

Can the Euro Area Cope Successfully with the Low Inflation Trap?

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Abstract

Can the Euro area cope successfully with the low inflation trap? A comparison of macroeconomic indices in the two leading economies shows that both the United States and the euro zone, more or less at the same time, managed to overcome a deep economic depression which they experienced in 2009, yet, in the next year, i.e. 2011, the euro zone economy clearly started to slow down which was revealed by the 2012 recession, still continued in 2013. Among the main causes of different behaviour of economic growth indices in the US and the euro zone the most important one seems to be a discrepancy in changes in long-term real interest rates on both markets. More than 1.5 point differences in long-term real interest rates in the years 2011-2012 translated into similar differences in the economic growth rate in the years 2012-2013. The reason why in the euro zone countries the long-term interest rates were maintained at such a high level was the inconsistency of the ECB policy concerning interest rates and lack of flexibility in the anti-inflation policy. The ultimate result is the occurrence of symptoms of the low inflation trap threatening the euro zone economies.

Keywords: monetary policy, ECB, FRS, real interest rates

1. Introduction

Price rise has always been perceived as a disadvantageous phenomenon for the development of economic processes. Consumers perceive it as a threat for their real incomes and standards of living whereas producers, due to a change of parameters in their environment, and in particular risk of the increase in the price of capital, see it as a threat for their ability to make rational economic decisions; This conviction is reflected by the evolution in views of the theory of economics on significance of price stability as a factor determining long-term economic growth.

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In the 1980s in the economic debates held in developed countries a view deeply rooted in a monetarist economic doctrine started to prevail which claimed that each price rise is harmful for economy and therefore it should evolve through the periods of very low inflation or even interim periods of deflation so that in the long run the price rise rate would be close to zero [Friedman,1968, p. 16]. Such a situation was also to create optimum conditions for long-term growth ensuring full employment of factors of production.

A postulate of full price stability was, to a large extent, a reaction to the experiences of developed countries from the times of two oil crises which hit their economies in the 1970s. The essence of these experiences led to the conviction that the price rise is the worst possible alternative and therefore pursuit of any other goals of economic policy (including reduction of unemployment) must be abandoned in order to effectively deal with the price rise which seemed to be the most important one. The foundation of this conviction also had its roots in classical economy's belief in the power of market mechanisms, especially in the situation when their working is not disturbed by accidental and frequent changes in economic parameters such as, e.g. price changes. It is interesting that these views seemed to be shared by wide circles of the developed countries' societies, which in those days was proved by spectacular electoral successes of conservative politicians whose attitudes were plainly anti-inflationary (R. Reagan in the USA, M. Thatcher in Great Britain).

A characteristic feature of the discussion on price stability which was held more than two decades ago with participation of the representatives of academic circles, central banking and economic journalists was focusing almost exclusively on its positive effects.

Negative aspects were not taken into consideration and even if some skeptical opinions were expressed, they were in minority and were treated as a "side track" of the mainstream discussion. Even today the situation remains like this although an explicit dichotomy appears between the postulates addressing economic policy by mainstream economy and solutions implemented by central banks in practice, especially in the last few years when developed countries have big problems to recover from one of the most serious crises in their history. Hence it seems that the arguments put forward by skeptics are in fact more significant than the role assigned to them implies.

The symptoms of the above mentioned dichotomy can be found already in the stipulations of the Taylor rule as well as in the inflation target correction made in 2003 by the European Central Bank. The Taylor rule, which is a specific test for the central bank monetary policy compliance with the concept of price stability, adopts 2% inflation as an indicator of this stability instead of zero inflation [Taylor,1993, p.202 and onwards]. Also in 2003, the European Central Bank abandoned the practice of establishing inflation target in the 0 - 2 percent range (which did not rule out attaining zero inflation by the Euro zone countries) in favour of inflation close to 2 percent.

Regardless of the already made "concessions", both in theory and practice of the central bank activities in favour of a more flexible price policy, a question remains whether a fixed, *a priori*, ambitious inflation target (e.g. established at the level of 2%), really creates optimum conditions for economic growth in every country no matter what its hitherto inflation history, economic structure, vulnerability to external shocks, tolerance for moderate price rise and eventually its developmental needs determined, for instance, by a necessity to make up for the developmental distance separating it from partner countries have been. The issue of risks entailed by the policy in which fighting inflation is a priority must also be considered.

