American Enterprise Institute for Public Policy Research

Economic Outlook

March 2009

Inflation Is Better Than Deflation

By John H. Makin

"Because no great strength would be required to hold back the rock that starts a landslide, it does not follow that the landslide will not be of major proportions."

—Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States: 1867–1960*

As the global financial and economic crisis has grown increasingly dire—the deterioration just since the November U.S. election is breathtaking—market participants and policymakers alike have looked to three past crisis models as part of an intensifying search for ways out of the current crisis. First, the Great Depression of the 1930s is being examined ever more closely for possible lessons now that commentators have moved past an under- standable reluctance to mention that experience as relevant to today's situation. Second, the Scandinavian financial crisis of the early 1990s, which included a proactive move toward bank nationalization by the Swedish government, is also widely discussed. Finally, many allusions have been made to the disquieting parallels between today's U.S. experience and that of Japan during its "lost decade" (1991–2001) of recession and deflation, especially after 1998.

Most of the lessons from past crises arise from painful demonstrations of what not to do in a crisis. The most compelling message to emerge from the experiences in postbubble economies centers on the need to avoid deflation and intensifying deflation expectations. Those are two necessary conditions for recovery. It is disconcerting that an antideflation message has not yet been transmitted clearly by central banks as the weakness in the global economy has worsened sharply over the past several months and demand has collapsed relative even to rapidly falling output. The awkward but compelling conclusion from postbubble periods is this: it is better to risk a period of higher inflation than it is to risk an episode of self-reinforcing deflation.

John H. Makin (jmakin@aei.org) is a visiting scholar at AEI.

Lessons: Encouraging and Disquieting

A careful examination of each of these crisis episodes is at once informative and disquieting in terms of possible lessons about causes and cures for the current global panic. The Scandinavian and Japanese crises resulted from the bursting of asset bubbles, which rendered banking systems dysfunctional. However, they were not nearly as difficult to manage as the current global financial and economic crisis insofar as they were not as broad in scope. In contrast, the Great Depression engulfed Western Europe and America but, again, was somewhat more contained insofar as it did not include, to nearly the degree that today's crisis does, the emerging markets of Latin America, Eastern Europe, and Asia. Asia here includes, of course, what has been a newly industrialized,

super-growth engine: China. Indeed, even in the current crisis, the emerging markets group was, until only a few months ago, thought to be "de-linked" from the intensifying problems of the industrial world that are tied to the collapse of housing values and to the resultant collapse of consumption and bank balance sheets.

But now, in 2009, there is no place to hide in the global economic financial system. The current crisis may not yet be as intense as the Great Depression (output and prices have not fallen by a third as they did in the early 1930s in the United States), but the crisis is more widespread and may well, as a result of its ubiquity, rapidly intensify. Beyond that, in this crisis, asset prices have already fallen by enough to erase more than a third of global wealth. U.S. home prices have dropped by at least a cumulative 25 percent and appear headed to descend 20 percent further. Major U.S. equity markets have dropped by more than 50 percent. Arguably, these huge wealth losses are more damaging to the global economy than the sharp drop in output and goods prices that occurred during the early years of the Great Depression. Sharp wealth losses prolong and intensify the increases in desired saving that depress demand growth and intensify pressure for more deflation.

> Japan's experience during its "lost decade," and more recently during the current crisis, provides powerful evidence of the dangers of allowing deflation to emerge and persist.

Lessons from Sweden and Japan

Despite their relatively narrow scope within the global system, the Swedish and Japanese crises are worth examining for the lessons they provide to those attempting to contain the current crisis. Sweden's approach to its financial crisis was transparent, preemptive, and systematic. Sweden began its program with a "bank support guarantee" approved by its parliament, the Riksdag, in December 1992 after a year of sharp economic contraction and sharply falling bank shares. All but the shareholders of banks were protected, no upper limit on state support was set, and the efforts by the Swedes were advertised globally. The absence of an upper limit placed the Swedish state in the position of guaranteeing the solvency of the banks that it was going to either keep in operation or stabilize through interim nationalization.

The Swedish effort laudably emphasized openness regarding the extent of the problems faced by the banks. Rather than allowing banks to defer recognition of market losses, steps were taken to report all expected losses and to assign realistic values to real estate and other assets with the help of a valuation board. Three classes of banks were established: those that would probably continue to satisfy an 8 percent capital adequacy requirement; those that might fall below the capital adequacy limit of 8 percent but would satisfy it later on; and those that were not viable, in which case bad assets should be sold off and the banks merged with stronger institutions.

