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Will the Politics or Economics of Deflation Prove More Harmful?

Although growth has returned to the periphery of Europe, with Spain, Ireland, Portugal and even Greece posting positive numbers, the rate of growth in their debts still outpaces their rate of GDP growth. That means, for example, that Portugal would have to run a current account surplus at Chinese levels for over a decade to get unemployment down to single figures, and that is simply not going to happen. Indeed, the most recent ECB unemployment projections predict double-digit unemployment out to 2017, regardless of the incipient recovery. Standard macro theory imagines that fiscal contractions are recessionary in the short run, but in the long run the supply side determines the trend rate of growth. What the eurozone has recently shown us is that you can contract so severely on the demand side that the supply side of the economy can be permanently damaged, which may have lowered inflationary expectations to a deflationary equilibrium point. This is extremely dangerous – more so for political than economic reasons.

The politics of periods of inflation and deflation are radically different. Inflation is a class-specific tax, insofar as it hits creditors and the owners of paper assets harder and faster than anyone else, especially at sustained moderate levels. Yes, people on fixed incomes also suffer in such conditions, but given that they are usually pensioners who vote in disproportionate numbers, we can be sure that relief will be forthcoming. An investor's profits know no such relief. Given this, the politics of collective action under inflation are clear. Investors know what they want and mobilize to get it: an end to inflation and the taming of inflationary forces. Labor, on the other hand, quite likes this debt-friendly world and the tight labor markets that it produces. As profits get squeezed, labor's share of national income grows. Think of this as the world in the 1970s, because those were the prevailing economic conditions at the time.

Conversely, the politics of the past 30 years, beginning in the 1980s, has been marked by the efforts of the investment class to construct a creditor-friendly economic order with strong anti-inflationary policies and positive real rates of interest. Their success was made possible by the disciplining of labor domestically and the increased mobility of capital internationally – all of which eventually led to a credit boom that ended badly, from which Europe is still trying to extricate itself.

Deflations are different insofar as, regardless of asset profile, one's first best effort to protect oneself leads to second-best outcomes both locally and globally. For example, any one worker taking a wage cut to price herself into a job is locally rational, but it is globally disastrous if everyone tries this, given the aggregate effects on consumption. The same is true at the country level: all countries should not simultaneously attempt to become "more competitive" if they are each other's trading partners and exchange similar goods in a shared currency.

Given this, deflationary periods produce an opposite politics than inflationary ones do. Rather than investor-friendly policies that seek to "bring the market back in and keep the state and labor out", deflations, especially when they begin in already deeply depressed economies, produce broad-based cross-class debtor coalitions that directly challenge creditor interests and their supporting institutions. In such a world, we should expect existing political forces, especially those on the left, to lose vote share and be

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challenged by upstarts from the left and the right that seek to "bring the state back in and push market forces back out", which is bad for the EMU project and all that flows from it.

Seen in this way, the core creditor countries that are not deflating still operate in line with creditor politics, in which mainstream parties form coalitions to maintain the status quo, even in traditionally majoritarian states such as the UK and Sweden. The debtor countries of the periphery, those to a greater or lesser extent at risk of locking in deflationary expectations, are beginning to operate in accordance with debtor politics, which seeks to challenge the anti-inflationary, pro-creditor policies of the past 30 years. The alternative to such a political shift would be acceptance of the forced economic adjustment through unemployment and prolonged stagnation advocated by the core creditor countries.

Syriza in Greece, the National Front in France, Sinn Fein in Ireland, UKIP in the UK, the SNP in Scotland, and Podemos in Spain are then more similar than different. They are all, regardless of leftist or rightist political stances, at base anti-creditor, anti-market populist movements. They constitute a threat, not just to macroeconomic stability, but to the very idea of Europe as it has been constructed over the past 30 years. When the National Front and UKIP on the right say they want out of the euro, they are not kidding. And while Syriza and Podemos say that they want to remain in the eurozone, the policies of the creditor bloc, which assert that "you must pay your debts even if you are insolvent", may well push these leftist parties towards the exit, too. Given all this, what Greece represents is not an economic threat to the euro so much as a political threat.

First of all, the eurozone leadership has effectively told the Greek people that more of the same policy is the only tonic available, regardless of whom they vote for. Instruments such as GDP-linked, infinite maturity or Brady bonds, as well as new haircuts, all of which are quite sensible and which have been utilized in every other debt workout in modern history, are not going to be used here for fear of spreading the demands for debt relief and fanning the flames of debtor-friendly populism elsewhere in the eurozone.

Second, Greece is insolvent. No amount of liquidity and "extend and pretend" is going to change that. So the continuation of the current regime is merely debt servitude, which is politically unsustainable. Given current maturity profiles, it is not the percentage of GDP paid in interest per year that matters (2.2 percent versus 5 percent for France). What matters is the effect that this debt overhang and the deflationary expectations engendered by these policies have on the real economy and on the polity if they become embedded.

Third, demography matters for debt sustainability, because it affects the underlying rate of growth. The Southern euro countries are particularly old, with an average age of 41.9 years, and migration has made this worse. Thomas Piketty has calculated that long-term growth rates for Europe going forward will settle at around 1.2 to 1.4 percent a year. With double-digit unemployment almost everywhere, bringing deflation to a halt, changing expectations, and increasing investment levels with growth rates that low may not happen as easily as some think.

In sum, the rather casual approach to deflation in the periphery that the leading European institutions seem to have at the moment belies the clear political risk that they generate. Part of recognizing that risk lies in remembering the economist Abba Lerner's dictum that economics has become queen of the social sciences by choosing "solved political problems" as its domain of operation. Given that the eurozone is far from being a "solved political problem", we should perhaps be more worried about the politics, and less about the economics, than we are at present.