2. Policy of Low Inflation and its Limitations

One of the main premises of monetary policy aiming at attainment of an *a priori* established, ambitious inflation target is stabilizing (anchoring) inflation expectations in such a way that in the medium-term they will not "depart" from" the already achieved low inflation indices.

The central bank shapes these expectations by creating an impression that it is ready, at any time, to implement measures effective enough (based mainly on a series of increases in interest rates) to stop a price rise. Credibility and reputation of the central bank depend on its determination in its reacting to a stimulation of an inflation impulse, which in turn translates into its effectiveness in fighting inflation (by shaping inflation expectations).

Although at first glance it may seem that so formulated rules of monetary policy allow for stabilization of conditions in which market participants operate (and consequently have a favourable impact on economic growth), it turns out, that it does not have to be so. We can name at least two crucial premises of an unfavourable impact of the policy pursuing an ambitious inflation target on macroeconomic situation. **First** – breaking up a connection between monetary policy and business cycle; **second** – shaping negative economic expectations based on the market participant conviction that the state will not support economy if the assumed inflation target is not attained.

1) Breaking up the connection between monetary policy and business cycle results from the fact that the said policy does not take natural price cyclicity into account. The thing is that the inflation rate reveals a natural tendency to grow in the periods of economic revival and an equally natural tendency to decline in the period of recession. Similar cyclicity refers to expectations. In short, practically there is no risk that a slight price rise (let us say, inflation of 4 – 6%) which we often deal with in the first phase of revival, will suddenly change into galloping inflation, because after some time, increased demand gets stabilized and supply responding to this growth in demand appears. In the meantime the inflation target remains unchanged.

It is bad when the central bank begins to interfere with the natural rhythm of economy yielding to a kind of anti-inflationary hysteria, raising interest rates when the first symptoms of revival occur and whenever the real inflation rate (not necessarily the one that was forecast) begins, even slightly, to divert upwards from the established inflation target. The central bank's overreaction to a price rise is a result of the Taylor rule logic, which implies a necessity of raising official interest rates by 1.5 percentage points when the inflation rate increases by 1 percentage point.

As nowadays a typical central bank practice involves "serial acting", i.e. implementing several consecutive increases in interest rates which is accompanied by a public announcement about the central bank determination to attain the assumed rate of price rise, economic entities start to include in their decisions considerably higher real costs of capital than it might be expected from the actual nominal interest rates and price rise rate (due to a simultaneous interest rate increase and inflation decrease). All this is perceived as worsening of the climate to conduct business and triggers off stagnation processes in economy.

In the period of recession caused, e.g. by an external shock, the central bank, aiming at full price stability (as it was shown by the European Central Bank practice during the last profound crisis), is very reluctant to implement lower interest rates all the time being afraid of losing its reputation as a guarantor of this stability. A poor reaction of the central bank to the crisis results also from the above quoted "Taylor rule" which implies a decrease of the official interest rate by only 0.5 percentage point when the real GDP growth rate falls by 1 percentage point. Consequently, in the period of a deepening crisis, real interest rates remain at a similar level as in the final phase of revival, which becomes an additional burden for economy. Eventually, economy may fall into a "low inflation trap" indicating a situation when an imagined risk of stimulating inflation makes the central bank keep permanently too high a level of the official interest rate, which in turn overstates the actual and in particular expected real interest rates and deepens stagnative tendencies in economy [Bednarczyk, 2010, pp. 15-26].

2) The countries which establish the inflation target (or the target range) at a very low level, are threatened by the risk of falling into a "low inflation trap", as it is in the case of Japanese economy. In such countries, over time deflation expectations develop which entail an increase in anticipated real interest rates and stagnation tendencies, which additionally become stronger during external shocks affecting global economy from time to time. "Toughened" by the central bank policy, economy entirely loses its ability to react to external disturbances which results in a deeper macroeconomic imbalance (for example, growing budget deficit and public debt), posing a permanent threat of crisis. When (at last) the Bank of Japan noticed these threats, on 22 January 2013 it raised the inflation target from 1 to 2% and put itself under an obligation to further loosen monetary policy.

It made a desperate attempt to reverse the price expectations from deflationary to inflationary ones, which might result in lowering anticipated real interest rates. Yet, a difficult question arises: are the measures applied sufficiently strong to move the economy of the country out of the "low inflation trap" into which it has been plunged for two decades. A similar attempt of rescuing economy against development of unfavourable economic expectations, based on the market participant convictions that the state will not attach sufficient importance to the problems of economic growth, was also undertaken by the Federal Reserve System.

