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The Impact of Inflation on Economic Performance

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Abstract: In the last 3 years a number of European Union countries have addressed low inflation or deflation. Central banks around the world are trying to reverse the negative economic development and are looking for various monetary instruments to achieve economic growth. They are looking for new monetary policy regimes which could replace inflation targeting. This study aims to analyse the most important impacts of low inflation on the economy of the country. The study analyses the evolution of inflation in the Czech Republic and the European Union and on the basis of latest central bank's measures, a prognosis of further development is developed.

Key words: Inflation, deflation, HICP, monetary policy, European Union, development

INTRODUCTION

The inflation rate is a key indicator of the macro-economic performance of a given state. Its importance is also emphasised by Convergence criteria where the first indent of Article 140 (1) of the treaty requires: the achievement of a high degree of price stability, this will be apparent from a rate of inflation which is close to that of, at most the three best performing member states in terms of price stability (ECB., 2016).

Declining inflation has been the main topic in the last 5 years with increasingly more (Katafono, 2000) in both economic literature and statistics. The inflation rate also gained importance during the financial crisis and the subsequent economic crisis. According to Strohsal *et al*. (2016), well-anchored inflation expectations have become a key indicator for the credibility of a central bank's inflation target. Since, the outbreak of the financial crisis, the (de-anchoring) of long-term US inflation expectations has been under debate.

Lin *et al*. (2015) show that pre-crisis contractionary monetary policy interacts with Fisherian debt-deflation dynamics and can increase the probability that a crisis occurs.

Scharnagl and Stapf (2015) look at the drivers and the anchoring of inflation expectations derived from inflation option data for the Euro zone. Inflation expectations show a decreasing mean but growing uncertainty, especially, since, 2011. The impact of monetary policy and macro news on inflation probabilities decreases. Growing uncertainty reveals market participant's concerns about extreme inflation or deflation outcomes.

Singer (Czech National Bank Governor hereinafter, also, referred to as CNB) states that since the 70's there has been a lesson regarding the perception of inflation as harmful. Experience with it has been in the background of central banks independence growth, the development of monetary theory and a number of interesting empirical research. The works showing that it isn't good to push inflation too low became a little lost among them (Barro, 2013) because the yields in the form of an increase in long-term economic growth rate may not respond to the expenses of a disinflationary policy that is too strict.

MATERIALS AND METHODS

More and more economies in the European Union are struggling with low inflation or deflation. Most states fear low inflation. The aim of the study is to analyse the most important effects of low inflation on the economy of the state. Based on the analysis of the current development of the inflation rate in EU countries and in the Czech Republic to analyse the current situation and outline possible prognosis. The study also pays attention to the newly elected governor of the Czech National Bank and the other two members and outlines the possible impacts of this change on inflation.

The study is based on secondary sources. They comprise of information about inflation and deflation, professional literature, information collected from the professional press, discussions or previous participations in professional seminars and conferences relating to the chosen subject. Most of the information is gained from the Czech Statistical Office and Eurostat.

Then, it was necessary to select, classify and update accessible relevant information from the numerous published materials that would provide the basic knowledge of the selected topic.

RESULTS AND DISCUSSION

The effects of deflation: The possibility of deflationary periods occurring in the world's most advanced economies is being signalled by many commentators. The effects of deflation on an economy depends on whether the deflation is caused by falls in demand or increased productivity. The former is essentially detrimental to economic growth and may in the worst case scenario, develop into a hard-to-break, self-reinforcing deflationary spiral whereas the latter is believed to be conducive to economic growth. Economists remain divided over the effects of inflation and whether or not it should be mitigated at all times. Some claim that deflation always creates more problems than benefits for an economy and as such should be actively prevented. Others argue that historical data does not show that inflation is preferable to deflation and what influences an economy most negatively is not the deflation itself but the significant fall in asset values (such as real estate or stocks) which often occurs first (Szcepanski, 2015).

Among the most important consequences of deflation are generally cited as follows (some economists disagree with them, especially with the first point).

Households are postponing consumption in the deflation: Deflation leads consumers to postpone purchases. People are waiting until the goods are cheaper. This waiting will lead to a decline in demand. A decline in demand can lead to a deepening of the recession. This claim is often being attacked. The best example is the information technology sector. The prices of computers, memory and digital devices in general have continuously declined in recent years.

