JOINT ECONOMIC COMMITTEE
CHAIRMAN ROBERT F. BENNETT

ECONOMIC POLICY RESEARCH
MAY 21, 2003

A PRIMER ON DEFLATION

The Federal Reserve recently warned of a small chance that inflation could fall substantially. With inflation already running very low, a substantial fall in inflation could push the economy into deflation. The U.S. has not experienced widespread deflation since the 1950s. In the intervening decades, economists have made significant progress in understanding the causes of deflation, its consequences, and the policies that can be used to combat it.

What is deflation?
Deflation means that prices are generally declining. This is the opposite of *inflation*, where prices generally increase. With inflation, a dollar today is worth more than a dollar tomorrow. With deflation, the reverse is true: a dollar today is worth less than a dollar tomorrow.

Are we currently experiencing deflation?
No. Consumer and producer prices did decline in April, but most of this reflects the post-war fall in energy prices. Over the last year, most broad price measures have shown moderate inflation of one to two percent. Inflation is thus very low, but not in a deflationary range. The one exception has been the "core" measure of producer prices, which excludes the highly volatile food and energy sectors; core producer prices have been essentially flat over the last year. While this narrower price measure is the only one suggesting current deflation, further declines in inflation could push us into wider deflation.[1]

What causes deflation?
In the short run, deflation can be caused by weakness on the demand side of the economy. When demand slackens, producers reduce prices to retain customers; if such price-cutting is widespread in the economy, deflation results.

To paraphrase Milton Friedman: Persistent deflation is always and everywhere a monetary phenomenon.

In the long run, deflation is the result of tight monetary policy. If the Federal Reserve allows monetary growth to lag behind the growth in purchases of goods and services, deflation will follow – as fewer dollars chase more products, prices must decline. Nobel Laureate Milton Friedman once noted that "*inflation* is always and everywhere a monetary phenomenon." The same is true of *deflation*: Persistent deflation is always and everywhere a monetary phenomenon.

Is deflation a problem? Why?
It depends. In the short run, deflation is usually a symptom of another economic problem like weak demand. However, over the longer term deflation may itself be the cause of economic problems. One concern is that prolonged and unexpected deflation undermines the ability of borrowers to repay debts. With deflation, the value of a dollar rises over time, so debts became increasingly expensive to repay. This may cause bankruptcies and disruptions in the nation's financial system as lenders become stuck with nonperforming loans to bankrupt borrowers.

Another worry is that deflation causes households and businesses to hold onto money, rather than spend it. If consumers anticipate that goods will cost less in the future, they have an incentive to wait before buying. Overall demand may suffer, leading to a sluggish economy.

A third concern is that monetary policy will lose its effectiveness under deflation. When inflation falls, nominal (dollar) returns on assets also tend to fall. Investors require less of a premium to compensate them for erosion of the purchasing power of money caused by inflation. But if inflation falls to zero or deflation creeps in, interest rates fall toward zero, and the Federal Reserve has limited ability to reduce real short-term interest rates. In that case, the Fed would have to combat deflation with other tools of monetary policy such as buying longer term bonds to reduce longer term interest rates.

Has the U.S. experienced deflation before?
Yes. The U.S. has experienced deflation, most notably when it was on a gold standard. Under the gold standard, the money supply was constrained by the nation's gold reserves. When gold reserves and money grew slower than production, prices would fall. The pace of gold discoveries was sufficient that, on average, the U.S. approached price stability with periods of inflation offsetting bouts of deflation. Following World War II, the U.S. has generally avoided deflation because of the separation, and eventual divorce, between gold and the money supply.

Have other countries experienced deflation?
Yes, with the most notable recent example being Japan. Japan's economy has struggled under the weight of weak demand, a troubled financial sector, and persistent deflation. Given Japan's sub-par economic performance many fear that their fate awaits the U.S.. Observing a sluggish economy along with deflation does not, however, prove that deflation caused Japan's economic problems.

Most believe that structural differences between Japan and the U.S. will help us avoid the deflation and economic malaise that have settled on Japan.

Some see similarities between Japan since the late 1980s and recent experiences in the U.S.. For example, in both cases large run-ups in asset prices were followed by sudden reversals. But most believe that structural differences between Japan and the U.S. will prevent us from experiencing the deflation and economic malaise that has settled on Japan. The U.S. financial system, for example, is remarkably more flexible and efficient, and the Federal Reserve is intent on not allowing deflation to take hold.

What policy tools can be used to combat deflation?
To combat short run deflation associated with weak demand, monetary and fiscal policies can be used to stimulate demand. In the long run, it is the job of the Federal Reserve to generate money growth sufficiently high to thwart deflation. The Fed can accomplish this using its traditional tools – increasing the money supply by buying short-term government bonds – and, if necessary, less familiar tools – e.g., buying longer-term bonds. In recent policy statements, Fed officials have emphasized their willingness to use these tools to avoid deflation.

---

[1] Some have characterized the period leading up to the recent recession as deflationary because gold prices declined and the dollar strengthened relative to foreign currencies. However, traditional measures of consumer and producer prices showed continuing inflation during the late 1990s and early 2000s, albeit at a slowing rate. Most economists thus view this as a period of *disinflation* – a declining inflation rate – not deflation.