



The Rising Threat of Deflation

By John H. Makin

As we enter the second half of 2010—the “post-crisis” year—while markets have been obsessed with Europe’s debt crisis, they have failed to notice potentially more ominous developments. The United States and Europe are heading toward—and Japan already suffers from—deflation, a classic prolonger of crises that boosts the real burden of debt and crushes profit margins.

U.S. year-over-year core inflation has dropped to 0.9 percent—its lowest level in forty-four years. The six-month annualized core consumer price index inflation level has dropped even closer to zero, at 0.4 percent. Europe’s year-over-year core inflation rate has fallen to 0.8 percent—the lowest level ever reported in the series that began in 1991. Heavily indebted Spain’s year-over-year core inflation rate is down to 0.1 percent. Ireland’s deflation rate is 2.7 percent. As commodity prices slip, inflation will become deflation globally in short order.

Meanwhile in Japan, while analysts were touting Japan’s first-quarter real growth rate of 5 percent, few bothered to notice that over the past year Japan’s gross domestic product (GDP) deflator had fallen 2.8 percent, reflecting an accelerating pace of deflation in a country where the price level has been falling every year since 2004. As of May, Japan’s year-over-year core deflation rate stood at 1.6 percent.

The Paradox of Crisis and Deflationary Pressure

The financial crisis of 2008 prompted aggressive monetary and fiscal easing by most governments.

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In the United States, the Federal Reserve cut its overnight lending rate to zero and tripled the size of its balance sheet during the year beginning in January 2009, during which time Congress and President Barack Obama enacted a substantial fiscal stimulus package.

Many market participants and policymakers have warned that such aggressive easing will lead to inflation. Contrary to those expectations, as noted above, core inflation has steadily moved lower in the United States and Europe and is approaching outright deflation, which Japan is already experiencing. By later this year, persistent excess capacity will probably create actual deflation in the United States and Europe. Moreover, the recent appreciation of the dollar, especially against the euro, exacerbates the U.S. deflation threat.

Fears of higher inflation are a persistent phenomenon at central banks after accommodative steps have been taken to cushion the negative impact on the real economy following a financial shock. During the Great Depression, the Federal Reserve allowed the money stock to fall rapidly because, among other concerns, Fed leaders feared inflation. The disastrous consequences, a serious exacerbation of the economic contraction already underway following the aftermath of a bursting bubble, are fully articulated in Milton Friedman and Anna Schwartz’s *Monetary History of the United States, 1867–1960* (Princeton University Press, 1963).

More recently, the Bank of Japan, slow to ease after the real estate bubble burst in 1990, has presided over two decades of disinflation that has become outright deflation. Japan’s nominal GDP, as of the first quarter of this year, at ¥480 trillion

has dropped by an extraordinary 7 percent over the past two years because of a combination of outright deflation and low-to-negative growth. Perhaps even more dismaying, in 2010, Japan's nominal GDP is equal to its 1993 GDP. It is encouraging to know that, after its May 20 meeting, the Bank of Japan's policy statement expressed the need to be more accommodative in light of resumed signs of financial distress centered in Europe. Perhaps the Fed's next policy statement after its June midyear policy review by the Federal Open Market Committee will emphasize further the need to remain accommodative for "an extended period."

Why Crises Are Deflationary

Financial crises are deflationary because they create a rise in the demand for cash that depresses aggregate demand at a time when substantial excess capacity exists.

The excess capacity is created during the run-up to the crisis, where underpricing of risk cuts the cost of capital and leads to substantial increases in the capital stock.

A number of reasons drive the rise in the demand for cash. First, a crisis causes a sharp rise in uncertainty—Keynes's precautionary motive. In an extreme crisis, one that entails bank runs, the demand surges for currency at the expense of bank deposits and, in turn, reduces the money multiplier, the ratio of the money supply to the bank reserves supplied by the central bank to commercial banks. That places more pressure on the central bank to accommodate the sharply rising demand for outright cash by printing money. Failure by the Fed to recognize the deflationary impact of a sharp rise in the demand for cash in 1932 resulted in its allowing a collapse in the money multiplier to sharply contract the money supply—cash and deposits—which, in turn, severely intensified the collapse of economic activity that was already underway.

