

Is deflation a risk?

A paper by Donald T Brash, Governor of the Reserve Bank of New Zealand at a Governors' Panel Discussion at the Annual General Meeting of the Bank for International Settlements, Basel, Switzerland, 6 June 1999

Mr Chairman, Ladies and gentlemen,

This morning I have been asked to discuss whether deflation is a risk. The question is ambiguous. It could mean: is deflation a risk, in the sense of is deflation *likely*? Or it could mean: would deflation be bad, if it occurred? These are both interesting questions, neither of which most of us have had to face in our careers as central bankers. They may also seem irrelevant questions to many North American observers, in a situation where the US economy continues to power ahead, and the Fed has recently moved to a tightening bias.

I am going to focus mainly on the question of: Is deflation likely, and my colleagues, Gordon Thiessen and Jacob Frenkel, are going to talk about whether deflation is a risk, in the sense of the implications of deflation for the effectiveness of monetary policy.

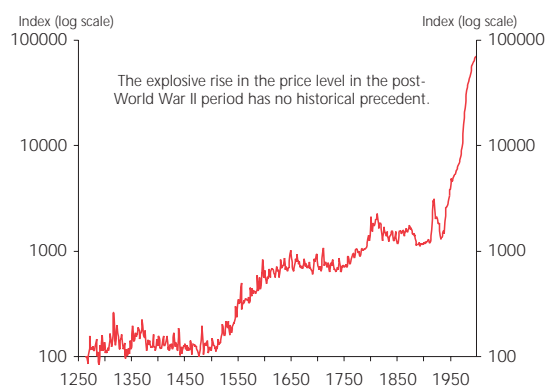
Is deflation likely? For the past quarter of a century, one of the biggest risks in most countries has been inflation. But, as we end the millennium, there is increasing public and media concern that a greater risk may be deflation.

Most people in most countries have in recent decades taken it for granted that prices for goods and services will always rise. Yet sustained inflation is a relatively recent phenomenon. Prior to World War II, the international experience was one of relative price stability: average prices essentially fluctuated around a stationary level. After short periods of inflation—usually war-related—the price level was generally restored in fairly short order by periods of deflation. In the United Kingdom, after the so-called great inflation of the 16th century, the price level was more or less stable for several centuries until the middle part of the 20th century.

Could the world revert to that earlier norm, where periods of inflation alternate with periods of deflation? More specifically, is the world on the brink of a period of deflation now?

It may be worth reflecting briefly on what we mean by 'deflation'. Clearly, we do not mean simply a fall in the headline inflation measure where that measure includes interest rates,

Figure 1
UK price level, 1264-1998

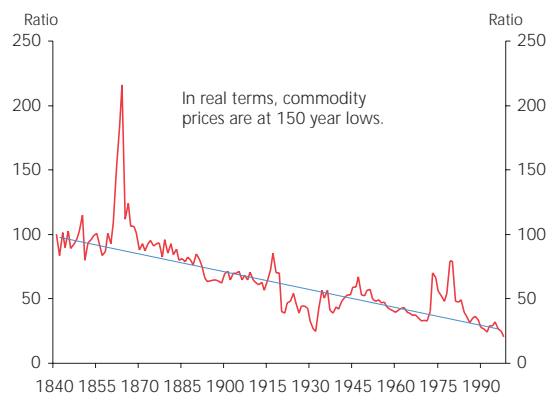


as it does in a number of countries (such as the United Kingdom, Sweden, Australia and New Zealand). In Australia, New Zealand and Sweden, and no doubt in a few other countries as well, the interest-rate-inclusive measure of consumer price inflation has recently been slightly negative, while the interest-rate-exclusive measure of inflation remains positive, because the central bank in each country has aggressively eased monetary policy to keep the real inflation rate on target. With the exception of a few in the media, and, I am bound to say, a few BIS economists, the essential irrelevance of the interest-rate-inclusive measure of inflation seems to be well understood.

Nor, of course, does deflation mean simply a situation where some prices are falling. Where prices are on average stable, or where the average price level is rising very slowly, it is almost inevitable that the prices of many items will be falling, while the prices of many other items will be rising.

