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Who's Afraid of a Little Deflation?

A sudden drop wouldn't be good, but a steady annual decline of, say, 2%? Worries about that are overblown.

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With European inflation declining to 0.3%, and U.S. inflation slowing, a specter now haunts the Western world. Deflation, the Economist recently proclaimed, is a "pernicious threat" and "the world's biggest economic problem." Christine Lagarde , managing director of the International Monetary Fund, called deflation an "ogre" that could "prove disastrous for the recovery."

True, a sudden, large and sharp collapse in prices, such as occurred in the early 1920s and 1930s, would be a problem: Debtors might fail, some prices and wages might not adjust quickly enough. But these deflations resulted directly from financial panics, when central banks couldn't or didn't accommodate a sudden demand for money.

The worry today is a slow slide toward falling prices, maybe 1% to 2% annually, with perpetually near-zero short-term interest rates. This scenario would unfold alongside positive, if sluggish, growth, ample money and low credit spreads, with financial panic long passed. And slight deflation has advantages. Milton Friedman long ago recognized slight deflation as the "optimal" monetary policy, since people and businesses can hold lots of cash without worrying about it losing value. So why do people think deflation, by itself, is a big problem?

1) Sticky wages. A common story is that employers are loath to cut wages, so deflation can make labor artificially expensive. With product prices falling and wages too high, employers will cut back or close down.

Sticky wages would be a problem for a sharp 20% deflation. But not for steady 2% deflation. A typical worker's earnings rise around 2% a year as he or she gains experience, and another 1%—hopefully more—from aggregate productivity growth. So there could be 3% deflation before a typical worker would have to take a wage cut. And the typical worker also changes jobs, and wages, every 4½ years. Moreover, "typical" is the middle of a highly volatile distribution of wage changes among a churning job market. Ultimately very few additional workers would have to take nominal wage cuts to accommodate 2% deflation.

Curiously, if sticky wages are the central problem, why do we not hear any loud cries to unstick wages: lower minimum wages, less unionization, less judicial meddling in wages such as comparable worth and disparate-impact discrimination suits, fewer occupational licenses and so forth?

2) Monetary policy headroom. The Federal Reserve wants a 2% inflation rate. That's because with "normal" 4% interest rates, the Fed will have some room to lower interest rates when it wants to stimulate the economy. This is like the argument that you should wear shoes two sizes too small, because it feels so good to take them off at night.

The weight you put on this argument depends on how much good rather than mischief you think the Fed has achieved by raising and lowering interest rates, and to what extent other measures like quantitative easing can substitute when rates are stuck at zero. In any case, establishing some headroom for stimulation in the next recession is not a big problem today.

3) Debt payments. The story here is that deflation will push debtors, and indebted governments especially, to default, causing financial crises. When prices fall unexpectedly, profits and tax revenues fall. Costs also fall, but required debt payments do not fall.

Again, a sudden, unexpected 20% deflation is one thing, but a slow slide to 2% deflation is quite another. A 100% debt-to-GDP ratio is, after a year of unexpected 2% deflation, a 102% debt-to-GDP ratio. You'd have to go decades like this before deflation causes a debt crisis.

Strangely, in the next breath deflation worriers tell governments to deliberately borrow lots of money and spend it on stimulus. This was the centerpiece of the IMF's October World Economic Outlook antideflation advice. The IMF at least seemed to realize this apparent inconsistency, claiming that spending would be so immensely stimulative that it would pay for itself.

4) Deflation spiral. Keynesians have been warning of a "deflation spiral" since Japanese interest rates hit zero two decades ago. Here's the story: Deflation with zero interest is the same thing as a high interest rate with moderate inflation: holding either money or zero-interest rate bonds, you can buy more next year. This incentive stymies "demand," as people postpone consumption. Falling demand causes output to fall, more deflation, and the economy spirals downward.

It never happened. Nowhere, ever, has an economy such as ours or Europe's, with fiat money, an interest-rate target, massive excess bank reserves and outstanding government debt, experienced the dreaded deflation spiral. Not even Japan, though it has had near-zero inflation for two decades, experienced the predicted spiral.

There are good reasons to believe it can't happen. Most of all, government solvency fears that don't matter for 2% deflation kick in and stop a deflation spiral. If prices fall 20%, or 30%, bond-holders will see that governments cannot pay back debts. They try to get rid of their bonds before the coming default. They buy things or other currencies, nipping the deflation spiral in the bud.

There is an unsettling feature of the current inflation situation, however. Clearly, our central banks want higher inflation, and the current slow decline was unintended. So, just as clearly, central banks have a lot less understanding of and control over inflation and deflation than most people think.

According to the conventional worldview, the economy is inherently unstable. Central banks control inflation the way you balance an upside-down broom, with interest rates on the bottom and inflation on top. Central banks have to actively move interest rates around to keep inflation and deflation from breaking out. And if they want more inflation, they must temporarily move interest rates the wrong way, let the inflation increase, and then move quickly to stabilize it.

Hence the zero-bound worry. When interest rates hit zero and the Fed can't move the broom handle any more, the top of the broom must topple into deflation. Except we hit the zero bound, and almost nothing happened. Maybe the economy isn't so inherently unstable and in need of constant guidance after all.

Bottom line? Relax. Every few months we hear a new "biggest economic problem" from which our "policy makers" must save us. Wait for the next one.

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