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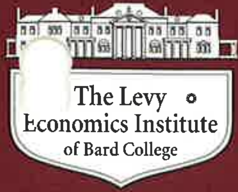

LEVY INSTITUTE

Policy Note

2003 / 5

DEFLATION WORRIES

L. RANDALL WRAY

For the first time since the 1930s, many worry that the world's economy faces the prospect of deflation—accompanied by massive job losses—on a global scale. In a rather hopeful sign, policymakers from euroland to Japan to America all seem to recognize the threat that falling prices pose to markets. Given the single-minded pursuit of deflationary policies over the past decade, this does come as something of a surprise. But policymakers—especially central bankers—in Europe and the United States seem to have little inkling of how to stave off deflation, with the result that prices are already falling in much of the world. Contrary to widespread beliefs, the worst outcome will not be avoided if the only response is to balance budgets and introduce new monetary policy gimmicks. To the contrary, policymakers should increase deficits to at least 7 percent of GDP.

THE CHIEF WEAPON CALLED UPON IN RECENT YEARS by inflation warriors has been the balanced government budget. The hinterlands were supposed to go further, with the adoption of exchange rate pegs, or, better still, currency boards based on the dollar in order to take away the possibility of running independent fiscal policy. Euroland upped the ante by abandoning national currencies altogether in favor of a stateless euro, beyond the control of any nation. In the monetary policy sphere, central banks were told to adopt money-growth targets, and when they failed to achieve them, inflation targets were sold as the ultimate test of central banker machismo. Fiscal and monetary restraint would wipe out inflation and lead to rapid productivity growth, full employment, and naturally robust growth.

Well, something happened on the way to the forum, as high unemployment, fiscal and financial crises, and stagnant growth reared their collective ugly heads. While one might

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have expected policymakers to celebrate their victory over inflation and to ignore the collateral damage done to economies, they have instead quickly and publicly begun to fret about the horrors of deflation.[1]

Pervasive Stagnation

The Japanese economy has stagnated for more than 10 years, even with zero interest rates for half a decade and even while the Bank of Japan supposedly "pumps money" into the economy until the cows come home. Argentina, poster child for the wisdom of currency boards—and for IMF austerity policies generally—simply imploded at the beginning of the new millennium. Growth in Germany has remained below 1.5 percent for a decade, even with the fall of the Berlin Wall and the investment and growth opportunities opened up in the East. France, Italy, and Portugal suffer rising unemployment and stagnant growth while, along with Germany, they test Maastricht limits to government deficits—which even Romano Prodi, the president of the council of the European Union, has labeled "stupid." The major Asian exporters, most notably China and Japan, are already experiencing deflation and are placing severe downward pressure on prices in international markets.

Under current arrangements the euro nations will be forced to slash spending and increase taxes, as soon as markets realize that those nations have given up currency sovereignty and become much like U.S. states.

The United States, main engine of growth over the 1990s, has stagnated since 2001—just managing to avoid slipping again into semi-official definitions of recession. Unemployment has steadily risen, even though most job-losers are uncounted because they have simply left the labor force, having found out that it is impossible to find work in the current environment; indeed, we've lost 2.6 million jobs (Davey with Leonhardt 2003; Altman 2003). Americans have seen their net wealth fall dramatically. At the same time, private indebtedness has continued to climb as consumers borrow against home equity in a desperate, precarious, and ultimately unsustainable attempt to maintain living standards in the face of job loss and pay cuts.

And what do policymakers have up their sleeves to relieve the dreaded deflationary pressures? In euroland, the solution is supposed to be market reform and fiscal constraint. Yes, let me say that again. Markets must be "reformed" to eliminate protection for workers, consumers, the elderly, and the environment, so that wages, prices, and incomes can fall sufficiently to compete with low-cost Asian producers (Bernstein 2003; Heise 2002; Roby 2002). Further, euroland hopes to reign in those black-sheep governments that are irresponsibly "spending beyond their means" (Osborn 2002; Landler 2002). In truth, under current arrangements the

Euro nations will be forced to slash spending and increase taxes anyway, as soon as markets realize that those nations have given up currency sovereignty and become much like U.S. states (or, worse, like Argentina under the currency board). Hence, both markets and policymakers will ramp up deflationary pressures over the coming months in an attempt to fight deflation.

The Fed to the Rescue?

Fortunately, policymakers in America do not speak with such a uniformly misguided approach. True, the Fed under Chairman Greenspan's leadership appears to have no inkling of what needs to be done. To his limited credit, Greenspan has given lukewarm support to tax cuts, but in the same breath he worries about prospective government deficits and warns policymakers that spending cuts are necessary (Rosenbaum 2003a). He claims the rising deficits will put upward pressure on interest rates, presumably knowing all too well that interest rates were actually falling so long as markets expected that the Fed would not raise the federal funds target in the near future (Leonhardt 2003). Interest rates have now reversed course on Greenspan's recent testimony that was interpreted to mean that the Fed would raise rates at the first hint of economic recovery (Morgenson 2003). He publicly fretted about the possibility of deflation, but argued that the Fed can prevent that by "pumping money" into the economy, buying long-term bonds if necessary[2] (Andrews 2002; Leonhardt 2003).

