The Wall Street Journal.

DEFEATING DEFLATION

November 19, 2001
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Deflation is upon us. Put another way, the U.S. economy is now experiencing a sustained reduction in the general level of prices. Last month, the Producer Price Index posted its biggest decline on record, 1.6%, and the Consumer Price Index fell by 0.3%. All of the major commodity price indices are down by 11% to 20% for the year. Many commodity prices are even below where they were 10 years ago. The only question is whether this deflation will be short-lived, or turn into the kind of problem Japan has been experiencing for a decade.

We normally view falling prices positively because we can buy more with our money. We have become used to falling computer prices, and we all view this as a good thing. Computer companies, meanwhile, were able to sustain price-cutting because they made enormous technological and productivity advances.

Other industries, such as the luxury restaurant business, have had slightly increasing prices, as their labor costs rose more rapidly than their productivity gains. Yet as long as the price declines in some goods and services roughly matched the price increases in other goods and services, we had overall price stability. Price stability is desirable because it enables producers, consumers, debtors and lenders to make long-term plans. Unanticipated inflation or deflation leads to a misallocation of resources, increased risk, and lower levels of investment and growth.

Deflation, like inflation, upsets stability and inflicts unexpected hardships. Many producers of commodities, as well as many high-tech and telecom companies, borrowed large amounts of money to finance their expansion. This was done under the reasonable expectation that the Federal Reserve would maintain stable money. The companies expected their prices would fall no faster than their productivity increased. However, the Fed supplied too little money, and their prices fell more rapidly than expected. As a result, they have been less able to service their debt.

Other problems will follow. Unless deflation is quickly stopped, key assets such as real estate will also begin to fall in price. Deflation means that debtors must pay back in more valuable dollars than the ones they borrowed. And those who live off interest from their savings, as do many retirees, will suffer as the rate of interest drops because of deflation.

The Federal Reserve has been increasing the money supply rapidly in recent months. If this had been done earlier, it would have stopped the deflation. Unfortunately, the Fed waited to start cutting interest rates until after much of the high-tech sector was in a depression. Sensitive prices began falling many months before Sept. 11, and the Fed was all too slow to realize its tight money policies were killing economic growth.

Theoretically, if the Fed cuts interest rates and increases the money supply, businesses and individuals should find it easier to borrow money and service their debt, and the economy should expand. But because the Fed waited, businesses were in a riskier situation from the falling prices of their products, and lenders added additional risk premiums to loans. Now, even though inter-bank interest rates have fallen, the real rate of interest has actually risen for many less credit-worthy borrowers and consumers.

Once this process starts, the ability of the Fed to reignite the economy is limited. The recent large increase in the supply of money has not gone into additional purchases or a rise in asset prices because people expect prices to fall and hold their cash. This means the velocity of money (the number of times a dollar turns over in a year) is falling. The Japanese have been in this dilemma for a decade and, though interest rates are now virtually zero, their economy remains stagnant.

The Japanese have tried to spend their way out of the mess. The only result is that the Japanese now have a government debt several times ours on a per-capita basis and no growth. The Keynesian crowd has argued that the increase in debt should cause massive inflation and high interest rates. In fact, supply-side economists correctly predicted that tight monetary policy would lead to deflation despite massive increases in government spending and taxation.

None of us know with certainty when the economy will grow again. A plausible case can be made that the fundamentals of the economy are strong and that as soon as the uncertainty about the war begins to abate, the Fed's injection of money will have its desired effect. The velocity of money will increase, leading to a quick demise of deflation and a return to strong growth. An equally plausible case can be made that the uncertainty will remain, that the Fed will not provide enough dollars to meet world demand, and that we will replicate Japan's extended deflation and stagnation. The Japanese themselves rapidly increased the supply of yen during the 1990s but still did not keep up with demand. Even though the Japanese monetary base as a percentage of gross domestic product is about double that of the U.S., they still have neither stopped deflation nor reignited growth.

Economic policy makers in Washington are now faced with the situation for which there is no clear road map. What should they do? Given the circumstances, the responsible and prudent policy maker ought to take those actions that will do no harm and are almost certain to make things better.

First, the Fed needs to say explicitly that it is adopting price-level targeting again, and that it is going to look at sensitive commodity prices as the indication of where prices are headed rather than the CPI and other lagging indices. The Fed should look at a market basket of commodities; if prices in the basket rise above a predetermined range, the Fed reduces the money supply and vice versa. This change would reduce uncertainty over Fed policy and make it clear that it is going to stop the fall in prices.

Second, the Bush administration and Congress need to rapidly remove the many well-known tax, trade and regulatory impediments to economic growth. The president should use some of his political capital to encourage Congress to move on, for example, misguided airline and telecom regulation. He should also take direct action through executive orders to remove counterproductive regulatory and costly reporting impediments.

Finally, it is time for responsible economic commentators to debunk the fallacy that we can create economic growth by increasing government spending. If government spending led to economic growth, Japan would have boomed in the 1990s, and socialist economies would have been economic miracles rather than basket cases. The historical evidence is overwhelming that private individuals and businesses spend and invest much more carefully than do governments. Every dollar the government spends is sucked and coerced out of the private sector through taxation or borrowing at considerable cost. The big increase in government spending since Sept. 11 will only be an economic depressant, not a stimulus.

We know from Japan the devastating effects of deflation. We also know from that country what policies won't work. Let's not make the same mistakes here.

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