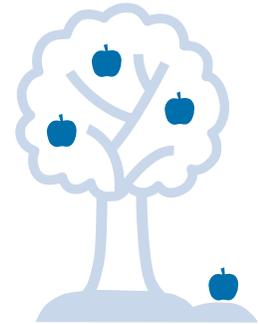


# Quarterly Review

April 2003

## THE GRAVITY OF FALLING PRICES

Do you remember the 1970s? Among other things, the seventies was a decade of high inflation. The Consumer Price Index (CPI) advanced 13.3% in 1979. Since then, however, the U.S. economy has experienced declining rates of growth in consumer prices. Today, with the CPI posting some of its lowest advances in two generations, and interest rates at historic lows, talk of deflation is circulating in North America and Europe. A comparison with Japan, where the effects of deflation have been felt for nearly five years, has become commonplace. What is this new threat to our economy? How does deflation occur? How likely is it that deflation will take hold in North America and Europe?



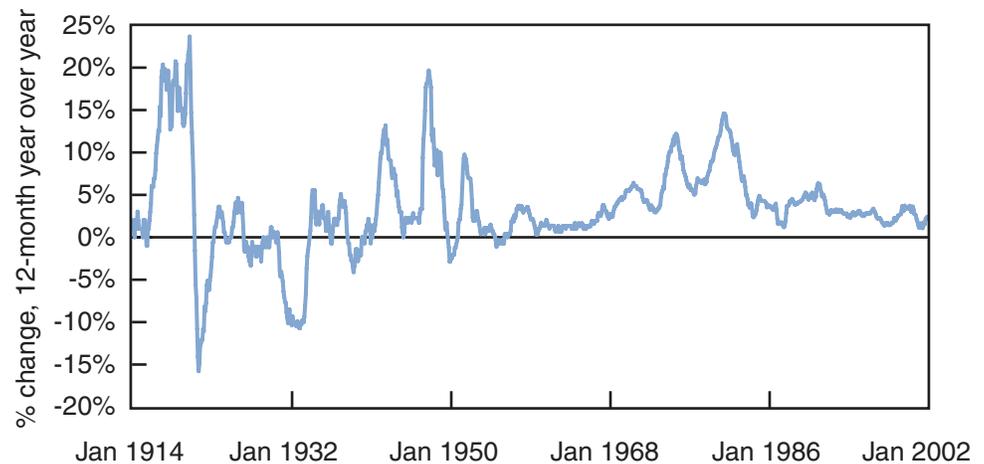
First, it is important to note that while prices are rising, they are rising at a slower rate than we saw in the seventies. This is, in fact, *disinflation*, not to be confused with *deflation*. Deflation is an economic condition in which there is an absolute decline in general prices that affects nearly every item.

The prices of products such as color television sets, computers and cellular phones has dropped due to remarkable technical innovation and high labor productivity. But a decline in the price of specific products does not constitute deflation. In Japan, nationwide core consumer prices have not risen since April 1998; in fact, the general level of prices has fallen about 1% each year. During the first four years of the Great Depression (1930–34), the general level of prices declined at the rate of 6.4% each year in the United States and 3.6% in the United Kingdom. The last episode of deflation in the United States was an 18-month period in 1954–55, when the CPI declined 1.1%.

### In This Review

- 1 The Gravity of Falling Prices
- 5 The State of American States
- 9 Great Financial Architecture
- 12 A New Topography for High Yield Bonds

### Deflation flared in the 1910s, 1930s and 1950s. (U.S. Consumer Price Index)



Source: Bureau of Labor Statistics, U.S. Department of Labor

### WHAT CAUSES DEFLATION?

***In a deflationary environment, producers and consumers play a game of “chicken.”***

Basic economic theory tells us that the price level is the meeting point of supply and demand. When demand exceeds supply, prices increase. So we know that deflation, or declining general prices, is typically created through a collapse in aggregate demand. In a deflationary environment, producers and consumers play a game of “chicken” in which producers continue to lower prices and consumers respond by doing nothing because they believe prices will move even lower. This vicious cycle naturally results in little or no profit for businesses, with corresponding reductions in employment and increases in stress to the economy. These dire conditions usually produce a weak banking system. This is currently the case in Japan and was also true of the United States in the 1930s. When consumers lose confidence in the safety of their deposits, it adds to the panic psychology of a deflationary environment.

