Euro Zone's Risk of Deflation Grows

By JOELLEN PERRY and SEBASTIAN MOFFETT

The inflation rate across the 16-nation euro zone fell to zero in May, figures showed Friday, its lowest in 13 years of records, underlining the increasing risk of deflation -- a damaging decline in wages and prices that could damp recovery prospects world-wide.

Prices are falling in six of the countries that share the euro. Spain logged a third consecutive month of negative inflation in May, with prices down an estimated 0.8% from the year before. German prices slipped 0.1% this month from May 2008.

The euro-zone estimate of 0% annual inflation for May surprised economists, whose consensus was for a 0.2% rise. Even that would have been the euro zone's lowest rate since comparable records began in 1996. Economists at Royal Bank of Scotland estimate inflation hasn't been as low since 1953.
Shallow, short-lived price falls won't wreak economic havoc. But inflation is so low and the recession so deep that risks are rising of a prolonged period of declining prices and wages. Some individual EU countries -- particularly Ireland and Spain -- are at risk partly because of the nature of the shared euro currency. They can't compensate by allowing national currencies to fall, so wages and prices fall instead.

Deflation can hurt businesses and consumers by reducing incomes while debts remain fixed. Falling prices also can prompt shoppers to defer spending to wait for lower prices, further depressing economic activity.

After daily foot traffic at Dublin's Kingsbury Furniture dropped more than half to about 100 people early this year, the store cut prices 10% across the board. But customers asked for deeper discounts. Kingsbury negotiated lower wholesale prices from suppliers and cut store prices another 10%.

The new cuts have brought visits back up to about 150 a day. "But we don't know how long this will last," says store manager Jim Owens.

Deflation already is stalking Japan, which struggled with it from 1999 to 2005. The central bank recently forecast prices will decline for the next two fiscal years. Consumer prices in the U.S. in April were 0.7% below year-ago levels, the steepest one-year drop since June 1955, though prices excluding food and energy rose.

The U.S. Federal Reserve has fought the deflation threat aggressively, cutting its key rate close to 0% and buying hundreds of billions of dollars of assets to boost economic activity. The European Central Bank, by contrast, maintains the deflation threat is minimal, even though the euro-zone slowdown is likely to be steeper and longer than the U.S.'s. "The likelihood of deflation ... now appears slight," said ECB policy maker Mario Draghi on Friday.

A shop in the center of Madrid advertises deep discounts as Spain logs declining prices and inflation flattens across the euro zone.

Data out Friday underscored the depth of the economic slowdown. Loans to euro-zone businesses and households increased 2.4% in April from a year earlier, down from 3.2% in March and the slowest pace since comparable records began in 1997, according to the ECB.

Some private-sector economists warn that the ECB's response itself makes deflation more likely in the euro zone than the U.S. Euro-zone "deflation is a risk and the risk is growing," said Julian Callow of Barclays Capital in London.

In April, the International Monetary Fund said both the U.S. and the euro zone faced a "moderate" deflation risk.

Euro-zone consumers increasingly expect lower prices over the next year. Inflation expectations in May fell to their lowest level since records began in 1990, according to a European
Commission survey Thursday. If consumers expect prices to fall, they may hold back on purchases, pushing prices down further.

ECB policy makers believe lower energy prices will push inflation into negative territory this summer, but they see inflation rising later in the year.

National falls in prices and wages could be welcome in some respects. Rising prices made Spanish and Irish businesses less competitive in recent years; lower costs could boost exports and draw investment. "From an economic point of view, it's exactly what these countries need," said James Nixon, an economist with Société Générale in London. "But that doesn't make it any less painful. What it means ... is a long period of declining income, grinding levels of unemployment and associated poverty."

Consumer prices in Ireland dropped 0.7% in April from April 2008, and there are signs that Irish wages also are falling as unemployment soars. Nearly half of 400 firms surveyed in March by Ireland's small and medium-size business association had cut pay in the previous six months. The European Commission expects Irish wages to fall 4.1% this year and further in 2010.

In Spain, unemployment reached 17.4% in March and prices have been falling since. Some economists dismiss the deflation threat. But a rising number of retailers are giving consumers the option to trade down to discount brands.

Questions:

1. Define deflation;
2. What evidence shows that Euro Zone nations are threatened by deflation?;
3. How would an economy be affected by deflation?;
4. What could be done to counteract the risk of deflation?.