Feature Article

THE PRICE IS RIGHT

Deflation has a bad name. But when productivity is increasing, prices should be allowed to fall.

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IT'S official: We should all start worrying about deflation. That, at least, is the message most listeners took from Alan Greenspan's January 3 speech before the American Economic Association. The Consumer Price Index rose only 1.7 per cent last year, and, if critics of its current method of calculation are correct, consumer price inflation was probably close to zero. Producers' prices actually fell last year. By this reckoning, deflation really is staring us in the face. Steve Forbes, Robert Reich, the editors of the *Wall Street Journal*, and the chief economist at Merrill Lynch have all explained that, inflation having been vanquished, ``deflationary pressures'' are the new threat.

The Federal Reserve can prevent deflation. It need only expand its purchases of government securities, which it pays for with newly created Federal Reserve dollars that are subsequently deposited in commercial banks. In recent years, this expansionary monetary policy has more than compensated for the deflationary effects of productivity gains, replacing what might have been mild deflation with mild inflation. But the fact that the Fed can prevent deflation doesn't mean it should. Right now, we should be welcoming a long-awaited opportunity to watch the cost of living decline -- something it has not done since 1955. The idea that deflation must be avoided at all costs traces back to myths that arose in the 1930s, when the Fed did allow it to proceed too far.

Myth #1: Deflation always means depression or recession. Actually, it depends on the cause. The deflation of the early 1930s was a genuine disaster, involving massive declines in production and employment. But what made that deflation so painful, besides its severity, was its underlying cause: a collapse of the money supply, which in turn led to a collapse in consumer spending. Deflation can also be a consequence of improvements in productivity, in which case it needn't be harmful at all. Such ``benign,'' productivity-driven deflation was a common occurrence during the last part of the nineteenth century, when people routinely looked forward to goods' getting cheaper. Today, with productivity growing at more than 2 per cent annually, prices ought to be falling concomitantly.

Myth #2: Falling prices mean falling wages and earnings. Not if they're based on improvements in productivity. When productivity rises, the cost of producing goods and services declines. Prices of goods and services can then be cut painlessly, without any absolute decline in business earnings or wages. Last year, for example, workers' average weekly earnings rose by about 4 per cent, or more than twice the official rate of inflation. Had monetary policy allowed consumer prices to fall 2 per cent -- roughly the rate of overall productivity growth -- average money wages would have risen slightly above their 1996 level. But because of lower prices, average *real* wages would still have risen by more than 2 per cent, just as much as their recorded increase under mild inflation.

Myth #3: Deflation harms debtors. Again, not necessarily. Suppose, for example, that over the course of one year productivity unexpectedly rises 2 per cent and prices therefore unexpectedly fall 2 per cent. Then, although loans would be repaid in dollars more valuable than before, the dollars the borrowers made with the loan would also be more valuable. On the other hand, a productivity-driven deflation is very kind to pensioners and others living on fixed incomes: When lowered costs of production are reflected in lowered prices, persons on fixed incomes share in overall gains that would otherwise be enjoyed only by persons with flexible incomes. Why shouldn't the benefits of improved productivity be passed on to *all* consumers?

MYTH #4: A stable price level serves best to avoid booms and busts. When productivity isn't changing, a stable price level is indeed consistent with overall stability of consumer spending, business earnings, and profits. But all this changes when productivity is growing. In that case, monetary policy can keep the price level from falling only by artificially boosting consumer spending and industry earnings and, in the short run at least, profits. Although this might not sound so bad, it actually means trouble: high profits are fine when only certain industries experience them and others suffer losses, for then they serve as a useful signal for the reorientation of investment. But high profits all around are the result of unneeded Fed additions to bank reserves, which artificially lower interest rates. That, in turn, leads to overspeculation in asset markets, including real estate and stocks. Then comes a recession, when bad investments are liquidated.

During the late 1920s, for example, the Fed strove to maintain a stable price level despite ongoing improvements in productivity. The result was one of the more dramatic stock-market booms in history. Several noteworthy economists at the time urged the Fed to let the price level fall, thereby preventing the boom from getting out of hand. The Fed did not heed this advice until 1928, when a gigantic stock-market bubble was already set to burst.

Most economists now agree that it is a good idea to allow the price level to rise somewhat when productivity suffers a serious setback -- as it did, for example, following the OPEC-sponsored oil shortages of the 1970s. The arguments for letting the price level fall in response to improvements in productivity are less well appreciated, but no less sound.

Everyone accepts the basic principle when it comes to particular firms and industries. Recent reductions in computer prices, for instance, have harmed neither the computer industry nor the U.S. economy as a whole. But the computer industry is only one of many that have witnessed substantial gains in productivity in recent years. Indeed, there is hardly a good or service that isn't being produced more efficiently today than was the case in years past. So what harm could there possibly be in allowing *general* improvements in productivity to be reflected in *general* price cuts? The answer is, No obvious harm at all, apart from the psychological anguish felt by certain Fed officials and economic pundits every time the CPI threatens to decline.

In a passage of his speech that seems to have gone unnoticed by most commentators, Mr. Greenspan conceded that deflation is not dangerous so long as it is based on overall gains in productivity. Well, overall annual gains in productivity have been the rule rather than the exception in the U.S. economy; and recent productivity growth has been especially pronounced. Thus, far from being something to fear, steady, mild deflation is something we ought to welcome. Mr. Greenspan, bring on those lower prices. The doomsayers can cry all the way to the supermarket.
