Deflation

Keith Rankin, 27 January 2015

In December 2014 I wrote in *The Daily Blog* about a possible clash of global economic crises that might reach its fullest intensity in the 2030s. One section of that article was called "Inflation or Deflation?" I saw a possible inflationary crisis arising from the spending by retired people of their huge accumulated retirement funds. And I saw a deflationary crisis arising from the global economic situation that has been emerging through this decade, beginning in 2010 with the widespread abandonment of the 'fiscal stimulus' spending policies pursued by governments in the wake of the 2008 financial crisis.

Since then the portents have moved quickly in the direction of a much earlier period of global deflation (see 'When growth loses its puff' by Brian Fallow in the *NZ Herald*, 23 Jan). And few of us – especially few of our major political leaders and their advisers – have any real idea of what deflation means, about how it arises, and about how it can be addressed by policymakers. The best we can do is mention that deflation was a central feature of the 1930s' Great Depression; and make obscure claims that when prices come down we spend less because we expect prices to fall even more (eg Fallow). While we have been exhorted to save more of our incomes for many years, an environment which apparently favours saving over spending now issues ripples of fear through the financial community.

We are heading into a phase of world capitalism known in the 1820s (by TR Malthus and others) as a 'general glut' of produce for sale. (The general glut is most obvious at present in the oil market, but is by no means confined to it.) Further, the notion of 'secular stagnation' – a term coined by economist Alvin Hansen in the 1930s – has been revived. Through much of the world there has been a substantial decline in aggregate demand for goods and services, and a growing preference to acquire financial assets (such as prime real estate) instead.

A deflationary spiral may be now underway, with oil prices magnifying the problem and attracting our attention. We see this most obviously in the European Union, where spending is weak and getting weaker; most Eurozone countries now have falling prices (on an annual basis) and show no credible prospect of reversing this. Greece has had deflation for two full years now, and is currently 'enjoying' annual inflation of *minus* 2.6 percent.

There are signs of a new credit boom in the USA which can be expected to forestall any immediate collapse of aggregate spending. Likewise, in New Zealand spending is likely to hold up for a year or three. (While New Zealand prices fell in December, we still have over two percent 'non-tradable' inflation.)

Yet we can sense that, beyond the basics of housing, food and utilities, there are not really many things that people want to buy much more of. Consumerism itself, in the developed economies, has run out of puff. Even hard-sell marketing is facing diminishing returns. The talk is that smart phones and robots will soon be able to do just about anything. The 'Future of Work' is back on the agenda, and in a more edgy way than it was in the late 1960s and the early 1980s. All of these point to accelerating deflation of consumer prices; and ongoing inflation (for a few years) of asset prices, given that income decline lags price decline.

Understanding and managing deflation

Like inflation, deflation has been traditionally understood as a monetary matter. In the early days of the gold standard 150 years ago, inflation was understood as a fall in the price of gold, and deflation was understood as a rise in the price of gold. Thus there was understood to be an exchange rate between money and stuff; stuff would get cheaper if money got dearer.

Under that 1860s' understanding, a country like Greece in 2010 would have come close to 'running out of money'. That shortage would have made money very dear in Greece; so, hey presto, it was assumed that the prices of stuff (and of labour) in Greece would have been very cheap. And, as a result of that cheapness of prices and wages, Greece – had it had its crisis in 1865 – would be in position to recover through cheap exports.

In reality, what would have happened is that foreign banks would have lent gold-backed money to Greek banks, and to the Greek government.

As the gold standard did not work in this way, other ways had to be devised to ensure that the amount of money in circulation in such a Greece really did fall. So, through the emerging reserve banks, interest rates would be required to be jacked up in Greece, as a way of reducing the amount of bank-created money. The belief was that, if this was done predictably and according to the 'rules of the game', prices and wages in Greece would fall even if gold reserves were replenished with loans from other countries. This was the state of play, as understood, when the gold standard was restored in the 1920s after World War 1. This flawed misunderstanding of the pre-WW1 global monetary system helped to create the Great Depression, and, indirectly, World War 2.