The prices of many goods have indeed fallen over the last year or so. Commodity prices are an obvious example. Indeed commodity prices have been in secular decline for at least 150 years. This long decline partly reflects the technological progress that has boosted crop yields and mineral-extraction rates. But the most recent sharp fall in prices, the fall of around 25 percent seen over the last two years, reflected declining demand in the wake of the crisis in East Asia, a big importer of raw materials.

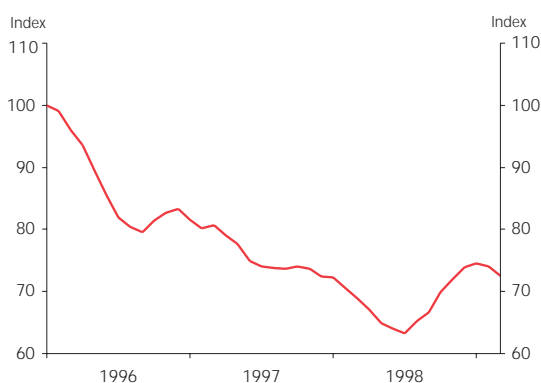
Figure 2
Ratio of US commodity prices to US CPI



The prices of many other products have also fallen. Cars, clothes, coffee and petrol are, in many countries, cheaper than they were last year. The average world price of semiconductors has fallen some 30 percent since the beginning of 1996. Lots of other prices have been falling for many years, with airline services and long-distance phone charges being good examples. *The Economist* magazine noted back in 1990 that, in 1990 prices, the price of a three minute phone call from London to New York was 469 pounds in 1930, 30 pounds in 1960, and 2 pounds 33 pence in 1990. I have no doubt that the price is cheaper still today. In February this year, *The Economist* noted that, in 14 of the 15 industrial economies it monitors, producer prices had fallen over the previous 12 months.

But are these sorts of falling prices dangerous? Probably not. What we are observing in many cases is a relative price shift, or price reductions driven by strong productivity growth. This was a feature of the 19th century in the UK and the US, and that was quite consistent with strong economic growth and

Figure 3
Average world price of semiconductors



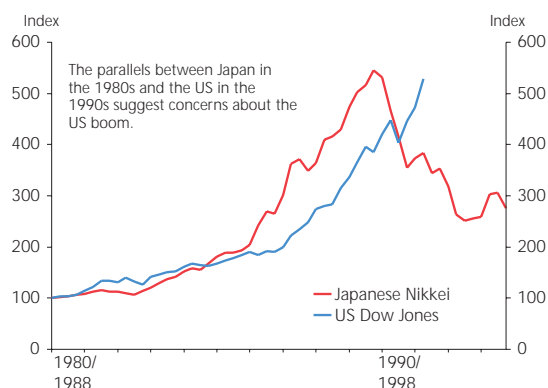
rising real incomes. Indeed, in the period 1870 to 1900, wholesale prices fell by around 50 percent in the US, while real growth averaged over 4 percent per annum. Consumer prices also fell at several stages during that period. Perhaps we should **also** have been seeing a gradual fall in average prices in the US over the last few years, given strong productivity growth, as argued recently in a very persuasive essay in the 1998 Annual Report of the Cleveland Fed.

What **would** be dangerous would be falling prices that locked economies into a downward spiral, in which shrinking demand and deepening pessimism led to sharply increased unemployment and serious banking sector difficulties. This could all be associated also with a sharp contraction in money and credit, and probably with falling asset prices. And if such a deflationary trend developed in large parts of the world economy simultaneously, then the world economy would be facing a serious deflation problem, for the first time since the 'thirties. What are the risks of this happening?

The IMF, at least, doesn't seem to rank the risk very highly. The most recent inflation forecasts by the IMF show falling consumer prices in only one country, Japan. And even there prices are forecast to fall by a mere 0.7 percent this year and 0.3 percent next year. Inflation is subdued in Europe, but neither the European Central Bank nor the central banks of the EU 'outs' appear to be concerned that inflation will soon become deflation. Most observers suggest that inflation is a bigger risk than deflation in the US, the world's largest economy, and the Fed has clearly signalled that that is how they see matters also, in moving to a tightening bias a week or two ago. Long-term inflation expectations in the US continue to be clearly positive.

