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Dealing With Deflation

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PEOPLE like low prices. So why is Alan Greenspan worried about deflation? Cheap is good . . . isn't it?

Yes, cheap is good. Deflation itself isn't necessarily bad; what matters is what causes the deflation.

Deflation is a symptom, not a disease. Just as a rosy complexion can be a sign of health or of a fever, deflation can be a sign of underlying economic strength or weakness.

Falling prices can arise from too much supply or too little demand. Having too much supply can often be a good thing, while having too little demand is almost always bad.

To understand the difference, it is helpful to look at two major periods of deflation: the post-Civil War deflation, which lasted 30 years or so, and the first three years of the Depression.

The post-Civil War deflation was essentially caused by increased productivity growth. The gold standard exacerbated the downward pressure on prices: With a fixed supply of money and an ever-increasing supply of goods, prices naturally fell.

Not everybody benefited from lower prices, of course. Just as inflation favors borrowers over lenders, deflation favors lenders over borrowers. Farmers had taken out mortgages when agricultural prices were high, but had to pay the money back when crop prices were low.

Back then most mortgages were what we today call balloon mortgages, with relatively short repayment periods. Remember that evil silent-movie banker twirling his mustache while he foreclosed on a family farm? He was a product of deflation.

This was the time of William Jennings Bryan and his "Cross of Gold" speech. Adopting silver as legal tender, he asserted, would push prices up, and allow farmers to pay back debts to those nasty bankers with cheap dollars. Bryan was right — adopting a more flexible monetary policy would have solved the

debtor problem, though it may also have had other, pernicious effects. Indexing the loans to the price level would have been another way to address this issue.

Over all, the deflation of the late 1800's was a good thing — the bad aspects of it resulted from inflexible financial contracts and monetary policy.

Compare this supply-side deflation with the demand-side deflation of the 1930's. During the Depression prices fell because there was too little demand, thanks to financial panic and widespread unemployment. As before, monetary policy was also a big part of the problem: Bank failures led to a collapse in the money supply, while the Federal Reserve stood by and did nothing.

But just as in the 1890's, the deflation of the 1930's wasn't the root cause of economic disruption — it was a symptom of the deeper problem of the shortfall in aggregate demand.

How do these two periods of deflation compare with today's "deflationary threat"? Neither offers an exact analogy. Today we have some of the excess supply pressures of the 1890's along with the weak demand pressures of the 1930's, albeit in a far milder form.

The big difference today is that the Fed is pursuing active monetary growth and has made it clear that it will be aggressive in dealing with any further economic deterioration.

The excess supply we see today comes from two related forces: the investment binge of the late 1990's and the strong productivity growth in recent years.

Because of these two factors, businesses have had little inclination to make new investments, leading to slack demand and downward pressure on prices. The Fed has responded appropriately by loosening monetary policy to stimulate aggregate demand.

Consumers have responded to low interest rates by refinancing their mortgages and continuing to buy, keeping aggregate demand stronger than it would have been under a tighter monetary policy. Prices aren't increasing, but they aren't falling, either.

The worry is that the loose monetary policy won't be effective indefinitely. If economic activity stays slow, and unemployment rises, consumers will become more cautious, making them more reluctant to spend. As John Maynard Keynes put it, "You can't push on a string," meaning you can give people more dollars, but you can't make them spend them.

To pursue the medical analogy introduced earlier: the symptom is deflation (or, at least, soft prices), the diagnosis is weak aggregate investment demand, and the recommended treatment is money supply growth. But the critical question is, as always, will the patient recover?

I'm cautiously optimistic.

There are signs that business spending is coming back to life, and the recent drop in the dollar will make America's exports much cheaper abroad, thereby increasing employment and investment in export-sensitive industries.

But relying on a weak dollar to solve our economic problems is tricky. First, it takes a long time to show results, and second, our trading partners don't like it. Trade relations between the United States and Europe are at the worst point in years, and we could easily see some sort of retaliation.

If monetary policy and exchange-rate jawboning don't do the trick, the next medication to try is fiscal policy. Given the weak investment demand and the increasing unemployment, the most effective policies would be temporary investment credits coupled with tax cuts for low-income workers and direct aid to state governments.

The first policy directly stimulates aggregate demand, which is the real source of the problem; the second helps counterbalance the potential drop in spending because of unemployment; and the third helps mitigate likely tax increases at the state level.

Unfortunately, that's not what Congress did. Instead we have a cut in taxes for high-income households, some rather modest investment incentives and aid to the states, and the truly bizarre temporary cut in the dividend tax rate.

This is like going to the doctor to complain about a headache and being told to soak your feet in hot water. Soaking your feet might not hurt you — but it sure won't do anything for your headache.

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