EXAGGERATED RISKS OF DEFLATION

Charles I. Plosser*
William E. Simon Graduate School of Business Administration
University of Rochester
Shadow Open Market Committee
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Over the past nine months there has been a growing number of articles written about the possibility of a serious deflation in the U.S. Articles have appeared in a wide range of respected business publications: "The Threat of Deflation" in *Business Week*, "Global Good Times, Meet the Global Glut" in *The New York Times*, "The Dreaded D Word" in *Forbes*, "Fear of Deflation is Latest Jitter on the Street" in *The Wall Street Journal* and "Deflation: The Real Enemy" in the *Financial Times*.

The sources of potential deflation most frequently cited in the popular writings on the subject are

- Excess global capacity
- Technological improvements
- Declining import prices due to the turmoil in Southeast Asia

What is extraordinary about virtually all the popular discussions of this topic is the total absence of any mention of the role of domestic monetary policy and the utter failure to distinguish between the behavior of relative prices and the overall price level. Sustained inflation is always a monetary phenomenon. Similarly, sustained deflation is also a monetary phenomenon. The Great Depression is the obvious case in point. Between 1929 and 1933 the price level fell by 22 percent. However, the money supply during the same period fell by 25 percent. It is highly unlikely that the Federal Reserve would ever engage in such a contractionary activity again. And unless the Federal Reserve becomes substantially more stingy with the growth in money than it has been, significant deflation is simply not in the cards.

At one level this is all that needs to be said about the prospects of deflation in the U.S. In other words, unless the Federal Reserve reduces the money supply growth to a rate that causes nominal demand growth to fall below the growth in real output,

significant deflation will not occur. Nevertheless, it is useful to discuss some of the fallacies inherent in the commonly expressed views about the source of deflation.

Let's begin with the claim that there is excess worldwide capacity in certain industries, including automobiles, chemicals, telecommunications and computer chips. There is probably evidence to support such a claim. It is also true that this may lead to declining prices in those markets **relative** to prices of other goods and services. It does **not** follow that there is excess capacity in all industries or all markets. What the global glutters fail to note is that scarcity and **rising** relative prices are the watchword in other markets such as aircraft, aerospace components, office space, hotel rooms, air travel, coffee beans, printed materials, lumber, skilled machinists, computer technicians, programmers and consultants.

In what has to be one of the strangest juxtapositions of news stories, *Business Week* hyped the fear of growing excess capacity in the article "The Threat of Deflation," and in the very next article in the issue they ran a story entitled "Sign of the Times: Help Wanted," which explained that industries all across the U.S. were begging for skilled, and even unskilled workers. Examples of robust growth and scarcity were cited n such industries as entertainment and leisure, retailing, computer services and shipbuilding.

Moreover, virtually all of the discussions by the global glut proponents focus on manufactured goods. And a lot of the evidence they cite is based on the behavior of the PPI. The fact of the matter is that large bulk of consumer demand and spending in advanced countries is on services, which the PPI does not measure. Figures 1 and 2 show the behavior of the year-over-year inflation rate of both the PPI and CPI. In general, the PPI is more volatile. Most recently, in 1985-87 and again in 1991, the PPI has exhibited deflationary characteristics but it has not been accompanied by deflationary behavior in broader price indices.

Figures 3 and 4 illustrate the point further. The CPI can be decomposed into a commodity and service price indexes. The weights in the overall CPI of these two components are 51.2 and 48.2 respectively. Here, too, one can see that for the past 40 years commodity prices have risen less than services. This has been an enduring pattern and should not surprise anyone. It is also true that commodity prices have fluctuated

more than service prices. Thus, even if commodity prices experience a brief period of deflation, it seems unlikely to be a cause for alarm—unless monetary policy changes.

An argument related to the excess capacity story is that technological progress is making it possible to produce goods more efficiently with less labor input. The result is rising productivity and a further contribution to global capacity. This is an old argument that has seen many forms. In fact, fears of too much productivity have arisen periodically throughout the past two centuries, particularly during periods of rapid industrialization. During the first century of the industrial revolution there were fears that new machinery would produce more goods, but it would take away jobs so that workers would not have the income to buy the goods that the new machines produced. Even today we hear concerns that automation reduces employment. After World War II there were fears that the great increase in industrial capacity stimulated by wartime production would fall idle and the U.S. would begin a period of secular stagnation, or worse, a return to the depression-like conditions that existed prior to the war. Of course, by and large, none of these fears came to pass. Indeed, the world economy is bigger, more productive and wealthier than ever before.

In most developed countries, manufacturing output accounts for about 20 percent of GDP and that hasn't changed much in the last 30 years, yet manufacturing's share of employment has fallen steadily from about 25 percent to almost 15 percent. Rapid productivity gains in manufacturing and slow productivity growth in service industries have resulted in a shift of jobs from manufacturing to services. Less expensive manufactured goods have allowed consumers to spend more on other things over the past two centuries. It has not led to gross excess supplies of manufactured goods or a general deficiency of demand as predicted by proponents of the global glut view.

The final source of deflationary pressure is based on the prospect that the U.S. will import deflation from the developing countries. In particular, the devaluation in Southeast Asia will lead to lower prices for U.S. consumers of imports from these countries. Thus, the story goes, competition will cause declines in domestic prices and hence the U.S. will suffer deflation. Of course the real problem with this scenario is that it tries, once again, to infer something about the overall price level based on the behavior of a few individual relative prices.

Finally, some have argued that the current rate of inflation is overstated and thus we are already experiencing mild deflation. It is true that inflation as measured by the CPI is overstated as was made clear in the Boskin Report last year. But, even after correcting the flaws in the current statistical methods and making the appropriate adjustments, one still finds that the U.S. is experiencing mild inflation, not deflation. This is confirmed by looking at the GDP chain-weighted deflator, which is not subject to as much bias as the CPI.

There is no doubt that some people will try to use the fear of deflation to urge Alan Greenspan to lower interest rates and pump up the money supply. This would be a mistake. Fortunately, there seems to be no evidence that Chairman Greenspan will take the bait—he knows better. The U.S. economy does not need a quick does of inflation.

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*The author is Dean and John M. Olin Distinguished Professor of Economics and Public Policy at the William E. Simon Graduate School of Business Administration, University of Rochester, Rochester, NY 14627.