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Ignore the Whining About Deflation

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There is growing concern that the US economy is where the Japanese economy was ten years ago: that following a stock market crash, we are on the verge of a decade of recession and deflation that no one can do anything about. While there are some things that I think about late into the night, deflation and the ineffectiveness of monetary policy are not among them.

Deflation is when prices are falling on average, not when some prices rise and some fall. The objective of most central banks is to stabilize prices on average, which means that some prices will be falling while others are rising.

People running the companies whose product prices are falling are not going to be happy about this. They are going to whine that something needs to be done about this "deflation". That something is the easing of monetary policy to help firms get their prices rising again. But the reality is that the prices that are falling are just the ones that are below average. These companies are the same companies that can only raise their prices by 5 per cent when overall inflation is 10 per cent. The difference is that now they can complain more effectively.

The closer the average inflation is to zero, the more producers there will be with shrinking prices. But that is price stability, not deflation. So long as central banks do not allow sustained, steady deflation, we will be fine. After decades of suffering from inflation of 5-10 per cent, we are now close to price stability. Let us congratulate policymakers for providing the foundations for stable long-term growth.

Related to these deflation fears is concern that monetary policy has become ineffective. People maintain that interest rate cuts no longer having the impact they once did, and that with the federal funds rate at 1.25 per cent, the Federal Reserve is going to run out of ammunition pretty soon. I do not believe either argument.

Monetary policy has always acted through corporate investment, consumer borrowing and the current account, and it still does. The changes in the system of financial intermediation especially the increased securitization of various types of loans that allows many borrowers to bypass conventional banks may have attenuated some of these affects. But generally they are alive and well.

What about the zero nominal interest-rate floor, the point at which central banks supposedly become impotent? Listening to officials from the Bank of Japan, you would think

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that once they set their interest rate target to zero, there was nothing else they could do about stagnant growth and falling prices. Again, I do not believe it. We all know that whatever a central bank does, it does it by adjusting its balance sheet - buying and selling securities and making loans to commercial banks. And, uniquely, the central bank can expand its balance sheet without limit. None of this changes when the nominal interest rate hits zero. Monetary policymakers can still buy securities, enlarging their balance sheet, increasing the amount of money in the economy and eventually driving prices up. These "unorthodox" methods are not all that mysterious. Federal Reserve policy-makers know how they work and will use them decisively if and when the time comes.

There is another very important reason not to worry that we are on the same road that Japan travelled in the 1990s. Even after a series of significant shocks financial crises in Asia and Latin America, the collapse of Long-Term Capital Management, the Internet bubble, the accounting scandals, and the corporate bankruptcies. U.S. banks continue to operate. And our regulators understand the importance of restructuring insolvent institutions quickly to insure that the financial intermediation system continues to function. On this count, we are very different from Japan.

What I am worried about is that the current account deficit will cause the dollar to depreciate suddenly, but I do not know what to do about that. I am worried that the US housing market is going to collapse, further impairing household balance sheets, leading to an abrupt fall in consumption, which is why I believe last week's rate cut may have been unwise.

I am worried that the federal budget deficit will balloon. If only politicians would take serious action to rectify the long-term imbalances in our national retirement and health care systems. But what worries me most is that fiscal and monetary policymakers will act under the assumption that growth will return quickly to the 4-plus per cent rates of the late 1990s. It is very tempting, since high growth makes small policy errors look even smaller.

I may be overly pessimistic, but I will be happy if the next ten years look like the last ten: average growth a bit over 3 per cent, inflation at 2 per cent, and unemployment under 5.5 percent. If either the Federal Reserve or Congress counts on more than that, we could easily return to the combination of higher inflation and ballooning budget deficits that brought us the low growth and high interest rates of the 1980s.

We must all be realistic. There is no need for panic. Policymakers have the tools to fix most of the problems, but they must use them wisely.