The final result is not that money has been "pumped" into the economy, but rather that the central bank holds more long-term bonds and fewer short-term bills, while banks hold the reverse position.

Anyone with even an elementary knowledge of central bank operations knows that no central bank can "pump money" into the economy as if it were flying black helicopters and dropping bags of newly printed greenbacks into backyards. It is true that the Fed can buy more long-term bonds by crediting private banks with more reserves, but this simply leads to excess reserve positions and pushes the federal funds rate to zero (as in Japan). If the Fed doesn't want overnight (interbank lending) rates at zero, it must turn right around and sell short-term bills to drain the excess reserves it just created when it bought long-term bonds. The final result is not that money has been "pumped" into the economy, but rather that the central bank holds more long-term bonds and fewer short-term bills, while banks hold the reverse position. There might be some reason to implement such a policy (known as "Operation Twist" in the early 1960s, when it was undertaken to try to lower long interest rates, with mixed success), but it is plain obfuscation to call this "pumping money," and it is highly delusional to believe it will be sufficient to stop deflation.

The Fiscal Policy Response

President Bush has been proposing tax cuts as a cure-all. To be sure, the federal budget's swing from a surplus of over 2 percent of GDP before recession to the current deficit of 4.5 percent of GDP has played a significant role in helping the economy to drag itself out of official recession. Some of the turnabout has resulted from the president's earlier tax relief legislation, which totals some $1.3 trillion over a decade. Unfortunately, that figure is deceptively large. First, it averages to less than $130 billion annually—a little over 1 percent of GDP today and much less as time passes. Second, much of it is back-loaded, with most benefits to be received later. Further, the tax relief is measured against what revenues might have been had the economy resumed robust growth, an assumption that now appears highly implausible. In other words, it is counting reductions of taxes that wouldn't have been paid.

Indeed, much of the budget turnaround thus far has little to do with tax relief, and not even much to do with increased spending for the military (not included in the deficit figures yet), enhanced security spending, or funds for rebuilding New York City. Rather, the budget has moved to large deficits because economic performance has deteriorated sufficiently to wipe out tax revenues. While this does help to put a floor on aggregate demand and thereby helps to hold recession at bay, it does not actively p[illegible] the economy back into shape to restore growth. This is why job loss[illegible] continue to mount. It is unlikely that robust growth can be resumed with a federal deficit less than 7 percent of GDP—requiring a combination of additional spending increases and tax cuts of some $250 billion annually.

By comparison the recent tax cuts passed would provide only about one-seventh of that—some $350 billion, spread over 10 years (Rosenbaum 2003b). What is more, the tax cuts are temporary and, as designed, give little "bang for the buck." While the tax relief measures for married couples and children could stimulate demand, they are slated to expire after 2004. The lower rates on capital gains and dividends will last through 2008, but they won't help to jump start the economy or the stock market, for the simple reason that there have to be taxable capital gains and dividends before this form of relief means much. It is possible that the stock market will begin to recover before the 2008 expiration date, but it is highly unlikely that Wall Street will lead the economy out of its current doldrums. Again, the tax relief in these plans is largely calculated against future taxes that would not have been paid according to any likely scenario regarding dividends and capital gains. This is no reason to oppose the plan, but it provides plenty of ammunition against the claim that the plan is a stimulus package.

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Note also that many supporters of tax relief are quick to agree with Greenspan that if deficits continue to grow, some combination of tax increases and spending cuts will be needed in the future. Even the president has pledged to trim the deficit, proclaiming that "spending discipline is crucial to my economic program"—in other words, he plans to undo what little stimulus might have been provided by his tax cuts (Bloomberg 2003a).

There is much talk about being able to "afford" the tax cuts. The future onslaught of baby-boomer retirees is mentioned as a reason to be concerned about a coming budget "crisis"—which, of course, is part of the reason for the sunset provisions in the tax relief legislation. Some Democrats, trying to position their party as defenders of fiscal responsibility, long for the days of budget surpluses, not realizing that it was the budget surpluses in the United States (and "fiscal responsibility" in much of the rest of the world) that generated the deflationary pressures in the first place. Similarly, the current president has argued that "governments should follow the example of American families by setting priorities and staying with them" (Bloomberg 2003a), completely unaware that American families ran up record deficits (and debts) during the Clinton expansion, precisely when the federal government was running surpluses![3]

For this reason, it is hard to get up much hope that even in the United States—which has at its disposal the ability to adopt sensible policy—policymakers will take decisive, discretionary action to move the short-term budget stance toward a deficit of at least 7 percent of GDP, and to move the long-term (full employment) structural budget to a deficit of 3–4 percent of GDP. This is what policymakers must do if they are serious about putting the United States back onto a sustainable growth path.