But should we be complacent? While the probability of generalized deflation is small, it is higher than at any time since the 'thirties. To anticipate comments by Gordon and Jacob perhaps, in my view deflation is not likely to occur if policy-makers keep their wits about them. There is ample scope, at least in the countries with which I am most familiar, such as the US, Canada, the UK, Australia and New Zealand, to ease policy, both monetary policy and fiscal policy, if deflation looked like becoming a reality. But the risks are considerable.

Figure 4
Japanese Nikkei (starting 1980q1=100) and US Dow Jones (starting 1988q1=100)



A sharp slowdown in the US, for example, could easily send world price levels falling. As is obvious to all, growth in the US is a crucial part of growth in the world economy at present. And US economic growth is being kept afloat by strong consumer spending. Much of this spending in turn is supported by the perceived wealth effect generated by a very strong stock market. But the US equity market appears grossly overvalued by traditional measures. (Indeed, if my memory is correct, Chairman Greenspan labeled the US share market as 'irrationally exuberant' when the Dow went through 6,500.) If the US market were to fall back to historical norms, either in terms of price-earnings ratios or in terms of the relationship between the capitalisation of the market and

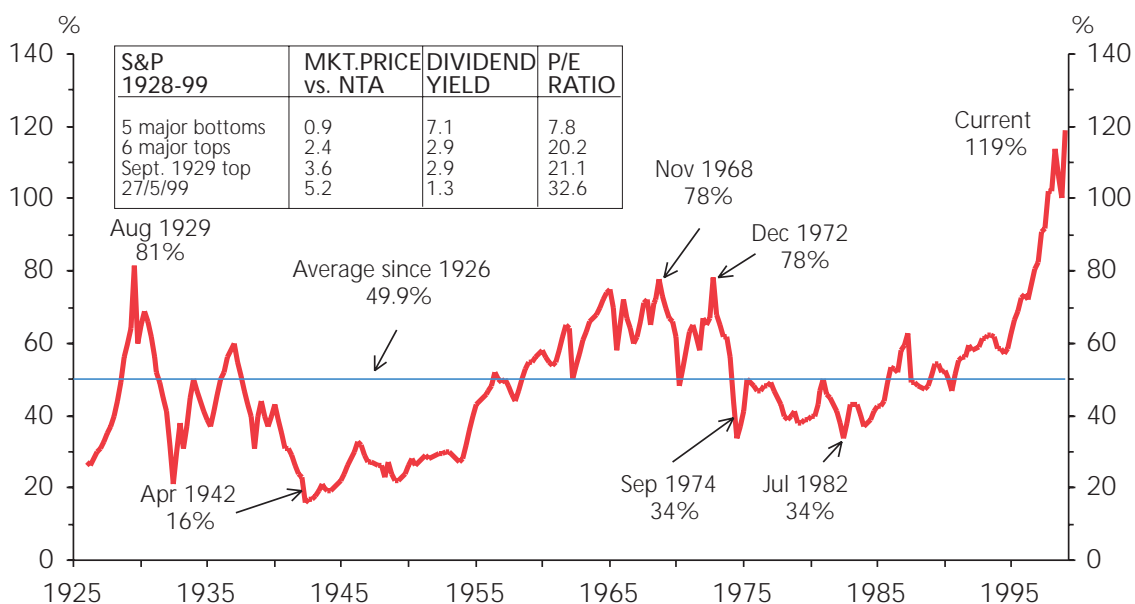
US GDP (perhaps involving a fall of some 30 to 50 percent), then the American consumer could stop spending. US growth could slow very sharply, and world growth with it.