Companies will lay-off during the deflation: If prices fall the company will sell the same volume of goods or services but they will get less money. However, this situation is not sustainable in a long term. It will lead into the firm in order to save, they will start to lay-off their employees. The GDP is currently growing in the Czech Republic and despite the low inflation rate, there is excess demand of skilled labour over the supply of labour.

Loans will become more expensive during deflation: Deflation is good for creditors. The lower inflation is the debt is more onerous and the accumulated debt increases. For households, firms and the state it is preferable to rely on the positive effect of inflation. As money loses price, it loses its value and its debt and realistically owe less. Entities in the economy are therefore careful to loans and investments based on external financing which again leads to economic recession and the deteriorated state of the economy.

Labour productivity growth: Deflation caused by the growth of labour productivity can be seen as negative or positive.

Good deflation which is caused by productivity growth could already be seen by Englis in 1928. "Rationalise production improves performance which leads to lower prices without reducing income, means an increase in the purchasing power of the monetary unit and not just an optical illusion but real increase in prosperity, since, lowering prices is not accompanied by reducing the levels of income. This increase in the purchasing power of the monetary unit may also lead to an increased exchange rate of currency abroad but it is not absolutely necessary".

The decline in bank lending and deflation: It is an example of "supply deflation". As a result of the financial crisis, people start to collectively withdraw from their current accounts in the banks their money, thus banks generated substantial liquidity problems which may end in bankruptcy. This worsens the financial crisis, more and more clients lose confidence in bank health and therefore come to the bank with a request for payment of their money from current accounts. Banks are trying to increase their reserves in order to meet their obligations. Due to the restriction of the money supply and thus to increase their value the prices fall and it leads to deflation.

Deflation as a result of the economic growth: This type of "demand inflation" is the natural state of a dynamically developing economy. The increasing productivity leads to a situation when a larger quantity of goods are produced in the economy and therefore manufacturers are forced to compete for existing money units in the economy in order to exchange the growing number of manufactured goods for them (Sima, 2002).

Deflation due to the accumulation of cash: The accumulation of money means that some people for certain reasons voluntarily choose to increase their cash holding. In this situation, quite naturally, selling the existing quantities of goods for less money is only possible, so that, the purchasing power of the monetary unit will increase, because of increased demand for the monetary units will increase the price expressed in the goods.

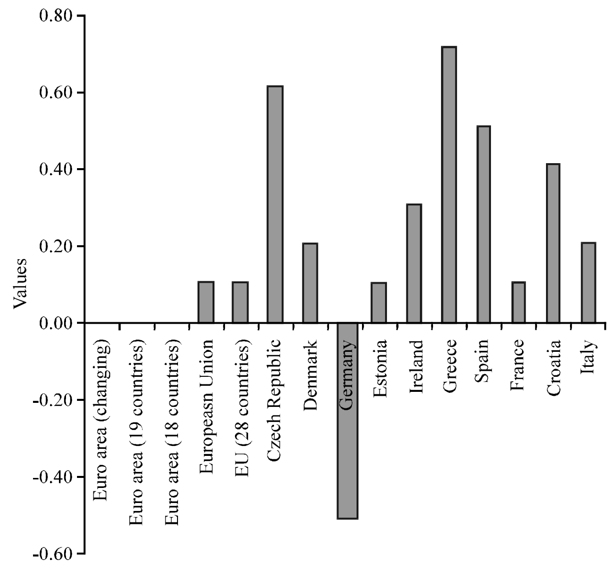

Fig. 1: Overall HICP inflation rates by countries-April 2016; Eurostat (2016) own processing

Confiscatory deflation: It is a state organised deflation which is tasked with the help disrupt the market and the disruption of property rights (through the confiscation of cash) to prevent deflation that leads to the decline in bank lending which leads to the recovery process, eliminate partially reserve banking (Rothbard, 1995).

Stagnation of investments: Deflation breaks the pressure on the investment of excess cash as the best yield is brought by a risk-free "sitting on cash". There is no reason to invest as assets (such as real estate, stocks or future production of enterprises) are depreciating. This may occur in the economy as a lack of capital for starting economic growth.

Disadvantaged in the international trade: Strengthening currency can only be beneficial for tourism abroad, tourists can buy more for domestic currency abroad. Effectively, therefore, imports are cheaper. Such a situation is not favourable for export-oriented companies which are supposed to be the engine of economic growth. Their production abroad becomes more expensive which reduces their competitiveness. Revenues are falling as they are converted back because firms receive less domestic currency for Foreign currency. However, at present most EU countries are on the brink of deflation (Fig. 1).