In its statement of 12 December 2012, the Federal Open Market Committee announced: "...The Committee decided to keep... the federal funds rate at 0 – 0.25 percent and currently anticipates that this exceptionally low range... will be appropriate at least as long as the unemployment rate remains above... 6.5 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well-anchored"[Board of Governors of the Federal Reserve System. Press Release, December 12, 2012]. It is a completely different identification of monetary policy goals as compared to the announcements published by the FOMC only 2 or 3 months earlier, which although expressed the will to keep the federal funds rate within an exceptionally low range of 0 - 0.25 percent "till at least mid-2015" [Bernanke, 2012], they did not mention a necessity to considerably reduce unemployment.

The statement of December 2012 was to have an even more pro-growth impact because the Federal Reserve System announced to continue purchasing both longer-term mortgage-backed securities as well as Treasury securities to the joined amount of 85 billion per month to "...maintain downward pressure on longer-term interest rates and help to make broader financial conditions more accommodative (favourable for concluding transactions and economic growth).."[Board of Governors of the Federal Reserve System. Press Release, December 12, 2012]. Apart from this, certain flexibility is allowed in the approach to inflation target. In this case the boundary value for inflation that may be approved by the FRS in its efforts to support revival and reduce the unemployment rate, is not 2 but 2.5 percent. The last decision of the FRS is convergent with the above mentioned decision of the Bank of Japan. Both of them aim to avoid the risk of developing "negative" economic expectations by signalling lower real interest rates in future with respect to a potentially higher inflation rate.

3. Crisis and the EBC Policy of Interest Rates

The activities undertaken by the FRS at the end of 2012 were a continuation of a decisively expansive monetary policy implemented by this bank almost directly after the first symptoms of the 2007 crisis had become visible. The FRS determination was well proved by its policy of interest rates.

In September 2007 the interest rate on federal funds was reduced from a high rate of 5.25 percent to 4.75 percent and then during the successive 15 months (until 16 December 2008) after carrying out 10 reductions (in three cases by even 0.75 base points) to a rate of 0 – 0.25 percent, that is the lowest rate ever [Federal Reserve Bank of New York ,14.03.2013].

If we really treated the Central Bank interest rate policy as a barometer of its will to overcome stagnative tendencies in economy which were triggered off by the global crisis, then the European Central Bank would compare much worse to the Federal Reserve System. First of all, in mid-2008, when the crisis symptoms revealed themselves in full, the ECB continued a series of interest rate increases controlled by itself and on 9 July 2008 raised its basic interest rate¹ to the level of 5.25%. It is worth mentioning that at that time the interest rate on federal funds stood at 2%.

Only 13 months later after the FRS (in October 2008), did the ECB initiate decreases in interest rates, and then in nine moves, in the course of 7 months, its basic interest rate was reduced from 5.25 to 1 percent and yet the rate was still maintained at a much higher level than the FRS basic interest rate. What is more, the ECB authorities were not consistent in creating the encouraging climate for the private sector (enterprises and households) because already on 13 April 2011 they decided about another increase in the basic interest rate (*fixed rate*) by 25 base points and then, on 13 July of the same year, by yet another 25 base points.

Consequently, until 9 November 2011 the basic interest rate was kept at a level of 1.5%. At that time, the authorities of the ECB managed by J.-C. Trichet used a very strong anti-inflation rhetoric despite the fact that that more and more Euro zone countries plunged into crisis. The change of the ECB manager in November 2011 coincided with the return to decreases in the basic interest rate which, following five reductions of 25 base points each, on 13 November 2013 reached the value of 0.25 percent and it is still maintained at this level.

Changes in official interest rates represent one of many tools which were used by both the Federal Reserve System and European Central Bank in order to facilitate access to money. Both banks undertook a number of extraordinary measures to sustain liquidity of not only the financial sector institutions but also non-financial economic entities (*quantitative and qualitative easing*).

The interest rate policy played a special role in those activities on account of its: 1) crucial effect on market participant expectations concerning changes in the overall climate for business, 2) indirect translating of the official interest rate into the cost of capital, 3) effect on market participant expectations concerning future levels of real interest rates re. 1) Market participants develop their expectations concerning medium-term economic development prospects. This results, among others, from the length of the investment cycle, possibilities of adjusting the production facilities to a new quantity and structure of demand, etc. If the central bank, as it happened in the case of the FRS, signals maintaining official interest rates at the extremely low levels for as long as economy does not reach full employment (at the level close to the natural unemployment rate), then market participants have all the reasons to believe that the authorities' activities are credible, really oriented towards economic improvement and can respond to them by their decisions leading to the development of their business activities.