If Argentina can keep up its nerve and ignore the budget-balancers, it may well avoid the fate to which euroland seems destined. We can only hope that U.S. policymakers will find enough backbone to relax our federal budget and allow robust growth to resume.

Argentina: Moving in the Right Direction

Ironically, Argentina seems to be emerging from its economic crisis with sensible policy—made possible when it abandoned the currency board and floated its currency. Argentina's new president, Nestor Kirchner, has argued that his country "can survive without an I.M.F. deal," and that it "has little or no chance of paying the amounts sought" by creditors, rightly recognizing that Argentina's dollar-denominated debts cannot and will not be paid (Rohter 2003; Bloomberg 2003b; Smith 2003).

Most important, Kirchner has argued that Argentina will spend its way out of recession and bankruptcy—exactly the medicine needed and feasible now that Argentina has dropped the dollar peg. He has announced plans to build 3 million new homes and promised many more public works projects. Argentina is also offering a limited "employer of last resort" program, to provide jobs to heads of household who cannot otherwise find them. If the nation can keep up its nerve and ignore the budget-balancers, it may well avoid the fate to which euroland seems destined. We can only hope that U.S. policymakers will find enough backbone to relax our federal budget and allow robust growth to resume.

The Risk of Asset and Debt Deflation

The dangers of deflation are real and already present. As mentioned, American household net worth has fallen sharply even as indebtedness reached new heights. Monetary policy has little power left, because interest rates have already fallen so low that debt service burdens cannot be reduced significantly through further interest rate reductions. This means that lower rates can stimulate growth only by encouraging more borrowing and raising debt service burdens (both are already high—debt ratios are easily at an all-time high, while debt-service ratios are close to record highs). The faltering stock market, together with low mortgage rates, pulled wealth into real estate, which now shows signs of bubbles in many regions. Other nations also have evidence of real estate bubbles—particularly in some of euroland (Spain, Italy, the Netherlands), in Australia, and in the United Kingdom (Crooks 2003).

In spite of proclamations by monetary policymakers, the Fed's only tool is the overnight rate; it cannot "pump money" into the economy to halt deflation pressures.

In other words, there is a danger that real estate asset prices will fall in many regions of the world—just as equity markets fell during the past three years. A real estate collapse in the United States would imperil the financial situation of a much broader cross section of U.S. households than did the stock market collapse. Rising unemployment and job losses, cascading bankruptcies, collapsing asset prices and falling net worth, stagnant wages, growth of GDP that is well under half of potential, a lack of business investment, and plummeting tax revenue at state and national levels should all be taken as evidence that if deflation has not yet arrived, it is dangerously close.

As the 1930s demonstrated, it is best to act early and decisively. Many have credited Greenspan with doing just that, but monetary policy cannot help further (even if it did help already), because interest rates are already low. In spite of proclamations by monetary poli-

cymakers, the Fed's only tool is the overnight rate; it cannot "pump money" into the economy to halt deflation pressures. However, sovereign nations that issue their own floating currency (euroland is the only notable exception among the major developed countries) can use fiscal policy to raise demand, without worrying about balancing budgets. Given the high propensity around the globe to save in the form of U.S. dollar assets (and, in particular, in the form of U.S. treasuries), much of the responsibility for restoring world economic growth rests on the shoulders of the U.S. federal government. But it is not a "burden" for the federal government to spend its way to economic prosperity. All that is required is the will to put unemployed resources back to work.

Notes

1. Exactly what is meant by the term "deflation" is usually not clear. See Papadimitriou and Wray (forthcoming) for a detailed analysis. Here, we will use the term simply to indicate downward pressure on prices due, mostly, to insufficient aggregate demand. This does not necessarily mean that any particular measure of prices (say, the CPI) is likely to decline.
2. For the most complete statement of the Fed's view on how it might fight deflation even after the federal funds rate is pushed to zero, see Remarks by Governor Ben S. Bernanke Before the National Economists Club, Washington, D.C., November 21, 2002, "Deflation: Making Sure 'It' Doesn't Happen Here" (www.federalreserve.gov/boarddocs/speeches/2002/200221121/default.htm).
3. There are a number of mistakes in the president's statement. First, the federal government is the issuer of our currency, while households are in the position of users of the currency. While this is not the place to go into this in detail, sovereign issuers of the currency *can* run sustained deficits (which is not the same thing as saying that they always should, nor that there are no negative impacts of large, sustained budget deficits). Second, the president does not seem to understand that there is an aggregate accounting identity according to which the private sector balance equals the sum of the government sector balance (including all levels of government) and the foreign sector balance (the current account). By the end of the Clinton expansion, the government surplus was about 2.5 percent of GDP and the current account deficit was about 4 percent of GDP; together, these summed to about 6.5 percent, which equaled the private sector deficit (meaning the private sector spent over $106 for every $100 earned). Given the likely continuation of a current account deficit, the private sector *cannot* run a balanced budget if the government balances its budget. A government deficit of some 4–5 percent of GDP will be required to allow the private sector to balance its budget.

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