

Debt Deflation: Can It Occur? Is It Dangerous?

Not long after the U.S. economy exited the 2001 recession, a few pundits sounded the alarm for a potential double-dip recession (including this author). Now, a smaller group raises the specter of a debt deflation. What is debt deflation? Is it dangerous?

What Is It?

A debt deflation occurs with a convergence of high debt levels by the private sector and a general pattern of falling prices or deflation, not just a decline in the rate of increase in prices. Currently, private debt levels in the U.S. exceed previous post-WWII highs at 150-percent of GDP. While deflation has not arrived, the inflation rate has fallen to within hailing distance of zero.

Deflation produces dangerous tendencies. Consumers delay purchases today, expecting even lower prices tomorrow. Merchants see losses in their sales and cut back orders. Production slows. Fear of job losses further lowers spending. Debt burdens impinge on economic activity as income shrinks. For example, deflation lowers the value of your home, erasing your equity, since the mortgage amount owed (and the monthly payment) do not change. Bankruptcies rise and the financial system becomes ever more fragile. A vicious circle spins in a downward spiral.

Deflation causes an additional problem for the monetary authority. The interest rate cannot fall below zero, since people can always hold non-interest earning cash. Suppose for the moment that the Fed could drive the interest rate below zero. Then people would switch funds from assets that earn a negative return to cash where the interest rate is zero. That is, cash dominates assets with a negative interest rate. In addition, deflation means that the real value of cash, its purchasing power, increases over time. In other words, while inflation imposes a tax on cash holding, deflation pays a return on cash holding.

The Federal Reserve (Fed) ordinarily can stimulate the economy by driving the real interest rate below zero, where the real interest rate equals the contract interest rate minus the inflation rate. To illustrate, facing a 3-percent inflation rate, savers need to earn 3-percent on their saving just to keep purchasing power constant. To see purchasing power rise requires an interest rate above 3 percent. For example, a 6 percent interest rate produces a 3-percent real return – 6-percent interest rate minus 3-percent inflation. So,

the Fed wants to lower the real interest rate below zero to encourage borrowing for consumption and investment. During a deflation, the Fed can no longer drive the interest rate below the inflation rate, which is now negative. Thus, monetary policy loses its power.

Has It Happened?

The Great Depression of the 1930s provides the classic example of a debt deflation. The private sector was burdened by high debt. Between 1929 and 1933, the price level fell by about 25%, causing the real interest rate to rise. Banks closed their doors; sources of credit evaporated. Combined with the stock market collapse in 1929, private sector wealth shrank dramatically. Finally, unemployment rose to around 25%.

At that time, the Fed, a relatively young institution, did not fully understand how it could control the economy. The emergence of deflation, however, probably made it impossible for the Fed to intervene effectively, even if it had fully comprehended its powers. John Maynard Keynes argued that monetary policy faced a “liquidity trap” and was impotent. That is, monetary policy was characterized as “pushing on a string.”

Can It Happen Today?

Those who warn of a possible worldwide deflation point to the current economic situations in three countries – Japan, Germany, and the U.S. Recession has stalked the Japanese economy for over a decade. Japan experienced deflation over the last 4 years. Interest rates fell to zero, or nearly so (e.g., the overnight collateralized rate currently equals 0.001%).

Germany’s policy makers can no longer freely operate as they see fit, since they must now respond to the dictates of the European Central bank and the European Monetary Union (EMU). The EMU currently targets a 2% inflation rate, but Germany’s is nearer 1%. Absent the EMU, German monetary policy makers would lower interest rates more than currently permitted. As such, it is easy to see how the German economy could slip into recession with deflation.

Whither is the U.S. economy? Our inflation rate has also reached the 1% level. The Fed argues that it appears unlikely that the U.S. economy could tip into deflation. But the rising unemployment rate and the possibility of a double-dip recession place downward pressure on the inflation rate.

Is It Dangerous?

The \$64 question, however, is how U.S. policy makers would respond to a debt deflation. As noted above, U.S. private sector debt has reached unprecedented levels. Some analysts have urged the Fed to lower interest rates now to ensure that the U.S. economy does not tip into a deflation. The Fed answered that call on November 6th with a 50 basis point reduction in the federal funds rate.

If the economy slips into a deflation and if monetary policy becomes impotent, are all bets off? No. The Great Depression spawned Keynes's most important observation. In such circumstances, the federal government can and should fulfill its fiscal function of "spender of last resort". Even Milton Friedman argued that the Great Depression might have represented the only time when fiscal policy dominated monetary policy as the tool of choice.

When monetary policy loses its traction, then policy makers need to engage fiscal policy – tax cuts and/or spending increases. Tax cuts seem most probable, given the recent Republican electoral gains. But tax cuts rely on households and business to carry the spending burden, something that households have done in recent years. High debt burdens, falling consumer and business confidence, and rumors of war may stop such spending from materializing. If so, then government spending may represent the last out. Many spending options exist – spending on homeland security, education, health care, perhaps war, and so on. But, should such fiscal spending become necessary, can Congress and the President generate the political will to provide the needed spending? That is the question.

Will It Happen?

It could happen, but the probabilities seem slender, at best. The Fed primed the economy with 11 interest rate cuts in 2001. While little evidence yet exists of those cuts' effectiveness, monetary policy does possess long and variable lags of up to two years. So, the private sector debt load, falling consumer and business confidence, and the rumors of war probably delayed the full response to the Fed stimulus.

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