The situation looks quite different when the central bank, as it is the case with the ECB, does not define the official medium-term interest rate and keeps market participants uncertain as regards future conditions of business. Then, their possibilities of assessment whether their investment decisions are going to be a failure in medium-term when the central bank fearing that it loses its credibility as a "guardian" of the ambitious inflation target decides about a series of increases in interest rates thus triggering off stagnative processes in economy are restricted. At such a moment they will probably choose to give up or limit their investment ventures, with all the adverse consequences for economic development. re. 2) Although changes in official interest rates do not have a direct impact on the interest rates on credits borrowed from banks by enterprises and households, yet their indirect impact through the costs of bank re-financing in the central bank is very strong [Pszczółka, 2007, pp.163-164]. If the central bank raises its interest rates, as it was in the case of the ECB, it means almost 100% certainty that the interest rates paid in banks by business and individuals will be higher. Theoretically, banks should also raise interest rates on deposits. However, as a rule, this is done with some delay in relation to the increases in interest on credits.

Besides, on some deposits (e.g. the money in current accounts) the banks pay very low interest. As a result of interest rate increases redistribution of income follows in favour of the banking sector and at the expense of production businesses and households.

It has a very adverse impact on the business cycle. re. 3) Shaping the market participant expectations concerning future values of real interest rates is the key aspect of the central bank interest rate policy. The level of these interest rates has an unquestionable effect on the dynamics of private consumption, investments in fixed assets and exports which, in turn, determine the GDP dynamics [Kosztowniak, 2010, pp.98-111]. The central bank has no possibilities of direct influencing the levels of current as well as future real interest rates. However, it can effectively affect them by changes in nominal interest rates controlled by itself, adopted and actually implemented inflation target and shaping inflation expectations, depending on the way of informing the market about its medium-term priorities [Sobol, 2008, pp. 39-42].

It is rather difficult to evaluate the European Central Bank's policy as the one fostering the market participant convictions about a possible future reduction of real interest rates. On the contrary, its activities can rather contribute to the expectations of their increase. All three factors of direct impact of the central bank on real interest rates which have been mentioned above seem to imply this. In particular, what we have in mind here is initiating fixed rate increases in 2011 which interrupted a series of decreases begun in 2008, maintaining in the Euro zone countries the average annual inflation indices very close to a stiff, 2% inflation target and, eventually, a very strong anti-inflation rhetoric appearing in the statements of both the previous and the current ECB President, which deprives the market participants of any illusions whatsoever concerning actual priorities of the Bank.

4. Has the Euro Zone Got Stuck in the Low Inflation Trap?

In this situation a question arises: have the Euro zone economies found themselves in the low inflation trap which has been well known to Japanese economy and, if so, can the monetary policy of the European Central Bank in the form which has been implemented so far help overcome this problem.

What can be helpful in our attempts to find the answer to the posed questions is a confrontation of macroeconomic indices for the period since 2007 when the crisis broke out between the United States carrying out the monetary policy aiming at price stability but in the context of clear economic revival and the Euro zone unanimously oriented towards price stability.

The comparisons will also consider the forecasts for these indices for the nearest future developed for both economies by the OECD. As the data included in Table 1 indicate, the efforts undertaken by the FRS resulted first in a fall and then in stability of short-term real interest rates at very low, negative levels actually over the entire post-crisis period. A similar tendency was also revealed by long-term interest rates although in the years 2011 and 2012 their values only slightly deviated downwards from zero (-0.3). Tendencies regarding short-term real interest rates in the Euro zone were fairly similar to those noted in the United States, yet the tendencies for the long-term interest rates show significant differences. In the years 2011 and 2012 a clear divergence in these rates was visible. Whereas in the United States they stood at -0.3, in the Euro zone they stood at 1.5 and 1.2, respectively. Differences will probably be sustained in the years 2014 and 2015.