The Swedish effort recognized that bank capital losses needed to be covered before banks could move forward as viable entities. State support of the banks during the crisis was undertaken to avoid the forced sale of assets.

The Swedish government established workout units whose task was to receive nonperforming loans and dispose of them at a realistic market price. The state received preferred shares for capital contributions to banks with voting power rising over time if loans were not repaid—in effect, a program of automatic nationalizations if the banks relied too long on state support. In return for state support, government representatives were placed on the boards of banks to monitor cost-cutting and management improvement efforts.

Sweden arguably faced a more manageable situation, in terms of its scope, than the present one. But the key elements of its government's policy—transparency, proactiveness, and systematic application—were the opposite of the approach taken, so far, by American policymakers to the current crisis. "Opaque," "ad hoc," and "unsystematic" accurately describe the response thus far to the crisis that emerged openly in August 2007. This was typified by the unfortunate February 10 presentation of a financial rescue package by Treasury Secretary Timothy Geithner. That said, the same criticism applies as well to all of the G7 countries, whose governments have spent much of the last eighteen months first denying that a crisis existed and then promulgating ad hoc responses that have been insufficient to contain it.

It would be misleading to claim that Sweden's program for dealing with its banks constituted, by itself, a solution to Sweden's economic and financial crisis. As a relatively small, open economy, Sweden was able aggressively to reflate and stimulate demand for its output by allowing its currency to float. The resulting rapid depreciation of the

krona against the deutsche mark by 30 percent, paired with the establishment of a viable Swedish banking system, formed a policy combination sufficient to reignite Swedish growth and move most of its banks into private hands. Shares of Swedish banks rose, on average, by a factor of seven during 1993 as the banking system recovered and Swedish growth turned positive by the third quarter that year.

Sweden's status as a small, open economy—not one engulfed in a global crisis of the scale we are seeing in 2009—enabled it to undertake the reflationary, sharp, and sudden currency depreciation that helped to return the country to growth. It is important to understand that that option is not available today to the large economies engulfed in a global crisis. Rather, the current behavior of currencies relative to each other and relative to gold is being determined by an intensifying search for a safe haven store of value.

The strengthening of the currencies of countries with capital-account surpluses underscores the dangers of intensifying global deflationary pressure. Take the example of Japan. As capital is repatriated by nervous Japanese investors, the yen strengthens. Yen appreciation exacerbates Japanese deflation, thereby resulting in a dynamically unstable increase in desired cash holdings that further exacerbates deflation and currency appreciation. This deflationary cycle coupled with a collapse in Asian growth caused Japan's economy to contract at an astonishing 12 percent annual rate during the fourth quarter of 2008. Japan has shown again that currency appreciation in a deflationary world is extremely dangerous, just as Sweden's experience after 1992 demonstrated the benefits of currency depreciation for a small, open economy not facing a global contraction.

Japan's experience during its "lost decade," and more recently during the current crisis, provides powerful evidence of the dangers of allowing deflation to emerge and persist. Japanese officials exacerbated their country's woes by exaggerating the scale of fiscal policy packages designed to stimulate the economy, while also failing to acknowledge and address the reality of a dysfunctional banking system.

During the 1990s, Japan announced numerous stimulus packages that boasted values as large as 4, 5, and 6 percent of GDP. These efforts intensified after a disastrous decision in the spring of 1997 to effect an increase in taxes on consumption. Japan's pattern of inflating stimulus packages by including multiyear expenditures and expenditures on items that would otherwise have been undertaken anyway is disconcertingly similar to the approach of the Obama administration in articulating its $787 billion stimulus package. Beyond that, the Obama administration made a crucial strategic error by electing to implement an inflated stimulus package before attacking the daunting problem of fixing the financial system. During 1998, even as Japan implemented massive fiscal stimulus packages, it announced a support program for troubled banks equal to 12 percent of GDP (the equivalent of $1.71 trillion in current U.S. dollar terms). But the economy continued to shrink in nominal terms. The stimulus packages were not ever fully carried out, and the financial rescue package, like U.S. packages so far, was opaque, reactive, and unsystematic.

Japan languished in recession until the world economic recovery after 2002 because it failed to recognize the extreme dangers arising from a byproduct of persistent deflation and negative nominal GDP growth. When the value of all the goods and services produced in the economy is persistently falling, profits shrink, investment dries up, and consumers spend less in anticipation of further cuts in prices. Ominously, the annualized drop in U.S. nominal growth was 4.1 percent during the fourth quarter of 2008—a virtual collapse from the positive 3.4 percent growth figure for the third quarter. Year-over-year nominal GDP growth fell to 1.7 percent. By the first quarter of 2009, year-over-year nominal U.S. GDP growth will drop below zero for the first time since 1958.