Another serious risk must be that an already weak Japan deteriorates further. Japan's negative output gap remains at record highs. The Japanese banking sector is being gradually strengthened but is still very frail, the insurance sector is in potentially serious difficulties, there is considerable overcapacity in many industries, the net public sector debt is rising strongly, and political leaders seem unable to deal with many structural problems. There has been severe deflation in asset prices over the last decade, and some observers suggest that official measures of consumer prices understate the extent of deflation in consumer prices. Consumer confidence remains at low levels, and consumer spending with it.

Europe does not, to this observer, appear to be in imminent danger of deflation of the Japanese kind. But 'core Europe' does have very high structural unemployment and appears to be unable to face the political difficulties involved in dealing with that. Interest rates are already fairly low, and fiscal deficits in several key countries, most recently Italy, are uncomfortably close to Maastricht-agreed limits.

Non-Japan Asia seems to have been recovering much more quickly than many had expected just a few short months ago, but the problems remain immense. Banking sector prob-

Figure 5
Market value of the S&P 500 companies as a percentage of GDP



lems in South Korea, Indonesia, Thailand and China remain very large by the standards of any historical precedent, while many corporate balance sheets in those countries remain similarly in a seriously weakened condition. The *Far Eastern Economic Review* quoted a study by ING Barings in October last year as estimating that to achieve a situation where the return on capital exceeded the cost of capital, 63 percent of manufacturing capacity would need to be closed in Indonesia, 61 percent in South Korea, 41 percent in Thailand, and 37 percent in Malaysia. Even allowing that those estimates may have been exaggerated by a factor of two or three, the excess capacity seems likely to remain large, and strong downward pressure on prices with it.

And of course considerable over-capacity persists in many other countries also, including some of the major countries of South America. Ken Courtis, Deutsche Bank's chief economist for Asia, recently noted that global capacity to produce motor vehicles exceeds current demand by about one-third, and as a result fewer than one-third of the world's 40 largest auto-makers are cash-flow positive.

Struggling firms often have an incentive to keep factories running. The global glut in many industries around the world (motor vehicles, steel, computer chips, office buildings, etc) is pushing many prices relentlessly lower. Individual countries may increase their share of world markets by devaluing their currencies and running balance of trade surpluses, but of course competitive devaluation cannot make the global excess capacity disappear; it simply transmits the problem to somebody else.

And this brings us to what I see as perhaps the biggest danger of them all, namely the risk that countries turn increasingly to protectionist measures. Too many countries still see their salvation in generating net export surpluses. A small number of countries are doing their bit for the world economy by running large trade and current account deficits (and New Zealand and Australia, and increasingly the US, are experts in this), but this itself runs considerable risks of generating protectionist reactions.

I suggest to you that protectionism is a particular risk in the US and EU, though perhaps for different reasons. In the US, the Administration seems to have no political capital to devote to maintaining open trade and gives way to even trivial pressure groups seeking protection—that situation would only get worse if US unemployment began rising from recent very low levels. In the EU, commitment to open trade has always been pretty selective, and with high unemployment that commitment does not seem likely to get any stronger.

None of these risks seems likely to cause deflation on their own. My real nightmare, as no doubt yours, is that some trigger causes all of these potential dangers to merge and compound. For example, for some inherently trivial reason – perhaps the Fed tightening modestly, some new political crisis in a major emerging country, or whatever – the US equity market falls by 30 percent. Household sector expenditure in the US slows abruptly, and investment expenditure in the US with it. Unemployment starts to rise. Demand for imports, the exports of many emerging and other countries, falls off sharply. There is a rise in protectionist pressures in the US, exacerbated by tensions over trade with the EU and a perception that Japan and China are trying to solve their economic problems by generating huge export surpluses with the US. The leaders in the race for the Presidency make it clear that, if elected, they will 'protect American jobs'. Equity markets around the world fall sharply, either in the immediate aftermath of the fall on Wall Street or a few months later as the implications of that fall for the world economy become evident. Japan, reluctant to antagonize the US by weakening the yen, does not ease monetary policy further but instead reverses the timid steps taken towards trade liberalization. And so on.

It is not difficult to see how the world *could* be into a very deflationary situation, fraught with extreme dangers to the liberal world order.

Is deflation a risk? If policy-makers do not heed the warning signs, a considerable risk.