Deflation Doldrums?

by Martin Feldstein

CAMBRIDGE – The rate of inflation is now close to zero in the United States and several other major countries. *The Economist* recently reported that economists it had surveyed predict that consumer prices in the US and Japan will actually fall for 2009 as a whole, while inflation in the euro zone will be only 0.6%. South Korea, Taiwan, and Thailand will also see declines in consumer price levels.

The prospect of falling prices reflects the collapse of industrial production, the resulting high level of unemployment, and the dramatic decline in commodity prices. Industrial production is falling at double-digit rates in the negative-inflation countries, and the price index for all commodities is down more than 30% over the past year.

Deflation is potentially a very serious problem, because falling prices – and the expectation that prices will continue to fall – would make the current economic downturn worse in three distinct ways.

The most direct adverse impact of deflation is to increase the real value of debt. Just as inflation helps debtors by eroding the real value of their debts, deflation hurts them by increasing the real value of what they owe. While the very modest extent of current deflation does not create a significant problem, if it continues, the price level could conceivably fall by a cumulative 10% over the next few years.

If that happens, a homeowner with a mortgage would see the real value of his debt rise by 10%. Since price declines would bring with them wage declines, the ratio of monthly mortgage payments to wage income would rise.

In addition to this increase in the real cost of debt service, deflation would mean higher loan-to-value ratios for homeowners, leading to increased mortgage defaults, especially in the US. A lower price level would also increase the real value of business debt, weakening balance sheets and thus making it harder for companies to get additional credit.

The second adverse effect of deflation is to raise the *real* interest rate, that is, the difference between the nominal interest rate and the rate of "inflation." When prices are rising, the real interest rate is less than the nominal rate since the borrower repays with dollars that are worth less. But when prices are falling, the real interest rate exceeds the nominal rate. This is exacerbated by the fact that borrowers can deduct only nominal interest payments when calculating their taxable income.

Because the US Federal Reserve and other central banks have driven their short-term interest rates close to zero, they cannot lower rates further in order to prevent deflation from raising the real rate of interest. Higher real interest rates discourage credit-financed purchases by households and businesses. This weakens overall demand, leading to steeper declines in prices.

The resulting unusual economic environment of falling prices and wages can also have a damaging psychological impact on households and businesses. With deflation, we are heading into unknown territory. If prices fall at a rate of 1%, could they fall at a rate of 10%? If the central bank cannot lower interest rates further to stimulate the economy, what will stop a potential downward spiral of prices? Such worries undermine confidence and make it harder to boost economic activity.

Some economists have said that the best way to deal with deflation is for the central bank to flood the economy with money in order to persuade the public that inflation will rise in the future, thereby reducing expected real long-term interest rates. That advice would lead central banks to keep expanding the money supply and bank reserves even after doing so no longer lowers interest rates. In fact, the Federal Reserve, the Bank of England, and the Bank of Japan are doing just that under the name of "quantitative easing."

Not surprisingly, central bankers who are committed to a formal or informal inflation target of about 2% per year are unwilling to abandon their mandates openly and to assert that they are pursuing a high rate of inflation. Nevertheless, their expansionary actions have helped to raise long-term inflation expectations toward the target levels.

In the US, the interest rate on government bonds now rises from 1.80% at five years to 2.86% for 10-year bonds and 3.70% for 30-year bonds. Comparing these interest rates with the yields on government inflation-protected bonds shows that the corresponding implied inflation rates are 0.9% for five years, 1.3% for 10 years and 1.7% for 30 years.

Ironically, although central banks are now focused on the problem of deflation, the more serious risk for the longer term is that inflation will rise rapidly as their economies recover and banks use the large volumes of recently accumulated reserves to create loans that expand spending and demand.

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