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Deflation
Not for Weaklings
Why it took years after the onset of the financial crisis until EU inflation retreated

> "Lowering prices is an investment into bigger market shares"
> (**Autors of the study "Inflation Dynamics During the Financial Crisis")**

The crisis broke out as early as 2007, triggered by underwater "subprime" mortgages in the United States. In 2009, it led to a massive contraction of economic activity in Europe, and continues as a sovereign debt crisis until today. Still, the inflation rate in the Eurozone was as high as 2.5% in 2012. Even in Greece, where the economy had shrunk by 15% since 2008, the rate of price increases was 1% in 2012. It was only in 2013 that inflation began to recede.

According to Volker Wieland from the University of Frankfurt (Main) in Germany, this indicates that the danger of deflation is smaller than perceived. He and his co-author Maik Wolters refer to an explanation of inflation which is in line with neo-Keynesian-neo-classical economic theory: Inflation will depend on inflationary expectations and the degree of slackness of production resources. A factor "alpha" determines how much inflation will fall when slackness increases. Wieland assumes that this "alpha" may be smaller for low inflation rates, as companies will change their prices less frequently in this case.

Theoretically this is plausible, but there is no empirical evidence. Simon Gilchrist and Raphael Schoenle (and two co-authors) undertook to analyze the data and came to a very different conclusion: In a financial crisis, many companies will simply not be able to afford lowering their prices. The four economists consider price decreases as an "investment into bigger market shares." Those who have acute problems of servicing their debts, can no longer make such investments, but have to keep their prices so high that at least short-term revenues are maximized, regardless of long-term consequences.

The economists divided big U.S. companies for which balance sheet information is available into two groups: those with a weak and those with a strong balance during the financial crisis. They compared the development of product prices of these firms (which had made their statistics available on a confidential basis) to the average prices of the respective product group. The result: companies with a weak balance increased their prices, while strong companied lowered their prices. This could explain why the inflation rate in crisis countries did not fall earlier and more substantially: The proportion of firms in crisis countries like Greece that fight for their sheer survival and cannot afford price cuts is particularly high.

Norbert Häring