

Deflation in America

The greater of two evils

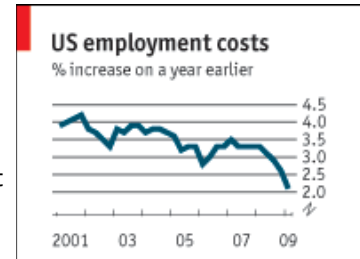
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Inflation is bad, but deflation is worse

MERLE HAZARD, an unusually satirical country and western crooner, has captured monetary confusion better than anyone else. "Inflation or deflation," he warbles, "tell me if you can: will we become Zimbabwe or will we be Japan?"

How do you guard against both the deflationary forces of America's worst recession since the 1930s and the vigorous response of the Federal Reserve, which has in effect cut interest rates to zero and rapidly expanded its balance-sheet? On May 4th Paul Krugman, a Nobel laureate in economics, gave warning that Japan-style deflation loomed, even as Allan Meltzer, an eminent Fed historian, foresaw a repeat of 1970s inflation—both on the same page of the *New York Times*.



There is something to both fears. But inflation is distant and containable, while deflation is at hand and pernicious.

Dragged down by debt

Fears about deflation do not rest on the 0.4% decline in American consumer prices in the year to March. Although this is the first such annual decline since 1955, it is the transitory result of a plunge in energy prices. Excluding food and energy, core inflation is 1.8%. Rather, the worry is of persistent price declines that characterise true deflation. With unemployment nearing 9%, economic output is further below the economy's potential than at any time since 1982. This gap is likely to widen. House prices are not part of America's inflation index but their decline is forcing households to reduce debt (see [article](#)), which could subdue economic growth for years. As workers compete for scarce jobs and firms underbid each other for sales, wages and prices will come under pressure.

So far, expectations of inflation remain stable: that sentiment is itself a welcome bulwark against deflation. But pay freezes and wage cuts may soon change people's minds. In one poll, more than a third of respondents said they or someone in their household had suffered a cut in pay or hours. The employment-cost index rose by just 2.1% in the year to the first quarter, the least since records began in 1982. In 2003, during the last deflation scare, total pay grew by almost 4%.

Does this matter? If prices are falling because of advancing productivity, as at the end of the 19th century, it is a sign of progress, not economic collapse. Today, though, deflation is more likely to resemble the malign 1930s sort than that earlier benign variety, because demand is weak and households and firms are burdened by debt. In deflation the nominal value of debts remains fixed even as nominal wages, prices and profits fall. Real debt burdens therefore rise, causing borrowers to cut spending to service their debts or to default. That undermines the financial system and deepens the recession.

From 1929 to 1933 prices fell by 27%. This time central banks are on the case. In America, Britain, Japan and Switzerland they have pushed short-term interest rates to, or close to, zero and vastly

expanded their balance-sheets by buying debt. It helps, too, that the world has abandoned the monetary straitjacket of the gold standard it wore in the 1930s.

Yet this anti-deflationary zeal is precisely what alarms people like Mr Meltzer. He worries that the price of seeing off deflation is that the Fed will be unable or unwilling to reverse itself in time to prevent a resurgence of inflation.

Fair enough, but inflation is easier to put right than deflation. A central bank can raise interest rates as high as it wants to suppress inflation, but it cannot cut nominal rates below zero. Deflation robs a central bank of its ability to stimulate spending using negative real interest rates. In the worst case, rising debts and defaults depress growth, poisoning the economy by deepening deflation and pressing real interest rates higher. Central banks that have lowered rates to nearly zero are now using unconventional, quantitative tools, but their efficacy is unproven. Given the choice, erring on the side of inflation would be less catastrophic than erring on the side of deflation.

That said, there is a legitimate concern that when the time comes to raise interest rates, the Fed may hold back because of political pressure or fear of fracturing financial markets. The Fed was too slow to raise interest rates after its deflation scare in 2003. Yet that is best addressed by strengthening the Fed. Barack Obama should nominate credible, independent people to the two vacant seats on the Federal Reserve Board, and bat away suggestions that the 12 reserve-bank presidents, who are not confirmed by Congress, lose their say in monetary policy. Congress should let the Fed issue its own debt, which would give it scope to tighten monetary policy without disorderly sales of the illiquid private debt it has taken on.

Affirming the Fed's political independence and equipping it with better tools would help the central bank combat inflation when the time comes. It would also lessen the risk that it tightens prematurely just to demonstrate its resolve.

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