

COMMENT & ANALYSIS: America is not in danger of deflation

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For most of the postwar era, deflation has been off on the radar screen of economic policymakers in the industrialized world. The United States has not experienced a sustained fall in prices since the Great Depression. Fighting inflation, not deflation, has been the main goal of most central banks. Yet today's newspapers are filled with claims that a ruinous 1930s-style deflation lies just ahead.

The story goes something like this: the end of a stock market bubble causes consumer spending and business investment to collapse. The subsequent fall in aggregate demand puts downward pressure on prices. Once deflation begins, the real burden of debt increases, so borrowers must cut their spending to pay off the real value of their debts and the cycle continues.

The new twist in the modern retelling of this story is the link between the fall in the stock market and the rise in housing values since 1997. Some have argued that the inevitable decline in consumption has been delayed by consumers refinancing their mortgages, extracting equity so that consumption levels are maintained, for a time. But the day of reckoning will eventually arrive, consumption will fall and the deflationary spiral will begin.

This modern deflation scenario seems to make a lot of sense - until you get out your calculator. When you do, the basic features of the US economy look quite good and deflation appears unlikely. To start with, analysis of the productivity data over the past six quarters confirms some of the best news that economists have delivered in a generation - the acceleration in productivity growth that began in 1995 continues unabated. Thanks to this, today's consumers can look forward to real incomes that grow much more quickly than they have during the past 30 years - a good omen for current consumption.

But even if the future looks good, what about the present? Won't the decline in the stock market - and the consequent loss in current wealth - reduce consumption today? It is true that the decline in equity markets have removed wealth from the economy, which tends to depress consumption. Research suggests that a loss of one dollar in stock market wealth reduces consumption by about three to five cents over the following three years, holding other factors constant. But other factors have not been constant. Disposable personal income - the amount of current income that consumers can spend - has held up much better over the current business cycle than in previous recessions.

Of course, one can point to the strength of the housing market as a factor keeping consumption strong. House values have risen and low mortgage rates have encouraged homeowners to take out some of the equity in their homes through refinancing. But while this process has been a part of healthy consumption growth, it has been only a part. A study by the Federal Reserve of the home refinancing wave of 1998-99 found that it added only about \$10bn to consumption expenditure, which totaled \$6,200bn in 1989.

Home refinancing has also been high in the past two years but the same lesson seems to apply.

The question of why house prices have risen so much in the past few years is interesting. The surge in immigration during the 1990s and the lack of land suitable for new housing in some cities with tight zoning restrictions are probably part of the answer. But fears that the US housing market is in the midst of a bubble are unwarranted. Behind any bubble is the hope that an investor can purchase an asset for one price and sell it quickly for a higher price. This is hard to achieve with houses, because of the high transaction costs in housing markets. And without a rapid and nationwide decline in housing wealth, it is hard to see how deflation can occur.

Last, one cannot discuss deflation without an examination of the price data themselves. First, falling prices are not always bad - indeed, in most cases they are a crucial stabilizing feature of modern economies. For evidence, just ask your local car salesperson. The surge in car sales brought about by zero per cent financing offers should add from ? to 1 full percentage point to gross domestic product growth in the third quarter.

Second, a sustained decline in prices that magnifies the real burden of debtors is not likely. In fact, the inflation rate for consumer commodities, which turned negative in 2001, has turned round and is now headed for positive territory. Moreover, the inflation rate for consumer services has stabilized at little more than 3 per cent a year. Private forecasters expect the overall rate of consumer inflation to rise to about 2.4 per cent in 2003 as the recovery takes hold.

In short, the stock market decline will not cause consumption expenditure to collapse. House price inflation may well moderate in the next few years but there is no housing bubble about to be pricked. Refinancing has helped maintain consumption growth but has not propped it up. And the economic fundamentals are sound.

While in the long run deflation - like inflation - is a monetary phenomenon, low aggregate demand is not likely to push the US toward deflation any time soon. It is a pretty boring story, compared with those told by the deflationists. But it does pretty well when confronted with the facts.

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