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Europe's Deflation Fear

The European Central Bank, as expected, unveiled a shotgun approach last Thursday to uplifting the Eurozone's stagnating economy. The story with the ECB was that all they had to do thus far was wave their metaphorical policy weapon without every firing a bullet. By acting last Thursday, investors should question whether Europe's problems are just beginning, or if it's just Europe's turn to embark on a beggar-thy-neighbour policy through euro devaluation.

It's too early to tell, and perhaps too bold to call for Europe to enter into a deflationary spiral. What we have seen occurring is a period of disinflation, which is seen when the inflation rate slowly gravitates towards zero. This has been the increasing challenge for policy makers as it is the lacking demand of a healthy economy that is seeing the price levels move lower. But this is a problem of the global economy in the manner in which central banks have operated, particularly over the last six years.

The strengthening euro, whether it's a result of unconventional monetary stimulus from the Federal Reserve, Bank of England, or Bank of Japan, is the reason for Europe's sluggish economy. As other economies boosted stimulus measures and coordinately weakened their respective exchange rates, they are essentially exporting their lower prices to their trading partners. As their goods are now priced cheaper in foreign markets they typically saw that pick up demand which saw their inflation rates track marginally higher. Eurozone nations and businesses, as we know, faced the consequences of importing lower prices from their trading partners at the result of their relatively strong euro. Following Thursday's announcement, if the ECB can be successful this is soon to change.

The measures implemented by the ECB on Thursday are their best effort to devalue the euro. Akin to the United States when the Federal Reserve expanded the level of accessible credit in their financial systems, there lacks the demand for those funds. Monetary Policy can create the right incentives for borrowers to want and have access to capital. It cannot, however, make the small and medium sized businesses that fuel the economy take on debt, invest in machinery, equipment, and technology, and hire employees.

The ECB's main measures were directed at their financial institutions. The first was lowering their deposit rate to negative territory to create a disincentive from banks leaving funds with the ECB overnight. As of late, however, European financial institutions have slowly decreased the level of deposits left with the ECB. As well, Mario Draghi, President of the ECB announced changes to their Long-term refinancing operation (LTRO). And again, the theory behind banks being able to lock in financing for near zero rates for up to five years creates great incentives for borrowers, but the dilemma remains whether or not they will be utilized.

Among many of his great quotes, Yogi Berra famously said, "in theory there is no difference between theory and practice. In practice there is." The theory is that the recent steps taken by the ECB should create the right incentives for participants in the Eurozone economies. The practice is what's to come, but the uncertainty is whether Europe will get a turn at the table in the beggar-thy-neighbour global recovery.