In the 1920s, the word 'deflation' had a wider meaning. Price statistics were well developed, but income statistics were at best sketchy. Thus the word 'deflation', in addition to meaning 'falling prices', also meant these modern terms: 'recession', 'austerity', 'internal devaluation' and 'fiscal consolidation'. 'Deflationary' policies of government austerity – also known as 'fiscal consolidation' – were known as 'retrenchment' in the 1920s and 1930s. When countries started to run out of money, governments responded by reducing government spending, aggravating the problem they were trying to solve. When the demand for money was slashed, the amount of money in circulation also declined.

Deflation was understood as an exchange rate problem; in particular a problem of an ounce of gold (or a gold coin) exchanging for more stuff than it previously exchanged for. This exchange rate way of understanding money took on a new dimension after 1971 when the era of gold was abandoned and the modern era of floating exchange rates was born. Economists and bankers continued to – and continue to – think of modern money 'as if' it was a relatively fixed commodity such as gold.

So the only policy response to post-2015 deflation will be monetary policies to depreciate national currencies. Reserve banks will be slashing interest rates (now *minus* 0.75% in Switzerland) and using other means to boost their economies with extra money. One outcome is a *de facto* currency war that will only aggravate the deflationary problem, globally.

Loose monetary policies are meant to reverse deflation in three ways. The (first) way most emphasised in the 1980s and 1990s (though in an anti-inflationary context) was the 'expectations' or placebo effect. This 'works' only so long as people (especially employers and employees) believe it will work.

The *second* way these policies are meant to work is by people being inspired to substantially increase their debt levels in response to low interest rates, and thereby to buy lots more stuff. We have seen since 2009 that in fact 'borrowing and spending' is not very sensitive to interest rates. People fear debt in times of uncertainty, even if debt is very cheap. (The response to Switzerland's negative interest rate policy has been much more foreign lending to Swiss banks – paying a penalty to do this – not more borrowing from them. The Swiss franc soared in value last week.)

The *third* policy mechanism is through using ever-lower interest rates to reduce the inflow of foreign money, thereby depreciating a country's exchange rate. This method *does* work in normal times – hence New Zealand's rising exchange rate as other countries reduced their interest rates towards zero – though reverses during crises when money tends to be repatriated.

So, over the next few years, we can expect each country to cut the interest rates through which the reserve banks interact with the commercial banks that create our money by lending to us. The problem is that this anti-deflationary policy works for individual countries only so long as the other countries are not doing the same thing. When interest rates are falling in all countries, then only the first and second effect can apply.

I have noted that the second effect – stimulating 'borrow and buy stuff' responses from you and me – by and large is ineffective. Actually it's more than ineffective. Loose monetary policy is systemically deflationary. Interest is an important cost – explicitly, as anyone with a mortgage will know – and also implicitly because it regulates how much companies must pay to their shareholders as dividends. Easy monetary policies are part of how we got ourselves into this deflationary spiral in the first place. Financial costs have fallen dramatically since 2008.

So, globally, the three arrows of counter-deflationary monetary policy are: (i) placebo effect, still effective; (ii) borrow and spend effect, which actually aggravates deflation; and (iii) exchange rate effect, which cannot be effective for the world as a whole.

Why is price deflation so bad?
Deflation squeezes business profits. It occurs when spending is weak and when firms have to work harder than ever just to survive. This means that more firms than usual do not survive. So more people become unemployed, more people default on their loans, and less tax is paid.

Effective ('real') interest rates rise substantially, as banks find it very difficult to levy negative interest rates. Further, with more bank loans subject to default, more people withdraw from the banking system. They place money – in the form of notes issued by their nation's Reserve Bank – under their beds or in their bottom drawers. These notes – as a form of personal asset – confer a capital gain to their possessors, in that they can buy more stuff as prices fall.

Debts get larger relative to prices, accentuating the inequalities between creditors and debtors. Attempts to repay debt make the deflation problem worse, because the key driver of deflation is *non*-spending. In short, prolonged global deflation is tantamount to global economic and financial collapse. It is far worse than global inflation; indeed global inflation served in the 1970s as a way of writing off debts. Global inflation helped to rebalance a very unbalanced economy in the wake of the 1974 oil price shock. Global deflation, however, aggravates existing credit-debt imbalances.