Economic recessions tend to result in a reduction of aggregate demand. When inflation rates are high, deflation is rarely a risk. But when inflation is low (as it is now), a prolonged recession could push the economy into a deflationary mode. Retailers have seen evidence of this in the last two Christmas shopping seasons, when consumers waited until the days immediately preceding the holiday to make their purchases. This waiting game is attributable not to a tendency to procrastinate, but rather to the large discounts consumers have come to expect at the last minute (i.e., the game of “chicken”). Once the psychology of deflation has entered the consumer’s mindset, it is very difficult to extricate.

Global trade does not cause deflation. Free trade increases the output of all goods through international specialization. Countries do what they do the best, concentrating on the areas in which they have a comparative advantage. A country may experience a loss of jobs in industries in which it does not have a comparative advantage and lower prices for those goods during the years of transition to its optimal mix. This process has been ongoing for centuries.

## AREN'T FALLING PRICES A GOOD THING?

If wages do not decline along with prices, then falling prices can be beneficial. Recent advances in productivity have resulted in declining prices for televisions, computers, and other technology goods. By definition, however, deflation affects all sectors of the economy. If deflation causes profit declines, then wages are also likely to decline. If wages do not decline, then businesses must cut expenses by reducing the work force. During long periods of deflation, businesses both lay off workers and reduce wages. This was the case in North America and Europe during the Great Depression and has recently been the case in Japan.

In a deflationary environment the attitude toward debt is the inverse of that to which we have grown accustomed. We all know that debt is repaid with dollars earned in the future. In periods of high inflation, those future dollars are worth less than they are today. Consumers have learned over the past four decades that a large debt burden is okay because inflation will help reduce their load. But in a deflationary environment, debt becomes a great burden as it is repaid with dollars that are worth more than they are today. A level of debt that would be considered acceptable in inflationary times could, under deflation, lead to bankruptcy.

## WILL DEFLATION BUSTERS HOLD DEFLATION AT BAY?

Once the deflation mindset has entered the collective consciousness of a nation, it takes on a life of its own. If policymakers are slow to react to a collapse in aggregate demand, then deflation can set in. The Bank of Japan waited nearly two years to cut interest rates following its economic decline. This delay undermined the ability of monetary policy to pull the Japanese economy out of its deflationary spiral.

The current evidence indicates that deflation is unlikely to take hold in North America and Europe for any meaningful length of time. The U.S. Federal Reserve has reacted quickly by lowering short-term interest rates. The European Central Bank has followed suit. Policymakers understand that if rate cuts provide too much stimulus, they can always reverse course and raise rates at a later date.

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Fiscal policy is also frequently used in an attempt to increase aggregate demand. The United States followed this course in the 1930s and is doing so again with record-setting budget deficits (see “Deficit Spending Déjà Vu,” *Quarterly Review*, July 2002). Japan has also been running budget deficits in an attempt to stimulate its economy, but deficit spending there has not created much economic growth.

Another policymaking technique is to influence the value of the domestic currency. Leaders of emerging-market countries have used the devaluation tool for decades. This practice is fairly reliable in producing inflation, but most economists do not believe that developed-market countries should pursue such a policy. The use of such a blunt tactic would destroy the credibility of a developed country, particularly vis-à-vis long-term, in-bound foreign investment. The more likely approach would be a currency depreciation, or lower drift, over a longer period of time. The Federal Reserve could accomplish this through asset purchases, which would have the same effect as printing more money. A greater supply of dollars usually results in a less valuable (or lower priced) dollar relative to other currencies.

The natural market force of competition also plays a role in staving off deflationary pressure. Businesses react to this pressure by reducing costs and turning profits. Companies that are unable to adjust file for bankruptcy. Weak competitors are thus eliminated from the economy, providing marginally increased pricing power for the survivors.

Prolonged periods of deflation can be extremely destructive. By contrast, lower rates of inflation, or disinflation, have generally been helpful to the economy since the 1970s. The financial system appears to be relatively healthy, especially considering the recent recession. Although nothing is certain, policymakers have been active on both the monetary and fiscal policy fronts to significantly lower the probability of a deflationary episode in North America and Europe. ■

***Policymakers have been active on both the monetary and fiscal policy fronts to lower the probability of a deflationary episode.***