Why deflation is good news for Europe

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In today's global economy, there is no price as important as that of crude oil. More than 80 million barrels are produced (and consumed) daily, and a large part of that output is traded internationally. Thus, the sharp fall in the crude-oil price – from about $110 last year to around $60 – is yielding hundreds of billions of dollars in savings for oil importers. For the European Union and the United States, the gain from that decline is worth about two-three per cent of gross domestic product (GDP).

For Europe, the benefits of cheap oil might grow over time, because long-term gas-supply contracts are to a significant degree indexed to the oil price. This represents another advantage for Europe, where prices for natural gas were, until recently, several times higher than in the US, which had been benefiting from lower-cost shale energy.

But many observers have argued that cheap oil also has a downside, because it exacerbates deflationary tendencies in the advanced countries, which already seem to be mired in a low-growth trap. The sharp fall in oil prices, according to this view, will make it even harder for these countries' central banks to achieve the two per cent annual inflation rate that most have targeted in fulfilling their price-stability mandate.

The eurozone, in particular, seems to be in danger, as prices are now falling for the first time since 2009. This deflation is bad, it is argued, because it makes it harder for debtors, especially in the troubled economies of the eurozone's periphery (Greece, Ireland, Italy, Portugal, and Spain), to pay what they owe.

But this fear is unfounded, because it is based on a misunderstanding. What matters for debt-service capacity is the debtors' income, not the general price level.

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As oil prices fall, households' real (inflation-adjusted) income should rise, because they do not have to spend as much on fuel and heating. Lower oil prices make life easier, not harder, for highly indebted households in the US or the eurozone periphery. Falling consumer prices should thus be viewed as a good sign.

Most manufacturing enterprises will also benefit from lower energy costs, improving their ability to service their debts. This, too, is particularly relevant in the eurozone periphery, where the non-financial sector accumulated too much debt during the credit boom that preceded the 2008 global financial crisis. Moreover, though most of the savings implied by lower energy costs might initially show up in higher profits, over time, competition will force companies to pass on some of these windfall gains in the form of lower prices or higher wages.

This is another important consequence of cheap oil: lower prices make it more difficult to judge the point at which wage pressure becomes inflationary. Because wages can increase to a greater extent without fueling inflation, the US Federal Reserve Board might be inclined to delay hiking interest rates, which it is now widely expected to do this summer.

Public finances should also benefit from the deflation engendered by lower oil prices. Government revenues depend on the value of domestic output, not only consumption. Though lower oil prices depress consumer prices, they should boost production and overall GDP.

Absent large price changes for raw materials, the consumer price index evolves along with the GDP deflator (the price deflator for the entire economy). But that will not be true this year, because consumer prices are falling, whereas the GDP deflator (and nominal GDP) is still increasing. This should lead to solid government revenues, which is good news for highly indebted governments throughout the industrialised world, but particularly for the eurozone periphery.

The fall in (consumer) prices that the eurozone currently is experiencing should thus be seen as a positive development for all energy importers. The eurozone periphery, in particular, can look forward to an ideal combination of low interest rates, a favourable euro exchange rate, and a boost in real incomes as a result of cheap oil. In a deflationary environment, lower oil prices appear to make it more difficult for the European Central Bank to achieve its target of an inflation rate close to two per cent. In reality, lower oil prices represent a boon for Europe - especially for its most beleaguered nations.