Table 1: Comparison of Selected Macroeconomic Indices in the USA and the Euro zone Countries in the Years 2007-2015* (%)

Description	Years								
	2007	2008	2009	2010	2011	2012	2013	2014 [*]	2015 [*]
I. Real economic growth rate									
United States	1.8	-0.3	-2.8	2.5	1.8	2.8	1.9	2.6	3.5
Euro zone	3.0	0.2	-4.4	1.9	1.6	-0.6	-0.4	1.2	1.7
II. Inflation rate									
United States	2.9	3.8	-0.3	1.6	3.1	2.1	1.5	1.5	1.7
Euro zone	2.1	3.3	0.3	1.6	2.7	2.5	1.3	0.7	1.1
III. Real interest rates:									
- short-term									
United States	2.4	-0.6	1.2	-1.1	-2.7	-1.7	-1.2	-1.2	-0.8
Euro zone	2.2	1.3	0.9	-0.8	-1.3	-1.9	-1.1	-0.6	-1.0
- long-term									
United States	1.7	-0.1	3.6	1.6	-0.3	-0.3	0.9	1.5	1.9
Euro zone	2.2	1.0	3.5	2.0	1.5	1.2	1.6	1.8	2.6
IV. Growth rate of investment in fixed assets									
United States	-1.2	-4.8	-13.1	1.1	3.4	5.5	2.9	3.5	9.2
Euro zone	5.1	-1.6	-12.7	-0.6	1.7	-3.8	-2.7	2.5	3.3
V. Unemployment rate									
United States	4.6	5.8	9.3	9.6	8.9	8.1	7.4	6.5	6.0
Euro zone	7.4	7.5	9.4	10.0	10.0	11.2	11.9	11.7	11.4

* OECD forecasts

Source: OECD Economic Outlook, Nr 95, May 2014. Preliminary Version, pp. 261, 265, 273, 278, 294, 295, and the author's own calculations.

So different tendencies as regards interest rates could not be without impact on macroeconomic indices observed in these countries and forecasts for the period 2013-2014. First of all, a significant difference is seen in the pace with which investments in fixed assets grow. Whereas in the United States we have witnessed a clear revival since 2011 with very good prospects for the years 2013 and 2014, in the Euro zone we noted growth in these investments in 2011, but in the next two years it was followed by a clear regression with a possibility to "bounce off" only in 2014.

Such an adverse situation in the field of investments was reflected in statistics concerning labour markets. Alongside investment stifling in the Euro zone, unemployment deepened and reached 11.9% in 2013; in the meantime unemployment in the USA had been halting down reaching 7.4% in 2013.

The comparison of economic growth indices proves that American economy has managed to overcome a deep economic breakdown which it experienced in 2009, that is more or less at the same time as the Euro zone economy. In 2010 both economies noted a fairly rapid growth rate: United States – 2.5% and the Euro zone – 1.9%, yet starting with 2011 the Euro zone economy clearly began to slow down which was reflected in the 2012 recession still continued in 2013. While looking for the reasons for different economic growth indices in the United States and the Euro zone it could be difficult not to notice the convergence of these tendencies with changes in the long-term real interest rates in both markets. More than 1,5-point differences in long-term real interest rates in the years 2011-2012 translated into similar differences in the economic growth rate in the years 2012-2013.

As it was stated above, one of the reasons for which long-term real interest rates in the Euro zone countries were kept at such a high level was the ECB's incoherent policy of interest rates in 2011, which could induce, at least in some market participants, an impression that first of all the Bank would pursue its inflation target, whereas economic growth prospects were of lesser importance to it.

Specificity of monetary policy carried out by both central banks is best reflected in the data regarding inflation. The range of fluctuations in inflation indices was larger in the United States than in the Euro zone (e.g. in the years 2008-2009 and then in 2010-2011); it refers also to absolute values of these indices.

However, in some years, e.g. 2009 and 2012, it was the United States which noted lower inflation indices. It is a very important observation indicating stronger anchoring of low level inflation expectations during the current economic situation than it might be expected in view of the earlier inflation history in these countries. If it is really so, then it should give more freedom to central banks in their choice of the monetary policy measures. It refers in particular to the European Central Bank which in the past proved itself to be very effective in maintaining the inflation rate close to the assumed inflation target.

Theoretically this bank should reduce its interest rates below the levels noted in the countries (such as the United States) which earlier noted slightly higher inflation indices in order to support economic revival [Bednarczyk, Sobol, 2012,p.69]. The ECB did not take advantage of this opportunity, however. It is difficult to estimate precisely to what degree the ECB conservative interest policy, and especially delayed initiation of a cycle of interest rate reductions (more than a year after the Federal Reserve System) contributed to reduction of many benefits which the Euroland economy could have achieved, if its central bank, on the basis of the anchored inflation expectations, had led to a stronger reduction of money costs, i.e. if the said reduction had reached a scale similar to that in the United States.