The actual aituation in the Euro area: The Euro area has experienced a period of low inflation, since 2013 and recently recorded successive declines in price levels. The European Commission and European Central Bank, however, predict that price levels will start to rise in 2016, while the International Monetary Fund and the OECD assess the risks of prolonged low inflation to be higher. Economists and commentators remain divided regarding the possible causes, risks, consequences and nature of this low inflation environment. Some indicate that it will create conditions favourable to economic growth while others fear that persistent low inflation or possible outright deflation will be hard to mitigate and will be harmful to economic recovery in the Euro area (Szcepanski, 2015).

Euro area annual inflation was 0.2% in April 2016, down from 0.0% in March. A year earlier the rate was 0.0%. The flash estimate for April published on 29 April 2016 was 0.2% (Fig. 1) (Eurostat, 2016).

Looking at the main components of Euro area inflation, services had the highest annual rate in April (0.9%, compared with 1.4% in March), followed by food, alcohol and tobacco (0.8%, stable compared with March), non-energy industrial goods (0.5%, stable compared with March) and energy (8.7%, stable compared with March) (Eurostat, 2016).

According to preliminary data of Eurostat, the 3-on-year change in the average Harmonized Index of Consumer Prices (HICP) in the EU28 member states amounted to 0.0% in March, i.e., 0.1 percentage point more than in February. Prices went up the most in Belgium 1.6% and Sweden 1.2%. On the other hand, the decrease occurred in 16 EU countries of which the largest in Romania 2.4% and Cyprus 2.2%. In Slovakia, prices fell by 0.5% in March 0.3% in February). In Germany, prices turned from a drop by 0.2% in february to a rise by 0.1% in March. According to preliminary calculations, the HICP in the Czech Republic in April was 0.6%, month-on-month and the year-on-year change was 0.5% (0.3% in March). The MUICP (Monetary Union Index of Consumer Prices) flash estimate for the Eurozone in April 2016 amounted to 0.2%, y-o-y as Eurostat announced (CSO., 2016a, b). The main components and their relative weights for 2016 are presented in Fig. 2.

Each of the main components contributes in varying degree to the headline inflation in the Euro area. In terms of weight, set at 1000 for the all-items HICP, services is the largest component, accounting for around 44.2% of individual consumption expenditure in the Euro area. It is followed by non-energy industrial goods with around 26.6%.

Food, alcohol and tobacco and energy account for around 19.5 and 9.7%, respectively. Together, they comprise less than one third of Euro area expenditure but

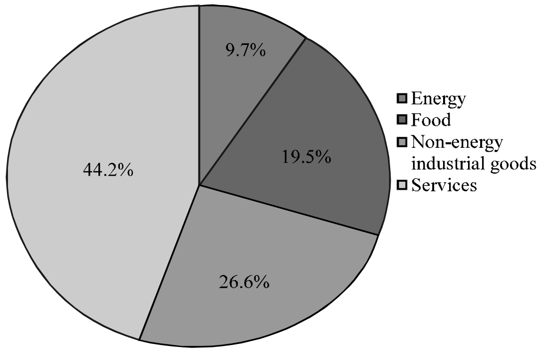

Fig. 2: Weights of the main components of the Euro area HICP; own processing based on Eurostat

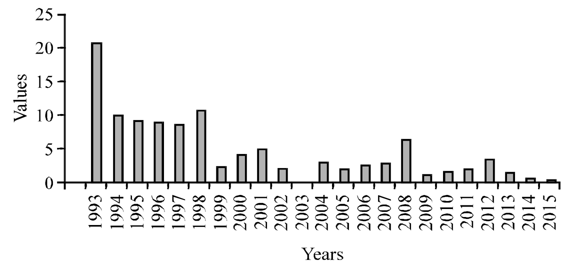

Fig. 3: Inflation rate (in %) in Czech Republic; own processing based on (CSO., 2016a, b)

they can have significant impacts on the headline inflation as their levels tend to fluctuate significantly more than the other components (Eurostat, 2016).

