

The Economy in Perspective

Too much of a little thing... Federal Reserve Board Chairman Alan Greenspan concluded his prepared testimony to the U.S. House of Representatives' Committee on Financial Services on April 30 with a comment about inflation. He noted that "...core prices by many measures have increased very slowly over the last six months. With price inflation already at a low level, substantial further disinflation would be an unwelcome development, especially to the extent it put pressure on profit margins and impeded the revival of business spending." Does this mean we have closed the door on an era in which accelerating inflation was the villainous foe of virtuous central banks? Have central banks become victims of their own success in the war against inflation?

From one perspective, concern about substantial further disinflation could be welcome. For decades, the Federal Reserve and many other central banks have reduced both the inflation rate and inflation expectations. U.S. inflation, for example, spiked at more than 14 percent in 1980; by 2002, the Consumer Price Index had fallen to 2.3 percent. The International Monetary Fund's consumer price index for industrialized countries peaked at more than 13 percent in 1980, but inflation in those countries registered 1.7 percent in 2002, an order of magnitude lower than the pace set two decades earlier. Equally important, inflation expectations now indicate that people believe inflation will remain close to these low rates.

In macroeconomic parlance, "price stability" is stability in money's purchasing power over time, the notion that a dollar tomorrow will buy the same amount of consumer satisfaction as it will today (in an economy with positive per capita productivity growth, consumers would have more dollars, hence more total satisfaction, in the future.) If an economy characterized by price stability did experience a small inflation or deflation from time to time, few problems would be likely to arise as long as people did not expect the deviations to persist long.

But it is hard to know for sure. Very low inflation and deflation have been rare events in industrialized economies, so it has not been possible to draw statistical inferences based on their recurring features. Nevertheless, we do know from research on very large economic contractions that deflation has often been present. In their monumental work, *A Monetary History of the United States, 1867–1960*,

Milton Friedman and Anna Jacobson Schwartz observed that every significant real output decline in the United States has been associated with deflation. The most notorious episode, of course, was the Great Depression: Between 1929 and 1933, the price level fell 24 percent, while real GDP fell nearly 40 percent. Furthermore, both output and prices remained below their 1929 levels until the end of the Thirties. During the same period, the United Kingdom, Germany, and France also experienced significant output declines and deflation.

But there are counterexamples in which the United States and other countries have experienced growth during periods of mild deflation. For example, from 1880 to 1896, the wholesale price level in the United States fell 30 percent. Far from being a time of gloom and doom, this deflationary episode was a period of relative prosperity: Real income increased 85 percent, an average of nearly 5 percent each year.

Many analysts use the recent experience of Japan—which is continuing its decade-long period of economic stagnation accompanied by a small deflation—as a cautionary example of deflation's dangers. From 1992 through 2001, Japan's real GDP growth averaged a mere 1 percent annually. The price level fell at an average rate of about 0.5 percent a year during that period; by the beginning of 2003, the country's economy had experienced deflation in four of the previous five years. But the very visible example of Japan may have overshadowed the counterexample of a neighbor: If deflation causes recession, how do we account for the situation in the People's Republic of China, where real GDP has been growing at the rate of between 6 percent and 8 percent for several years, despite deflation?

The Federal Reserve Bank of Cleveland's *2002 Annual Report* contains an essay on deflation, which conjectures that deflation in itself is not the culprit it is often made out to be. Rather, monetary economies seem capable of breaking down when interest rates approach zero, rendering money almost indistinguishable from interest-bearing assets. Although such an outcome seems remote, operating in very low inflation environments might present new challenges for central banks. But we should recognize that we have created these possibilities by vanquishing an old foe.