Preach Price Flexibility, Mr Draghi

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The Eurozone is slouching towards deflation. To combat a further recession with policy rates at rock bottom, Mr. Draghi must teach Europeans the necessity of price flexibility. The idea that nominal wages cannot, or should not, fall needs to be cracked. If not, the Eurozone will break its neck under the burden of idle resources.

According to Mario Draghi the use of conventional monetary policy has been exhausted. Thus, there are no monetary anti-depressants available if autumn doldrums accelerate. Promising to keep policy rates at their current low level is no substitute for temporary easing. For, paradoxically, disinflation and eventually deflation is the long-term effect of passive “easy money”. The ECB thinks that monetary unconventionality might do the trick. That’s a mirage. The markets are going to digest more sour grapes than was brought forth in Naples on Oct. 2. Aside for pumping up ECB liquidity, which cuts money market rates by a few basis points, central bank-initiated loans and asset swap programs have negligible effects when financial markets are functioning. That’s been evidenced since Japan invented QE. What about raising the inflation target in order to shrink real interest rates? The problem is not the target, but the ECB’s brinkmanship. The ECB targets 2% but hits 0.3%. How come they should hit the bull’s eye if the target is lifted? By screaming the new target until expectations are shaken? While Abenomics initially succeeded in hiking inflation through proclamations, the first arrow is now bending more than a badly mishandled iPhone6+. Why? “Credible promising to be irresponsible”– Paul Krugman’s catchphrase for successfully exiting a liquidity trap – is a contradiction in terms. Irresponsible men don’t make credible promises. Also, the type of irresponsibility that could lift inflation needs more than a Casanova at the helm of the ECB. High inflation is a fiscal phenomenon; road to Weimar was paved by public debt. Thus it requires a madcap Chancellor on Berlin and irresponsible Princelings in the other capitals. While there are some aspiring candidates, the electorate has luckily so far kept them in the shadows. For, if they came to power, they would not deliver just enough inflation to let the real interest rate track its market-clearing level. Instead, high inflation would wreak havoc on commercial activities and give us a miserable replay of stagflation.

With inflation on the road to extinction, what should Mr. Draghi do then? He should prepare Europeans for a bout of deflation. Deflation per se is not harmful. Check Japan’s record. Since its CPI began to slip in 1998, GDP per capita has grown 0.3 percentage points percyearcless than in France – a difference that evaporates when adjusted for the relative use of walkers. Deflation is only a concern all prices aren’t able to fall freely. Economists typically assume that wage rates are sticky. In Japan unemployment increased from 3.5% in 1997 to 5.4% in 2002, but then fell back. Part of the explanation was probably that wages initially did not adjust to the onset of deflation. Mr. Draghi’s herculean task is to explain the need to deregulate labor markets. It's a combination of unionism, minimum wage legislation and opiates to the unemployed which cause nominal wage rates to be downwardly sticky. This nominal price floor on labor services has to be shattered if the CPI starts to dip. If not, unemployment will soar to new heights.. Don't wage decreases send the economy spiraling into a deflationary black hole? Some economists warn against price labor market flexibility out of such a fear. That's misguided. While there has been plenty of hyperinflation, you won't find "hyperdeflation" in the dictionary. Why? As prices fall the real value of government debt increases. The lower bound on the price level is hit when people start treating government debt as hot potatoes. Theit collective effort to get rid of the debt causes the price level to climb back to its long-run trend. If this sounds academic, look at how the US leapt from its 1920-21 laissez-faire recession.

Inflationary Mario is on his way to Tokyo. He might not realize it yet, but by implication of his own words he is effectively suspended himself as central bank governor. He's a carpenter without wood and nails, and inflation, barely afloat at 0.3%, keeps sailing south. Mr. Draghi should spend his time as a preacher man, mustering intellectual ammunition for the necessity of overall price flexibility. The odds, of course, are that he is talking to deaf ears. But maybe he succeeds in conceiving establishment politicians. A cold turkey recession with wage rigidity will be nasty, brutish – and probably outlive the Eurozone. With deep labor market reforms, however, we will discover that despite a bout of deflation, there are more bright spots of potential prosperity between Nicosia and Helsinki than ever dreamt of in the ECB's Frankfurt tower.