The 1920s and agricultural commodities
In the 1920s, the deflationary spiral that became the Great Depression was well underway before the financial collapse of 1929. In particular, primary product prices were falling consistently from 1926, due in large part to both global expansion of lands cultivated and mined, and to substantially increased mechanisation and productivity in primary production.

In New Zealand the problem was substantially aggravated by the British general strike in the later part of 1926. The ensuing repercussion of farm deflation was that more indebted farmers walked off their farms in 1927 than in any year of the Great Depression (1931-34 in New Zealand). In addition to the loss of farms, the introduction of milking machines underpinned a substantial migration of young people to the cities, in 1927-30. There was severe downward market pressure on wages in these years.

We see similar issues arising today – hence Shamubeel Eaqub warning (Growing Apart) that some of our provincial towns are becoming economically unsustainable. Productivity increases add to a growing world glut of dairy products. Further dairy farmers in 2015, as in the mid-late 1920s, are burdened with debt.

What looked in the late 1920s as a boon to consumers (falling prices of food and energy) proved a loss of livelihood – falling incomes – for many. This was aggravated by increasing labour supply – city immigration combined with teenagers and women entering the labour force to compensate for lost adult male incomes.

Ending the 1930s' Great Depression
The thesis of secular stagnation, noted earlier, suggested to some that there would be no recovery from the 1930s' Great Depression. Loose monetary policies had, at most, zero impact on deflation. Devaluations were effective in individual countries, given that different countries faced their worst conditions at different times from each other, but aggravated conditions in other countries. New Zealand's devaluation of January 1933 was especially effective in raising prices paid to farmers. Inflation – albeit very low inflation – was restored in New Zealand in 1933.

But it was debt-funded government spending that got most countries out of the economic crisis. This was the fiscal policy stimulus advocated by British economist JM Keynes, and others including New Zealand's own 'brains trust'.

The problem was always a lack of spending. Once sufficient government counter-austerity was able to offset entrenched private sector austerity, employment revived, and incomes increased substantially. Business confidence increased as governments increasingly became the customers of business.

Eurozone today
What of Greece (see The Rumblings of the Left: Podemos, Syriza and Greece, Binoy Kampmark, *Scoop* 26 Jan) and the rest of the Eurozone in 2015? The new Greek government should at least be able to redirect debt service 'spending' to rebuilding government services, and may achieve a whole lot more. Greece may leave the Eurozone. If Greece leaves, Portugal and Spain may follow. (Further, I'm picking Belgium, France and Finland to be the next victims of German mercantilism.)

The Eurozone acts – and is meant to act – much as the gold standard once did. The fixed-exchange system has a substantial deflationary bias, and it requires 'internal devaluations' in place of the conventional depreciations that are associated with floating exchange rates. The underlying idea is that countries like Greece and Spain must have deflation in lieu of currency depreciations. And countries like Germany and Netherlands should have inflation in lieu of currency appreciations.

One problem is that these internal price realignments are technically more difficult to achieve than most economists would admit. The bigger problem, however, is that countries like Germany refuse to implement their side of the Euro-rebalancing-contract They ask Greece to deflate but refuse to implement an internal revaluation (inflation).

New Eurozone members Latvia and Lithuania underwent voluntary internal devaluations – economic 'cold turkey' – creating huge increases in unemployment in order to become 'competitive' within the Eurozone. This indicates why Germany will not play its own game; the rules require that Germans reduce their productive effort in order that Germany becomes less competitive. (We might note that Japan – to its credit – has acted to inflate and reduce its competitiveness.)

Final Comments
In my earlier reference to crises in the 2030s, I took a more optimistic view. In that article I wondered whether two very different crises would act in the future to effectively cancel each other out. However I am reminded by a book I read a few years ago (Christopher Brown: *Inequality, Consumer Credit and the Saving Puzzle*), that suggested retired people actually have higher saving (ie non-spending) rates than younger cohorts. If so, then the possibility that spending by baby-boomer-seniors of their retirement savings might provide a counter-deflationary stimulus most likely will prove illusory.

I hesitate to forecast another global Great Depression in the 2020s. However I think that recent portents substantially raise the likelihood that the world economy faces two decades of deflation – as in the 1920-30s (and indeed as much of the world did in the 1820-30s). And prolonged deflation substantially raises the likelihood of economic depression.
