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Forget devaluation, it's more domestic demand we need

With the franc much higher, Switzerland's exports are going to be clobbered and its tourist industry decimated

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Not only has UK inflation fallen to 0.5pc, but it **now looks likely that the rate will shortly turn negative**. This has given rise to a heated debate about the distinction between "good" and "bad" deflation. I am reminded of when doctors started talking about the difference between good and bad cholesterol. At that point, I thought the game was up.

With regard to deflation, the good/bad distinction is useful – but only up to a point. If aggregate demand is weak and that forces firms to cut prices and pay, then deflation is a sign of the economy's weakness. That is the bad variety. By contrast, if a fall in import prices causes inflation to turn negative, this provides a boost to real incomes without implying anything adverse about the state of the domestic economy. This is good deflation.

In practice, this distinction can be a bit blurred, because it may well be that the fall in import prices is itself due to weak aggregate demand in the world. This is surely partly true today. In that case, what may be good deflation for an oil-importing country like the UK, **is still bad deflation for the world as a whole**.

But once you move on from the origins of falling prices to think about the consequences, this distinction between good and bad deflation loses all force. The current situation mirrors what happened in the opposite direction in the 1970s. When oil prices first shot up in 1973-74, this implied a reduction in real incomes and living standards for oil-consuming countries.

If people accepted this, then there was no reason for the rise in prices to cause continuing inflation. But they didn't accept it. Workers pushed for higher wages to compensate them for higher prices, and firms raised prices faster in order to compensate them for higher wage costs. This became a wage/price spiral. Strikingly, the position was utterly different when UK inflation was well above the 2pc target two to five years ago. Wage inflation did not respond.

Will workers this time respond by accepting lower pay rises, just as they responded in the 1970s by pushing pay rises up? Or will they simply accept the rise in real incomes without further knock-on effects, just as they accepted the reduction two to five years ago?

The conventional wisdom is that they will simply lie back and enjoy their good fortune. But I am not altogether convinced. If wage inflation drops back, then what could have been a one-off dip into deflation could be consolidated into a new norm. Good deflation will have become bad. Admittedly, that is not what most economists now expect. But the stagflation of the 1970s was also largely unexpected.

It is sometimes argued that even “bad” deflation isn’t bad after all. There were frequent bouts of deflation in the 19th century and they did not seem to interrupt economic growth. But that was a very different world. Personal debt was extremely low and although government indebtedness was high, policy was dedicated to bringing it down sharply.

The UK is probably one of the best placed countries to avoid deflation. We have a large service sector, congenitally inclined to rising prices. Moreover, looking forward, the pound is vulnerable. As and when it falls, this will give an upward kick to the price level.

You don’t have to look far, however, to see the opposite forces in play.**Last week’s dramatic rise of the Swiss franc** will bring momentous consequences. Switzerland has already dipped into deflation. It may now experience an extended period of falling prices.

Although this sharp rise in its currency was the outcome of a policy change by the central bank, it was fully in line with fundamental economic forces. Switzerland has been running an enormous current account surplus, last year of the order of about 13pc of GDP. In proportionate terms, this put the Swiss well ahead of the Germans, the Dutch, the Norwegians and most of the Arab oil-producing states.

Now, with the franc much higher, Switzerland’s exports are going to be clobbered and its tourist industry decimated. This may even send Switzerland into recession. And it will intensify the tendency towards falling prices that the strength of the Swiss franc has already set in train.

Similar factors could apply to the eurozone, which is now running a large current account surplus. In normal conditions this might cause the euro to be strong on the exchanges – as it was until very recently. But now that we have the prospect of quantitative easing, **which may be announced by the ECB this Thursday**, things have changed. This has already weakened the euro considerably, and may yet weaken it further. It will help to moderate the deflationary trends that are already under way in the eurozone.

But apart from that, the switch in policy in the eurozone is completely anomalous. Here we have a bloc which is already running a big surplus of exports over imports taking a policy action that will have the effect of boosting exports still further. In effect, the eurozone will be exporting deflation to the rest of the world.

No prizes for guessing the country first in line to receive this gift – dear old Blighty. It is true that the pound has been weak against the dollar, but it has been strong against the euro, now pushing over €1.30. If the pound's average value rises, this would heighten the prospect of falling prices here.

If all that were not enough to make this a momentous week, on Sunday comes the Greek general election. If the opposition party, Syriza, wins, then we can expect a bout of wrangling over Greek demands for less austerity. The markets are so febrile that, even if you knew the outcome of the election and the subsequent wrangling, it would still not be easy to predict the effect on the euro.

I suspect that on Thursday Mario Draghi will announce that the ECB will embark on quantitative easing. He may try to sidestep the question of whether Greek government bonds will be included, but he will be hard-pressed on this issue at the press conference.

On whether a Syriza victory will lead to immediate Grexit, I am agnostic. Even if this doesn't happen over the next week or two, the strains in the eurozone will remain intense.

What the eurozone – and the world – needs is not a burst of competitive devaluations, but much faster growth of domestic demand. In Europe, that prospect remains as elusive as ever.

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