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Deflation -- Delusion or Danger?

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The collapse in home prices during the past few years is a reminder of the horrors of deflation. Millions of homeowners owe lenders more than their homes are worth, making it impossible to sell, trade up, downsize or move for a new job. What would happen if deflation were to spread across the entire economy, driving down wages and the prices of all goods and services?

Not many economists expect deep, prolonged Depression era-like deflation. But the U.S. and world economies are not emerging from the recession as quickly as many had predicted at the start of the year, and some experts warn that the risk of deflation should be a top concern for policymakers. "I think there's a reasonable probability we will have deflation in a number of Western countries sometime over the next year or two," says Wharton finance professorFranklin Allen, who included the United States in that assessment.

A key factor would be policies by the Chinese government to rein in growth to curb the threat of inflation, Allen notes. That would reduce worldwide demand for commodities, driving down prices. In addition, many Americans, worried about their jobs and the value of their investments and homes, have stepped up their savings rate, leaving them with less to spend. Because savings yields are so low -- well below 1% on most types of bank savings, for instance -- people will feel a need to save even more.

But Allen does not expect rampant deflation, and he notes that Japan has managed fairly well despite annual deflation of 1% to 2% for many years. At that modest level, individuals and businesses find their debts to be manageable, so they don't descend into the cycle of panic that produces deep deflation, he says.

But more experts consider deflation a bigger risk now than they did at the start of the year. Minutes of the August meeting of the Federal Reserve's Federal Open Market Committee state that: "While no member saw an appreciable risk of deflation, some judged that the risk of further near-term disinflation had increased somewhat." Disinflation is a drop in the inflation rate, grabbing central bankers' attention like a sneeze before a cold. Because the inflation rate is currently so low, about 1%, it would not take much for the economy to enter a state of deflation.

Paul Krugman, a Nobel Prize-winning Princeton University economist, recently wrote in his *New York Times* column that he found the "Fed's complacency about disinflation and deflation baffling." Noting that some other economists share this view, including one of the top economists at Goldman Sachs, Krugman pointed to factors like a decline in inflation-rate expectations reflected by bond prices.

In a recent paper, "The Seven Faces of 'The Peril,'" James Bullard, president of the St. Louis Fed, warned that the FOMC's publicly stated plan to keep interest rates very low for an extended period "may be increasing the probability of a Japanese-style outcome for the U.S.," referring to Japan's ongoing deflationary period, one which started in the early 1990s.

Huge Drag on Spending

While the idea of declining prices seems appealing at first glance, deflation can wreak havoc on an economy. Businesses and individuals find that their debt levels stay the same while their income drops,

making loan payments harder to shoulder. Consumers and companies stop buying goods and services out of fear, or hope, that prices will fall further. That cuts into company profits, hurting stock prices and triggering layoffs, which prolong and deepen the cycle by reducing spending even more. With little investment, the economy shrinks. "The problem with deflation is that, once it starts, it's very had to intervene to stop it," notes Howard Pack, a Wharton professor of business and public policy.

Deflation comes in two flavors, says Wharton finance professor Richard Marston. One is caused by excessive supply of goods and services. "That's the deflation that threatened the world economy a few years ago. It never came to pass, but I always thought that it was not such a bad thing. Why would we care if our cost of living fell if it's because of the abundance of products?" Steadily falling prices for electronics products is a type of deflation most people welcome, for example.

The second, more damaging type of deflation, Marston says, is caused by too little demand, the downward spiral that occurs when everyone is unwilling to spend money. "That's what we faced in the 1930s -- too little investment demand, consumer demand, export demand. That's what some people fear today. This latter type of deflation is more frightening. But I just don't believe it's a real threat today."

Worried about the future, Americans have lifted their savings rate to around 6%, from a level of 1% to 2% in recent years, leaving them with less money to spend. That worries some deflation hawks because it reduces demand and tends to force prices down. Nonetheless, says Marston, consumer demand, which fell from the end of 2007 to the first quarter of 2009, has been growing steadily since then and is now not far off the 2007 levels.