The actual situation in the Czech Republic: The Bank Board of the Czech National Bank decided unanimously to keep interest rates unchanged at technical zero. The Bank Board decided to continue using the exchange rate as an additional instrument for easing the monetary conditions and confirmed the CNB's commitment to intervene on the Foreign exchange market if needed to weaken the Koruna, so that, the exchange rate of the Koruna is kept close to CZK 27 to the Euro. In line with this, the CNB still stands ready to intervene automatically, i.e., without the need for an additional decision of the Bank Board and without any time or volume limits. The asymmetric nature of this exchange rate commitment, i.e., the willingness only to intervene against appreciation of the koruna below the announced level is unchanged.

This decision is underpinned by a new macroeconomic forecast. The forecast assumes that market interest rates will be flat at their current very low level and the exchange rate will be used as a monetary policy instrument until mid-2017. Consistent with the forecast is an increase in market interest rates thereafter. Inflation is still well below the CNB's target of 2%. According to the new forecast, inflation will decline temporarily close to zero in the near future, mainly due to cost-push effects from abroad. However, it will then increase, hitting the 2% target at the monetary policy horizon. According to the forecast, sustainable fulfilment of the target which is a condition for a return to conventional monetary policy will occur from mid-2017. The Bank Board assessed the risks to the forecast at the monetary policy horizon as being slightly anti-inflationary (CNB., 2016a, b).

Compared to the previous forecast, the inflation prediction is markedly lower until mid-2017, owing to lower observed prices (especially food prices), a more subdued outlook for Foreign producer prices and lower growth in domestic nominal wages (Fig. 3) (CSO., 2016a, b).

The new governor of the Czech National Bank will be Jioi Rusnok. He was appointed to the post in May 2016 for 6 years which comes into effect from the 1st of July 2016. Mr. Rusnok is currently a member of the CNB Bank Board. The CNB Board also receives two new members (Vojtech Benda and Tomas Nidetzky). For this reason, we can discuss whether the personnel changes in the leadership of the Czech National Bank can lead to a reassessment of the policy of an artificially weak Czech crown?

From one perspective, the new governor is Mr. Rusnok and the two new members are his former colleagues. Rusnok came to the CNB after Foreign exchange intervention from November 2013 and the significant intervention in the economy, therefore is not his achievement. Because of that, it may be easier for him to terminate these interventions.

On the other hand, neither Mr. Rusnok, nor anyone else from the current or prospective board members have expressed a criticism of the model of CNB's monetary policy as such. It is still working with the basic thesis that inflation is synonymous with economic growth. Therefore, the CNB keeps the Czech crown artificially weakened even at a time when the economy is growing and we have the lowest unemployment rate in twenty years-it lacks a higher inflation. The CNB can still strengthen its interventions. Until the CNB musters-up the courage to change the model and abandon the inflation target, the Bank Board will be constantly forced to take extraordinary measures in order to avoid excessively low inflation or mild deflation (Ryska, 2016; CNB., 2016a, b).

CONCLUSION

The Czech National Bank still has room to cut interest rates and may even go to negative interest rates. The question for discussion is whether it will continue in direct interventions to target inflation or change interest rates or only changes in the methods used will occur.

The situation in the EU is very similar, it depends on the actions of the European Central Bank and individual central banks of the member states. Increasing the inflation rate is the goal of most European Union countries and use the appropriate monetary policy tools for it. Even here, there is a question regarding the effectiveness of inflation targeting.

In March 2016, the ECB also supported economic growth making significant steps and trying to prevent the persistence of very low inflation in the Euro-zone and restore its reputation from the end of last year when it disappointed the markets by the lack of action. Unexpectedly, the ECB cut its key interest rate to zero and the deposit rate collided deeper into the negative zone. With negative deposit rate the banks have to pay for money deposited with the ECB which should compel them to more lending.

The above measures show the importance of a macro-economic indicator of inflation and creating conditions for economic growth. One way can also be a replacement of inflation targeting with GDP targeting (Gross Domestic Product). A new macroeconomic assumes that market interest rates will be flat at their current very low level and the koruna exchange rate will be used as a monetary policy instrument until mid-2017 in the Czech Republic.

RECOMMENDATIONS

Inflation is still well below the CNB's target of 2%. According to the new forecast, inflation will start rising in the near future, driven by increasing domestic economic activity and wages. At the same time, the anti-inflationary effect of import prices will weaken. Inflation will slightly exceed the 2% target at the monetary policy horizon and then return to it from above. According to the new forecast, sustainable fulfilment of the target which is a condition for a return to conventional monetary policy will occur in mid-2017. The Bank Board assessed the risks to the new forecast at the monetary policy horizon as being balanced (CNB., 2016a, b).

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