

Deflation Boogeyman

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The probability of an unwelcome substantial fall in inflation, though minor, exceeds that of a pickup in inflation from its already low level.

-- Statement of the Federal

Open Market Committee, May 6

Well, we face a new danger: deflation. So says the Federal Open Market Committee (FOMC), the Federal Reserve's main policymaking body. It's astonishing what a few words can do, and these words riveted attention on something that, until recently, seemed a historical curiosity. Deflation signifies a general decline of prices; it hasn't happened in the United States since the Great Depression. Although the FOMC didn't mention "deflation," legions of Fed watchers concluded that it meant deflation -- and that it's mighty worried.

Deflation would arise from too much supply (of everything from computer chips to airplane seats) chasing too little demand. Prices would drop as companies competed for buyers. The problem of surplus labor and capital pushing down prices is global. In Germany, weak demand has led to 13 months of rising unemployment.

Whatever happens, the FOMC's statement -- echoed last week by the European Central Bank -- signals a historic break. Since the early 1960s, inflation (which peaked at 13.3 percent in 1979) has dominated the economy. Its rise and fall affected interest rates, the stock market, housing prices and wages. Demoting inflation's importance means we've entered a new era with unfamiliar threats.

Inflation looks defeated. In March the consumer price index was up 3 percent from a year earlier; that's unimpressive, but much of the increase stemmed from soaring oil prices that are now receding. What's called "core inflation," without erratic energy and food prices, is rising at about a 1 percent annual rate. Moreover, prices for many expensive items have been dropping for several years. Since March 2000, prices have declined 2.8 percent for cars, 3.4 percent for major appliances (including washers, dryers and microwave ovens), 9.9 percent for women's suits and 57 percent for personal computers.

These price decreases reflect new technology, better management and intense competition, including imports. But a few falling prices don't make deflation if -- as is now true -- other prices are rising faster. Since March 2000, prices are up 19.5 percent for college tuition, 16 percent for nursing-home care, 10.5

percent for car repair and 8.8 percent for haircuts. It's often said that deflation can't happen because services (about 60 percent of the consumer price index, covering everything from health care to housing) don't experience productivity gains and prices don't decline.

This argument is weaker than it sounds. Big price declines for goods (cars, computers, etc.) could overwhelm modest increases in services. And some services do benefit from productivity gains; prices for cellular phone services have declined 14.6 percent since March 2000. Elsewhere, other services (airfares, hotel rates) drop because they can't defy the law of supply and demand. And suppose deflation does occur? Why would that be bad? Lower prices would allow people to buy more with their wages; the economy could benefit.

But what's also true is that deflation poses dangers: (1) lower prices could squeeze corporate profits, hurt the stock market and pressure companies to fire workers and cut wages; (2) falling prices could lower overnight interest rates to near zero, making it harder for the Fed to stimulate the economy; (3) companies and farmers might default on loans, which are fixed while the prices they receive fall, and (4) consumers might delay purchases, believing future prices will be lower. In the Depression, the dangers materialized. From 1929 to 1933, retail prices dropped 24 percent. Thousands of businesses and farmers went bankrupt. About 40 percent of banks failed. By 1933 unemployment was 25 percent. Although the Fed cut interest rates, the economy didn't respond. (In the summer of 1931, the Fed's discount rate was 1.5 percent; but prices were down 9 percent, meaning that loans were repaid in more expensive dollars and that the true cost of money was almost 11 percent.) Still, deflation doesn't always spell disaster. From 1870 to 1896, prices fell about 1.2 percent a year, reports a study by economists Michael Bordo of Rutgers and Angela Redish of the University of British Columbia. Despite periodic slumps and banking crises, the economy grew about 4 percent annually. Income per person rose about 1.6 percent a year. Industrialization spread. From 1870 to 1890, iron and steel production quintupled, cigar production almost quadrupled and sugar production nearly tripled. Farmers' complaints about falling prices and oppressive debts triggered a populist backlash, but mainly workers and companies adapted.

A year ago the Fed published a study by its economists on Japan's deflation. The chief conclusions were that the Japanese hadn't anticipated deflation and that their countermeasures were too little too late. Once deflation becomes a possibility, the study said, a government should undertake economic stimulus "beyond the levels conventionally implied" -- an ounce of prevention being worth a pound of cure. It may be that even lower interest rates and, temporarily, even bigger budget deficits are necessary. This is, as yet, a lesson that still makes Washington uncomfortable.