In the meantime, maintaining high interest rates, especially in 2008, undoubtedly contributed to further appreciation of the euro and, to some extent, to deeper downturn in exports, which for the biggest Euro zone economies is a key element in stimulating economic growth. Higher interest rates exerted also an adverse effect on investments in fixed assets and certainly consumption dynamics. Thus it seems that the ECB did not use sufficiently the trust it had enjoyed, implementing from the very outset of its operations a decisive inflation-restricting policy. As a result, despite the fact that the ECB had more leeway than e.g. the Federal Reserve System, its activities led only to a slow-down in the financial sector crisis but were not able to create in the economy the adequate climate for economic revival [Kosterna, 2010]. Consequently, the economic downturn in the Euro zone countries was stronger than in the US economy and the years following the crisis showed that European economy practically has no chance to at least repeat the American scenario of overcoming a recession, which here proved itself more profound and persistent.

The way in which monetary policy is articulated in the Euro zone countries, the main criteria of its effectiveness and most of all the evolution of the macroeconomic situation in these countries seem to support a thesis that the said countries are in the low inflation trap, which essentially is similar to that which for more than two decades has been experienced by Japan. If the ECB does not change its policy to the one which favours economic revival more, then in the nearest years the main success of the Euro zone countries (as the OECD forecasts included in Table 1 indicate) will be maintaining low inflation indices. The indices will be below the Bank's official inflation target. Yet, at the same time long-term real interest rates will tend to grow and in this way they will effectively discourage market participants to expand the scale of their business activities, which will be reflected, among others, in stagnation in investments in fixed assets and real GDP growth but in growing unemployment.

What is left is answering a question: how should the ECB policy be changed to avoid fixing the Japanese scenario in the Euroland? First of all the ECB should start to build its credibility as an institution favouring economic revival not only by stabilizing the inflation rate, but also by active creation of conditions for stabilizing the anticipated long-term real interest rates at a lower level. Even if the ECB does not want to follow the same path as the Bank of Japan took raising its inflation rate by 1 percentage point, or the Federal Reserve allowing a possibility of initiating anti-inflation activities after the inflation index exceeds the official 2%-inflation target by 0.5 percentage point, at least it should apply the monetary policy instruments at its disposal in such a way as to make the anticipated inflation indices not deviate downwards from the official inflation target. Especially, the inflation indices anticipated in the Euro zone countries for the years 2014 and 2015 to be at the level of 0.7 and 1.1 %, in view of the unemployment rate reaching there 11.7 and 11.4 % respectively, seem to be a complete misunderstanding and a failure of the ECB monetary policy. Many earlier discussions which were held, among others, at the ECB itself, made it clear that the inflation rate of at least 2% can be a moderately safe protection against development of deflationary expectations particularly dangerous for the prospective functioning of economy. The occurrence of such expectations would considerably reduce the chances of the Euro zone to overcome the low inflation trap and would even more procrastinate prospects of a stronger economic revival.

5. Conclusions

Establishing the inflation target by central banks was to eliminate inflation as a cause of disturbances in economic growth processes. With time it turned out that the main instrument which central banks could use to carry out this task, i.e. regulation of short-term interest rates, can be a double-edged weapon. Rapid changes in the interest rate or maintaining it by the central bank at too high a level in order to be credible as a low inflation guarantor, can in some situations induce equally dangerous effects for economic growth prospects as the inflation itself. The point is the risk of the economy finding itself in the low inflation trap, that is a situation when discouraged by a high level of anticipated long-term real interest rates and absence of trustworthy signals coming from authorities which would indicate their direct engagement in the policy supporting economic revival, the private sector business entities limit their medium-term development plans.

The result of an economy in the low inflation trap is a slow-down followed by stagnation of economic growth, growing unemployment and gradual deepening of macroeconomic imbalances (growing budget deficit, exchange rate appreciation, current account deficit, etc.). If this situation persists for a longer time, economy is threatened by the occurrence and then gradual strengthening of deflationary expectations which make economic revival extremely difficult.

The research done shows that starting in 2011 onwards the Euro zone economy may be entering the low inflation trap. It is testified to by continuous growth of the anticipated long-term interest rate accompanied by a decline in the pace of investments in fixed assets, growing unemployment and a fall in the inflation rate which dangerously approaches the level at which business entities can change their expectations from inflationary to deflationary ones.

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