The Fed aggressively addressed a similar problem in 2008 when it sharply boosted the monetary base (currency and bank reserves) by enough to avoid a sharp drop in the money supply. Despite the rapid rise in the monetary base, the M2 money supply (cash and bank deposits) has stagnated over the past year. This is because the money multiplier has dropped as households—still cautious—have elected to hold more cash relative to bank deposits while banks—still reluctant to expand credit—have held higher reserves.

In fact, banks have virtually ceased to function as financial intermediaries since 2008, preferring to use the zero cost of money provided by the Fed to finance purchases of Treasury securities instead of supplying loans to households and small businesses. After a financial crisis, banks become much more risk averse, as is manifest in their willingness to lend only to the government instead of to households and businesses. That development is deflationary because it means that a sharp boost in the monetary base engineered by the Fed does not translate into faster monetary growth at a time when the precautionary demand for money has been boosted by elevated uncertainty.

The increased demand for money that results from higher desired precautionary balances and stingy monetary creation by the banks is deflationary, just as an excess supply of money is inflationary. The fear that a sharp rise in the size of the Fed's

balance sheet—the reflection of a sharp boost in the monetary base—is inflationary is misplaced for two reasons. First, such fear does not recognize that the money multiplier has dropped so rapidly that the money supply—a key determinant of inflation—has stagnated. Additionally, it overlooks the increase in the precautionary demand for money that adds to the deflationary excess demand for money.

There is a bigger risk that deflation will intensify sharply because once the price level actually starts to fall, the demand for money will be further enhanced. A deflationary spiral—a self-reinforcing, accelerating drop in the price level—can result. This is because a falling price level means that cash "earns interest" since it enhances the purchasing power of otherwise sterile cash assets that pay zero interest, just as interest on a bond adds to its value in terms of its ability to be used to buy goods and services. That is why deflation drives down nominal (market) interest rates just as inflation drives them up. The "real" return on cash rises as inflation falls, thereby further boosting the excess demand for money and, in turn, exacerbating deflationary pressure. The fact that deflationary real returns on cash are not taxed further exacerbates deflationary pressure by enhancing the demand for cash.

The "Zero Bound" Looms

The Fed's dreaded "zero bound problem," whereby interest rates even at zero percent are still not low enough to

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stimulate demand, results from the rising real return on idle cash that subtracts from demand growth as deflation accelerates. Once the Fed has cut interest rates to zero, as it has done on short-term loans, any rise in deflation boosts the real return on cash that, in turn, exacerbates deflation. The Fed is, and has been, forced to print money by purchasing Treasury securities and mortgage-backed securities in order to satisfy the deflationary rise in money demand.

Beyond a crisis-induced rise in the precautionary demand for cash, and the related tendency for bank disintermediation, postcrisis deflation pressures can be enhanced by an excess supply of goods and services beyond that caused by the rising demand for cash. This is because the run-up in asset prices that creates a bubble in the first place lowers the cost of capital while the bubble is inflating. Firms find it easier to borrow as prices of risky stocks and bonds rise, so they add to productive capacity. Households, encouraged by cheap credit, buy more cars and houses, thereby increasing the stock of durable sources of a stream of housing and transportation services.

Once the bubble bursts, wealth is destroyed and workers are laid off—both causes of a sharp drop in demand for goods and services, whose supply is increased by the sharp increase in investment during the rise of the financial bubble. Excess capacity adds to the deflationary pressure induced by a sharp rise in the demand for money and the disintermediation that accompanies a financial crisis and its aftermath.

The Cusp of Global Deflation?