"Second," adds Marston, "growth elsewhere in the world is reviving our exports to almost the same level as in 2007. Only business investment remains depressed." That, too, is likely to recover, perhaps by early next year, after Washington clears up uncertainty about the future of the Bush-era tax cuts that expire at the end of this year, he says. "Why aren't we facing the deflation of the 1930s?" Marston asks. "Because, unlike in the 1930s, the Fed has flooded the banking system with liquidity. Cash at banks is more than twice as large as normal." Cash at commercial banks, for instance, grew from less than $400 billion in mid-2008 to nearly $1.4 trillion by the start of this year.

Mark Zandi, chief economist and cofounder of what is now Moody's Economy.com, agrees that the risks of "the virulent form of deflation are low." For serious deflation to be triggered, the economy would have to re-enter recession, and Zandi believes the recovery, though slow, is likely to continue. "The odds of a double dip [of recession] are, I think, still well below even -- maybe one in three at the outside," he says, adding that the economy is creating jobs, though not fast enough to offset population growth and reduce the unemployment rate.

Also, rental rates for housing are rising, strengthening a key factor in calculations for the consumer price index, he notes. Prices in the bond market show that investors expect inflation to be in the 1.5% to 2% range in five years, again weakening the case for deflation. While forward-looking inflation expectations are not a foolproof indicator, having failed (as Krugman notes) to foreshadow Japan's deflation, they do support the no-deflation case, Zandi says. "It's no guarantee, but I think that's an important barrier."

Finally, Zandi states, "wage growth remains positive," staying at the 1% to 2% annual rate of the past year or so. While that is modest, it does give consumers more money to spend if they choose to. "There seems to be this psychological barrier that employers don't want to cross over, not en masse," Zandi said, referring to employers' apparent reluctance to cut wages. Pay cuts can drive workers away, if not immediately, then after the economy strengthens and angry employees have other opportunities.

Slow Growth Likely

Though most experts agree that the risk of serious deflation is not high, few expect a rapid economic recovery. One obstacle, says Pack, is the hangover from the excessive borrowing in the build-up to the financial crisis. Businesses and individuals that believe their debt levels are too high are likely to use extra cash to pay down loans rather than to buy goods and services. "There aren't really great prospects [for economic growth] until all countries start to grow again, and that's [going] to be awhile off because there is still a process of deleveraging, and that's got to take some time," he argues.

Though generally optimistic, Zandi thinks the recovery will be slow. He expects the Fed to keep interest

rates low for some time, and to resume quantitative easing programs such as the purchase of Treasury securities to keep rates from rising.

Rates are already very low, with the target Fed funds rate at 0% to 0.25%, the 10-year Treasury note at 2.7% and the 30-year mortgage below 4.5%. But borrowing, which can stimulate the economy and cause prices to rise, has been limited nonetheless by nervousness among both lenders and borrowers, Zandi says. "It's kind of a chicken and egg problem." He notes, however, that the big banks have plenty of money to lend, and once they feel a bit more confident, they are likely to loosen underwriting standards that have made it hard for many applicants to qualify for loans.

Even the deeply troubled housing market is showing some signs of improvement, Zandi says. Home prices have fallen back to where they should be in relation to incomes and rents. Home construction is so low -- at World War II levels -- that the supply of homes for sale will gradually shrink, helping to nudge prices up, he adds.

Mauro F. Guillén, professor of international management at Wharton, notes that the government has yet to spend much of the $787 billion set aside in 2009 to stimulate the economy, and that the Obama administration has recently announced an additional $50 billion spending plan for transportation infrastructure. That spending should help boost the economy, though not very fast, Guillen notes. "I personally don't think the risk [of deflation] is as high as some people believe it is. But I'm not arguing the economy will grow at 3% or 4%. I think we are in for a period of relatively sluggish growth that may not be enough to reduce unemployment in any significant way." High unemployment dampens spending.

The government has a tough dilemma, he adds, choosing between spending to stimulate the economy and preventing the budget deficit and debt from ballooning further.

Even if political battles did not influence policy, it is not completely clear that the standard actions like reducing interest rates will always perk up the economy and prevent deflation, Allen warns. He notes that deflation persisted in Japan despite low-rate policies. In fact, Allen believes raising rates might work better. If consumers felt they were earning reasonable yields on savings, they might feel encouraged enough about the economic situation to spend more freely. But the Fed, he concedes, is unlikely to see it this way: "They don't put enough emphasis on the fact that people who live off interest are being drastically affected by these [low] rates."