

**The risk of deflation****Comparing symptoms**

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**Can lower interest rates prevent the spread of debt-deflation to America and Europe?**

STOCKMARKETS rose in expectation of the Federal Reserve's half-point cut in interest rates on November 6th to 1.25%, the lowest rate for more than 40 years. The following day, the European Central Bank and the Bank of England decided not to cut their rates, but they are still expected to ease next month. However, investors' exuberance is odd, for interest rates are coming down because the world economy is in worse shape than had been hoped.

America's recovery is stalling, as consumers tighten their belts. In the euro area, consumer and business confidence are both on the wane. Although euro-area inflation is above the 2% ceiling set by the ECB, weak demand will push inflation down next year. The case for interest-rate cuts in both America and the euro area was strong, even though the ECB has not yet moved. But will rate cuts work?

Most policymakers in America and Europe blame Japan's slump on mistakes—which they can avoid. An alternative view is that much of Japan's economic sickness is the inevitable after-effect of its bubble in the 1980s. Asset-price bubbles tend to be followed by periods of weak growth, as financial excesses are unwound. The table attempts, in unscientific fashion, to assess the risks of America and Germany catching the Japanese disease.

America's **stockmarket bubble** in the late 1990s mirrored Japan's of a decade earlier. Its housing market has also been looking suspiciously like a bubble—though with less froth than Japan's. More surprising, German share prices rose, and then fell, by more than America's. Indeed, at its low point in October, Germany's **DAX index** was almost 70% below its peak. On the other hand, fewer Germans own shares than do Americans.

The other aspect of the bubbles in Japan and America was a surge in **corporate investment**, based on cheap capital and unrealistic expectations about future profits—often inflated by shady accounting practices. By and large, German business escaped such overinvestment.

The most serious aspect of Japan's economic sickness is **deflation**. Falling prices have increased real debt burdens, depressed consumer spending, and made it impossible for the Bank of Japan to deliver the negative real interest rates that the economy needs to revive demand. It is often argued that the central bank was too slow to cut rates after the stockmarket collapsed. Yet in fact Japan's economy initially held up much better than America's. In relation to GDP growth and the size of Japan's output gap—a big influence on inflation—the Bank of Japan cut interest rates as rapidly as the Fed did last year.

America does not yet have deflation. Still, its GDP deflator fell to 0.8% in the year to the third quarter; so long as the level of GDP remains below potential, inflation will keep falling. Deflation currently seems unlikely in Britain or the euro area as a whole, but Germany is at risk. German consumer prices have fallen at an annual rate of 0.4% over the past six months. More worryingly, Germany, unlike Japan in the early 1990s or America today, is not free to cut interest rates or run a looser fiscal policy. Interest rates are set by the ECB on the basis of economic conditions in the whole euro area, and budget deficits are limited by the European Union's stability pact. The risk of deflation may therefore be greater in Germany than in America.

Deflation is particularly deadly when an economy has lots of **debt**, because falling prices swell the real debt burden. In America and Germany, firms and households have borrowed heavily in recent years, lifting total debts of the non-financial private sector to 150% and 160% of GDP respectively. In the early 1990s Japan's debt burden was equivalent to almost 250% of GDP. Japanese firms are still much more in hock than those in America or Germany. On the other hand, American households look more vulnerable. Even at the peak of Japan's bubble, households remained big savers. Last year German households saved as much as 10% of their income; Americans saved only 1.5%.

A cocktail of debt and deflation has left Japanese **banks** crippled by bad loans, forcing them to cut lending. American banks are in better shape; and the economy is less dependent on banks, relying more on capital markets for finance. Even so, concerns are growing about the threat of a credit

| Testing for Nipponitis       |       |               |         |
|------------------------------|-------|---------------|---------|
|                              | Japan | United States | Germany |
| Size of asset-price bubble   | ✓✓    | ✓✓            | ✓       |
| Corporate overinvestment     | ✓✓    | ✓✓            | ✗       |
| Risk of deflation            | ✓✓    | ✓             | ✓       |
| Large private-sector debts   | ✓✓    | ✓✓            | ✓✓      |
| Weak banking system          | ✓✓    | ✗             | ✓       |
| Severe structural rigidities | ✓✓    | ✗             | ✓       |
| Political/social paralysis   | ✓✓    | ✗             | ✓       |
| Shrinking/ageing population  | ✓✓    | ✗             | ✓✓      |

Source: *The Economist*

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crunch, as conditions tighten in America's corporate-bond market.

German banks look shakier, with poor profitability and shrinking capital as share prices have fallen—as in Japan. Increased competition and the need to lift profits is putting pressure on banks to reduce their traditional relationship lending, resulting in a collapse in new bank lending to small and medium-sized firms. This form of credit crunch has a different cause to the one in Japan, but its effect of exacerbating the downturn is similar.

Germany scores badly on another symptom of the Japan disease. America's flexible and competitive markets should force firms to cut excess capacity and labour more quickly and so restore profits. By contrast, Japanese firms have been slow to cut excess capacity, thanks to a raft of **structural rigidities**. Germany, too, suffers from rigid labour and product markets. German industry also has a cross-shareholding structure that partly echoes the *keiretsu* system in Japan, which hinders the weeding-out of inefficient firms.

In Japan government subsidies and interest rates at zero have kept inefficient firms afloat and so delayed restructuring. American firms are under greater market discipline; on the other hand, consumers need more discipline to save more. The Fed's low interest rates have merely postponed this adjustment.

One other big difference is that America does not suffer the same **political paralysis** as Japan. If politicians fail to deliver recovery, they will be replaced. The same may be true of Germany; but, worryingly, in other ways Germany displays a political and social resistance to structural reform similar to Japan's.

America's **demographics** are more favourable than Japan's, where the population is both shrinking and ageing. A shrinking labour force implies a slower growth rate, future problems for financing public-sector pensions, and greater opposition to reform than in a more youthful country. Germany again appears similar to Japan. Its working-age population is expected to shrink by 0.2% a year over the next decade, compared with likely annual growth in America of around 1%.

Our analysis suggests that Germany has more symptoms of the Japanese disease than America. America's bigger bubble infected its economy more severely; but its more flexible markets and institutions should now help it to adjust. For now, both countries remain in danger.

Policymakers dismiss the risk of deflation—just as in 1990 it would have seemed far-fetched to predict that Japan would enter a deflationary slump that would last for more than a decade. Yet as Marx reminds us: history repeats itself first as tragedy, then as farce.