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Consequences for Economic Policy

Panel Discussion

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In view of the quite dramatic increases in the oil price in the past few years, inflation persistence has become a highly topical and relevant issue. Even though inflation rates were considerably lower at the onset of the latest oil price shock than in 1973 or 1978, the extent and the duration of the after effects of the most recent shock will have a great relevance for the issue of price stability.

The central result of Baumgartner's very detailed empirical study leaves no doubt: Inflation persistence has decreased substantially since the first and second oil price shocks. This means that no or almost no secondary effects, which tend to prolong or even intensify the original inflation impulse, are to be expected. From my point of view, this result suggests that the latest inflation developments can – and should – be watched calmly.

However, it seems to me that the European Central Bank (ECB) has not taken note of the inflation research results refereed here because the latest increase in the key interest rate, which was carried out despite warnings and protests not only by notorious critics but also by institutions like the Ecofin Council and the Organization for Economic Cooperation and Development (OECD), does not imply at all that there is no need to worry. To explain that the interest rate had to be increased because of inflationary risks although the euro area HICP climbed to 2.5% in October 2005 (against October 2004) and 2.4% in November 2005 and, at 1.5%, the inflation rate, excluding energy prices, was even declining slightly, implies "obsession" rather than a calm attitude. Let us hope that no more such steps will be taken and lower inflation persistence will eventually find reflection.

I am convinced that the U.S.-Federal Reserve's growth and employment policies over the past ten years have been much more favorable than those of the ECB, with the Federal Reserve giving greater consideration to reduced inflation persistence after economic shocks, in addition to allowing a somewhat higher inflation tolerance than the ECB's 2% inflation ceiling.

There is one important aspect of the studies on price formation and inflation persistence that seems to be insufficiently explicit, which harbors the risk that conclusions could be drawn without the necessary awareness of what they are

really based on. Subliminally, this topic captures the neoclassical idea that we would be living in the best of all possible worlds if all prices and, especially, all wages were completely flexible, which would also include downward flexibility. Then, we would always have a perfect balance on all markets, with full employment of all resources and with immediate adjustment to external shocks. It was no less a person than Keynes who in (chapter 19) of his General Theory of Employment, Interest and Money[1] put an end to this abstruse idea and pointed out the necessity for a "nominal anchor" for the price system, arguing, above all, that a falling price level would have serious negative consequences. Since the interest rate can never drop below zero and the companies' nominal debt remains the same, the companies will become insolvent increasingly. Even today, this "risk of deflation" is not a mere calling of the ghosts, as the number of companies affected by dropping nominal sales rates due to falling prices will turn into a problem even before the general inflation rate has reached zero[2].

Another essential argument supporting the positive aspects of price rigidities was already presented by Karl Aiginger: The "New Institutional Economics" shows that it will not be possible to stabilize the expectations by relying on various "implicit contracts" if there are wild price and wage fluctuations. Especially the more recent experiences with the euro changeover have demonstrated clearly to what extent prices and price structures are rooted in the lower layers of consciousness.

These considerations, however, must not lead to the anti-competitive conclusion that price rigidities are to be deemed generally positive and price reductions are therefore negative. On the contrary, competition is necessary, above all, to effect price reductions in situations where product or process innovations facilitate cost and price reductions that will enable large quantitative sales increases if the demand is price elastic. Karl Aiginger has already described this in greater detail and I agree with him.

Finally, I would like to address some questions relating to price formation, which would also deserve closer examination, maybe even by the OeNB.

- Where is the critical range of the inflation rate when deflationary effects start to occur to an degree that is relevant to the economy as a whole?
- In recent years, the phenomenon of very high, even excessive profits has been increasingly seen to occur – this should raise questions relating to the competitive situation and the mark-ups in the respective areas and should not be limited to elated reports from the stock exchange.

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1 Keynes, J. M. (1936) The General Theory of Employment, Interest and Money. Macmillan Cambridge University Press.

2 From this perspective, the ECB's inflation target that allows such zero inflation is also questionable. However, as regards the euro, the central bank's actual reaction has not been put to the test yet.

- Finally, there is the “persistent” phenomenon of large price differences for one and the same service in the tertiary sector. Even though – or maybe just because – available data are rather scarce, from the consumer’s point of view it would be useful to conduct a study on this subject.