Europe's sovereign debt crisis has been exacerbated by the European Central Bank's (ECB) stringent policies that imply either drastic wage and price deflation in southern Europe or a breakup of the European Monetary Union. The upshot, so far, of this crisis is a sharp weakening of the euro against the dollar. The 18 percent depreciation of the euro since last November amounts to an export of deflation from Europe to the United States, not to mention China, the rest of Asia, and emerging markets. The transmission of that deflationary impulse has helped to spread the negative impact on markets emanating from the European crisis.

More recently, an ominous drop in commodity prices and commodity-sensitive currencies, such as the Australian dollar, has accompanied signs that the pace of expansion in

China may be slowing rapidly, in part because of stern measures aimed at deflating China's property bubble. The price of copper—a widely followed bellwether for global demand—has dropped 20 percent since April. A

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combination of weakening currencies in commodity-rich nations and lower commodity prices, coupled with a move toward deflation in the G3 economies, is a troubling sign that a series of rolling financial crises may lie before us. That outcome would seriously exacerbate the balance sheet problems of commercial banks worldwide that hold substantial quantities of

debt that is less likely to be repaid in an environment of global deflation.

There are exceptions. The price of gold, a classic inflation hedge, is up by 8 percent since April. Gold is a hedge for those who fear that the aftermath of the financial crisis may include inflation. But simultaneously, the price of a thirty-year U.S. government bond is up about 10 percent on the year, with virtually all of that price increase having come in May as the deflationary euro crisis has unwound. Most of the rise in the thirty-year-bond price is tied to a drop in inflation expectations.

Policymakers Ignoring Deflation Risks

Perhaps it is time for central banks, the ECB especially, to take note. Financial crises are usually deflationary. Pretending otherwise because of a policy of low interest rates and sharp increases in the monetary base undertaken after financial bubbles have burst constitutes a necessary, although not sufficient, condition for a global depression. This would be especially true if China's response to the crisis was to create more excess capacity while refusing to allow its currency to appreciate. A persistent failure to respond to the dangers of further deflation, such as the premature removal of accommodative monetary policy apparently favored at the ECB or a sharp fiscal contraction favored by the European Monetary Union, would sharply elevate the risk of global deflation and depression.

At this point in the postbubble transition to deflation, fiscal rectitude and monetary stringency are a dangerous policy combination, as appealing as they may be to the virtuous instincts of policymakers faced with a surfeit of sovereign debt. The result of Europe's embrace of fiscal rectitude will be—paradoxically in the eyes of some—to export deflation to the United States, Asia, and the emerging markets. Additionally, Japan's new government's

proposal to double the consumption tax as a way to promote growth has been appropriately chastised by the opposition Your Party leader Yoshimi Watanabe, who retorted: “Boosting the economy with a tax hike? That is an obscene stretch.” Japan is threatening to repeat its disastrous experience of 1997, when a consumption tax hike threw the economy back into a sharp slowdown followed by intensified deflation.

The G20’s shift toward rapid, global fiscal consolidation—a halving of deficits by 2013—threatens a public sector, Keynesian “paradox of thrift” whereby because all governments are simultaneously tightening fiscal policy, growth is cut so much that revenues collapse and budget deficits actually rise. The underlying hope or expectation that easier money, a weaker currency, and higher exports can somehow compensate for the negative impact on growth from rapid, global fiscal consolidation cannot be realized everywhere at once. The combination of tighter fiscal

policy, easy money, and a weaker currency, which can work for a small open economy, cannot work for the global economy.

The link between volatile financial conditions and the real economy has been powerfully underscored by the events since mid-2007. Growth has suffered and subsequently recovered given powerful monetary and fiscal stimulus. And yet, the damaged financial sector, unable to supply credit; a jump in the precautionary demand for cash; and a persistent overhang of global production capacity have combined to leave deflation pressure intact. The G20’s newfound embrace of fiscal stringency only adds to the extant deflation pressure.

No wonder no country wants a strong currency anymore, as attested to by Europe’s easy acceptance of a weaker euro. The acute phase of the financial crisis is over, but the chronic trend toward deflation that has followed it is not.

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