By the first quarter of 2009, year-over-year nominal U.S. GDP growth will drop below zero for the first time since 1958.

Negative year-over-year nominal GDP growth is virtually unknown in the postwar period outside Japan, save for two brief episodes in the United States during 1954 and 1958 that were tied to external factors. Persistently negative nominal GDP growth tied to a global economic slowdown and intensifying deflation is a phenomenon not seen globally since the Great Depression. In Japan, year-over-year nominal GDP growth fell to –2 percent during 1998 and remained negative for over two years after the poorly timed 1997 consumption tax increase, the Asian crisis, and poor implementation of stimulus and financial rescue packages.

With the benefit of hindsight, it is probably fair to say that Japan did everything wrong in dealing with a post-bubble financial and economic collapse. Poorly designed fiscal stimulus packages with inflated numbers attached;

opaque, reactive, and haphazard measures to try to restore a functional banking system; and a failure, proactively, to address an emerging deflation all doomed Japan for more than a decade of low growth and massive wealth loss. For its part, the Bank of Japan eventually ended up cutting interest rates to zero by 2001, but it did so only reluctantly with announcements couched in promises that the minute prices started to rise again, it would abruptly reverse the low rates and easier liquidity conditions.

The European currency system will not survive a period of persistent deflation.

The most disconcerting aspect of the American response to the crisis (and to varying degrees the responses of other industrial countries) is the persistent repetition of mistakes made by Japanese monetary and fiscal authorities as they struggled to contain the economic and financial damage from the bursting of Japan's asset bubble in 1990. This is especially disquieting since many of the leading U.S. policymakers today, including Federal Reserve chairman Ben Bernanke and National Economic Council chairman Lawrence Summers, were advising the Japanese aggressively to reflate after 1998 in order to contain the damaging deflation that had emerged. Let us hope they heed their old advice now because, if anything, the problems facing American policymakers today are considerably more daunting than the problems that faced either Swedish or Japanese policymakers. Today's world losses are far larger and more widely dispersed than those confronting Swedish and Japanese authorities.

The Swedes had two advantages. They chose to deal with the financial crisis first, and they had the option of stimulating the economy through a sharp currency depreciation, which helped to avoid intensifying deflation. The Japanese mishandled stimulus packages and financial rescue packages, but most damaging, they allowed deflation to emerge and persist for far too long. If nothing else, the experience of the Swedish and Japanese with their financial crises confronts U.S. and other G7 policymakers with sobering realities in 2009. So, too, do the lessons of the Great Depression.

Lessons from the Great Depression

America's experience after the stock market collapse in 1929 was part of a global deflationary environment that emerged as central banks, and especially the Federal Reserve, allowed a sharp contraction in the money supply at a time when intensifying deflation was boosting the demand for money. The result was a sharp drop in prices, especially of agricultural products, that put increasing pressure on employing weaker exchange rates as a means to cushion the deflationary impact of the spreading global depression in the early 1930s.

The British, who had been defending an overvalued pound since the inadvisable return of sterling to the gold standard in 1926, were forced to devalue in 1931, thereby relieving some of the deflationary pressure in the United Kingdom and eventually providing a recovery in industrial production. It is important to understand that because the industrial world was on a gold standard at the time of the asset bubble collapse in 1929 and afterward the way to implement a reflationary devaluation of the currency was to boost the currency price of gold.

During the disastrously contractionary 1931–32 period in the United States, citizens began hoarding gold as a store of value in anticipation of a boost in its dollar price. During 1933, the Roosevelt administration moved to prohibit gold hoarding and eventually forced all private U.S. citizens to disgorge their gold to the government at a price of $22 an ounce, after which time, in 1934, the official price was raised to $35 an ounce. That step had two important implications. First, it devalued the dollar against currencies then pegged to gold, such as those of France and Belgium. Second, it accomplished a sharp reflation of product prices, including those of internationally traded agricultural products, and thereby helped to arrest deflationary pressures in the United States while aiding the beleaguered American agricultural sector. That sector was the locus of much distress tied to the rising burden of debt in a deflationary environment. The reflationary step of sharply boosting the dollar price of gold helped U.S. industrial production to recover sharply until 1936, when the Federal Reserve prematurely began to withdraw liquidity from the U.S. financial system, thereby precipitating another sharp collapse in the economy.

