to detect long-term risks to price stability, in both directions. The message today is clear: both money and credit are growing very slowly in the euro area as a whole. The M3 money-supply aggregate grew by 2.1% in September. These trends do not signal deflation, but warrant monitoring and vigilance when facing an uncertain future.

Obviously, intentions may not always suffice and must be backed, when necessary, by appropriate and timely actions. Recent decisions by the governing council regarding both policy rates and liquidity provision show that we are ready to make the necessary decisions. Many instruments remain available should further risks materialize. There should be no doubt that the Eurosystem will ensure that price stability, as currently defined, will be maintained in the euro area.