The risk of falling prices is greater than at any time since the 1930s

FOR decades inflation was the bogeyman in rich countries. But now some economists reckon that deflation, or falling prices, may be a more serious threat—in America and Europe as well as Japan. That would be decidedly awkward, given the surge in borrowing by firms and households in recent years. Particularly worrying is the rise in borrowing by American households to finance purchases of houses, cars or luxury goods. Deflation would swell the real burden of these debts, forcing consumers to cut their spending.

Policymakers in America and Europe have been quick to dismiss any fears of possible deflation. Bond markets, on the other hand, reckon that the risk is mounting: bond yields have fallen to historical lows. Many products, from clothes to cars, are certainly cheaper than they were a year ago. But full-blown deflation requires a persistent fall in the overall price level. The recent fall in the prices of durable goods has been offset by rising prices of services; so outside Japan, average prices continue to rise, albeit at the slowest pace for decades. As measured by the GDP deflator, the best economy-wide gauge, America's inflation rate has fallen to 1.1%, its lowest for 40 years. Its consumer-price index has risen by 1.8% over the past 12 months, but prices have fallen in half of its 16 main product categories—the biggest proportion since the current series started.

The world is still awash with excess capacity, in industries from telecoms and cars to airlines and banking. Until this is eliminated, downward pressure on inflation will persist. A good measure is the output gap, the level of actual minus potential GDP. Historically there has been a close relationship in most countries between the size of the output gap and changes in the inflation rate (see chart). When the output gap is negative (ie, actual output is below potential), inflation usually declines. The OECD estimates that America's GDP is about 1% below its potential. If growth remains at or below its trend rate of around 3% over the next two years, the negative output gap will persist into 2004, pushing inflation even lower. It
would not take much to tip into deflation.

Optimists argue that deflation is much less likely today than in the 1930s because services now account for a bigger slice of the economy. The prices of services tend to be more resistant to dropping than the prices of goods because they are more labour-intensive, and wages rarely fall. However, Stephen Roach, an economist at Morgan Stanley, observes that service-sector inflation is now much weaker than usual. The rate of increase in the services component of America's GDP deflator fell from 3% in the year to the fourth quarter of 2000 to 2.2% in the second quarter of this year. In the previous six recessions, service-sector inflation actually increased over the comparable period.

Although Mr Roach reckons that deflation is a serious risk, economists at Salomon Smith Barney argue that fears of it are vastly overdone. Incompetent monetary policies were largely to blame for deflation in America in the 1930s and in Japan today. Outside Japan, they argue, no central bank would tolerate a persistent decline in prices. A recent paper by economists at the Federal Reserve draws lessons from Japan's deflation and concludes that, when inflation is unusually low, central banks must be especially alert to the risk of deflation and cut rates by more than is normally justified by inflation and growth rates.

The Fed is at least aware of the risks. However, not all central banks may be either willing or able to learn from Japan's mistakes. Germany probably faces a higher risk of deflation than America. The ECB's interest rate of 3.25% is broadly appropriate for the euro area as a whole, given its inflation rate (2.2%), the size of the output gap, and the bank's chosen inflation target of "less than 2%". But the ECB seems unlikely to cut interest rates until inflation dips below 2%. And its inflation target is arguably too low. Research by the IMF and the Fed suggests that, if central banks aim for inflation below 2%, the risk of deflation rises markedly. If the ECB had an inflation target with a mid-point (rather than a ceiling) of 2%, it could now trim interest rates.

Even then, however, rates would still be too high for Germany. Since it is the highest-cost producer within the euro area, a fixed exchange rate tends to cause price convergence by forcing inflation to be lower in Germany than in the rest of the euro area. Germany's core rate of inflation (excluding food and energy) has averaged 0.6 percentage points below the euro-area average over the past three years; it is now a full point lower, at 1.1%.

Since interest rates are the same across the whole of the euro area, this implies that real rates will be higher in Germany and growth consequently slower. Germany's output gap, at an estimated 2.5% of GDP, is the second biggest after Japan among the G7 countries, and it is likely to widen. Deutsche Bank recently cut its growth forecast for Germany to only 0.1% for this year and 0.6% in 2003.

Back-of-the-envelope calculations suggest that, if the old Bundesbank were setting interest rates to suit Germany alone, they would now be below 2%. Worse still, not only is Germany unable to cut interest rates, but the EU's stability and growth pact also obstructs any fiscal easing. Nor can it devalue its currency. Stripped of all its macroeconomic policy weapons, Germany now runs a serious risk of following Japan into deflation.

**Friend or foe?**
Deflation is not necessarily bad. If falling prices are caused by faster productivity growth, as happened in the late 19th century, then it can go hand in hand with robust growth. On the other hand, if deflation reflects a slump in demand and excess capacity, it can be dangerous, as it was in the 1930s, triggering a downward spiral of demand and prices.

Today, both the good and bad sorts of deflation are at work. Some prices are falling because of productivity gains, thanks to information technology. But the weakness of profits suggests that most deflation is now bad, not good. Deflation is particularly harmful when an economy is awash with debt. Total private-sector debt is now much higher than when deflation was last experienced in the 1930s. Falling prices not only increase the real burden of debt, they also make it impossible for a central bank to deliver negative real interest rates, because nominal rates cannot go below zero.

If deflation causes real debts to swell, debtors may have to cut spending and sell assets to meet their payments. This can unleash a vicious spiral of falling incomes, asset prices and rising real debt. Irving Fisher, an American economist, described this process in a famous article in 1933 entitled “The Debt-Deflation Theory of Great Depressions”. He described how attempts by individuals to reduce their debt burden by cutting costs could paradoxically cause their debt burden to swell. Unable to increase prices to boost profits, firms have to cut costs, either by reducing labour costs and hence household income or by buying less from other firms. This is sensible for an individual firm, but it reduces demand in the economy, thwarting the desired improvement in profit, leading to another round of cuts and putting further downward pressure on prices.

America's corporate sector is already suffering deflation, with the price deflator of non-financial businesses falling in the past year for the first time since the second world war. Many firms that borrowed heavily in the late 1990s, expecting rapid revenue growth to finance their debts, are now in trouble. Ed McKelvey, an economist at Goldman Sachs, worries that corporate-sector deflation could create wider deflation if firms try to slash labour costs.

When Japan was the only country with deflation, one sure cure might have been a big devaluation of the yen to push up inflation. But for the world as a whole, this is not an option. Global deflation could be even harder to budge.