The Importance of Avoiding Deflation

The lessons derived from the postbubble crises during the Great Depression and later in Sweden and Japan are many, but perhaps the most important one is the demonstrable need for a reflationary shock to end deflationary expectations and ensure positive, nominal GDP growth. The fundamental reason that a reflationary shock is needed in a postbubble period is tied to the need to

reduce the real burden of debt. As bubbles inflate, households and firms assume more and more debt with interest rates fixed largely in nominal terms.

During the Great Depression, much of the debt was taken on by the agricultural sector, so that the collapse in agricultural products resulted in an even more acute increase in the real value of debts and led to the dust bowl and the migration of American farmers westward. During the current crisis, overly indebted U.S. households are at the core of the rising real debt burden from collapsing home prices, incipient deflation, and declining consumption. Clumsy U.S. efforts to reduce the burden of debts tied to real estate by, in effect, mandating or buying down the rates simply switch the burden of debt from borrower to lender and in the process assure that lenders will cease to lend.

Because the United States is not on a gold standard, it does not have the option to devalue the dollar against gold and thereby provide a sharp reflationary thrust to U.S. and global recovery efforts. The devaluation of any major currency today simply exports deflationary pressure to other currency areas where, say, a weaker dollar means a stronger local currency. Japan is already experiencing this difficulty. The dollar does not depreciate despite frequent warnings to the contrary simply because no one can provide a consistent answer to this question: against what?

Yes, the yen has appreciated somewhat, largely because of repatriation efforts by Japan's global investors, but the resultant deflationary impact on Japan's economy has only precipitated more economic and financial distress. Even yen appreciation appears to be reversing as Japan's collapsing current account surplus reduces the demand for yen. The result is more deflationary pressure on the United States as the trade-weighted dollar rises in value.

Again, there is a clear lesson from the postbubble experiences during the last seventy-five years. Central banks must clearly articulate policy measures that will arrest deflation and the attendant disastrous collapse in nominal GDP. Deflation is an unstable process because as prices fall and nominal GDP shrinks, the real burden of debts rises, financial institutions' viability is severely impaired or destroyed, consumption and investment collapse, employment falls, and another round of further deflation continues the cycle.

To put it simply, it is a more attractive policy alternative to risk some inflation than to allow deflation to intensify. The "landslide" analogy of Friedman and Schwartz, cited at the beginning of this *Outlook*, is apt when it comes to deflation and intensifying deflation expectations. The Federal Reserve has begun to indicate its concern about deflation by suggesting that it wishes to avoid an inflation rate that is below that consistent with stable growth of output. That is a step in the right direction, but it is not explicit enough. Central banks need to articulate clearly their determination to assure that next year's price level will be higher than this year's. That way, the anticipated real burden of debt does not rise, and households do not reduce consumption even more in anticipation of continued falling prices. Investment will be the last to recover, but in an environment where higher future prices are expected, at least the redundancy of the existing capital stock is not being multiplied daily by consistently falling prices.

The most important lesson about targeting a higher price level and the policy implications that arise therefrom comes from Japan's experience. Throughout a period of persistent deflation, wealth destruction, and negative growth, the Bank of Japan was never willing to articulate a target of above-normal inflation in order to mitigate the real burden of debt and to quell behavior tied to a broadening expectation of falling prices.

The European Central Bank continues to express its concern about incipient inflation and will probably do so until actual deflation engulfs Europe and creates a quagmire even worse than the one that is already emerging. The European currency system will not survive a period of persistent deflation.

Leadership on the reflationary front will have to be exercised by the U.S. Federal Reserve. The Fed needs to announce clearly its intention to prevent deflation by declaring a future price-level target that implies an inflation rate averaging between 2 and 3 percent per year until the real burden of debt and the attendant contractionary behavior in the economy begin to atrophy. In effect, the Fed needs to set a level of expectations that largely validates existing nominal contracts, such as mortgages of 5 percent. If inflation runs at 3 percent for several years, the Fed will have to move eventually to reestablish a credible inflation rate somewhere below that—probably at 2 percent. While that may be a daunting task that carries risks, it is a far more manageable task than arresting accelerating deflation expectations should the U.S. price levels start to fall at a rate of 2 percent or more. The rule that applies to financial rescues—be transparent, proactive, and systematic—also applies to central bank policy when it comes to arresting a move toward highly damaging deflation.