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There ought to be deflation

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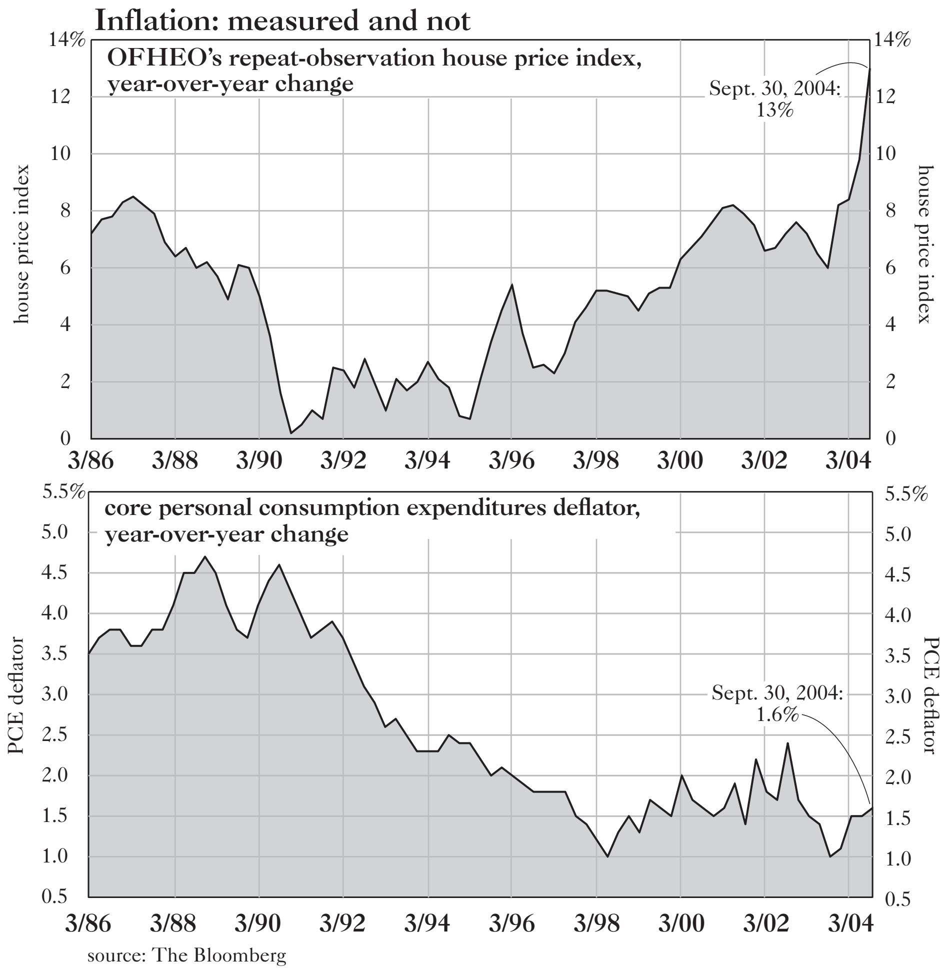
The world is a cornucopia. Thanks to the infernal machine of American debt finance, the Internet and the economic emergence of China and India, among other millennial economic forces, goods are superabundant. More and more services, too, are globally traded, therefore cheaper than they would be in the absence of international competition. Yet the measured rate of inflation in the United States is positive, not negative, as it was in so many prior eras of free trade and technological progress. Following is a meditation on the meaning of this fact and some thoughts on what to do about it.

From George Washington until the A-bomb, prices alternately rose and fell. They rose in wartime and fell in peacetime. As Alan Greenspan himself has pointed out, the American price level registered little net change between 1800 and 1929. Four years after the Crash, the Roosevelt administration put the gold standard, or what was left of it, out of its misery. In 1946, the Truman administration passed an act to mandate full employment. In effect, inflation became the law of the land. "In the two decades following the abandonment of the gold standard in 1933," Greenspan noted not long ago, "the consumer price index in the United States nearly doubled. And, in the four decades after that, prices quintupled. Monetary policy, unleashed from the constraint of gold convertibility, had allowed a persistent overissuance of money." That is, Greenspan added, until now.

The chairman was holding forth in December 2002, a time when—so his colleagues and he insisted—the U.S. confronted a meaningful risk of falling prices. To forestall this supposed crisis, the Fed pushed down the funds rate to a 46-year low. The object of this policy was to restore the familiar post-war lift to the American price level. Oddly, the public registered no protest, though, as consumers, Americans love a bargain. Economists



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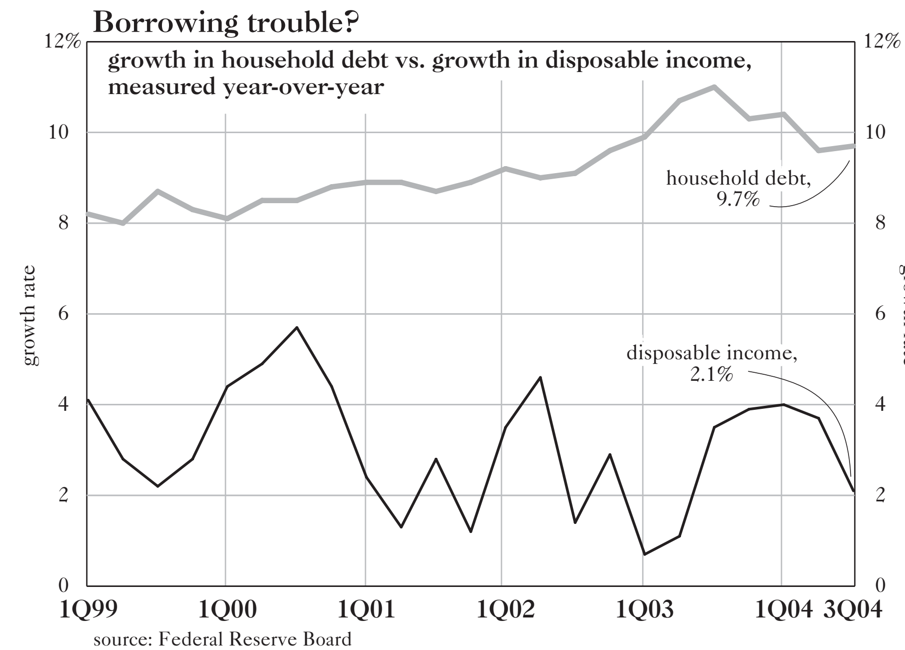

had drummed it into their heads that falling prices were bad for growth, bad for employment, bad for debtors and, not least, bad for the way the Fed conducts monetary policy. Let the central bank guide the price level gently higher, the call went out.

Which, by appearances, the central bank has done. Supposedly, the great Greenspan has implemented a perfect measure of monetary stimulus. He has averted deflation while steering clear of what the bond market might regard as a worrying rate of inflation.

At least, so say the members of the loosely organized Greenspan for Mount Rushmore Committee. *Grant's* has an alternative view, which requires a short definitional preface. What inflation is not, we believe, is "too many dollars chasing too few goods." Pure and simple, it is "too many dollars." What the redundant dollars chase is unpredictable. In recent months, they have chased stocks, commodities, euros, junk bonds, emerging-market debt and houses. On Wall Street, such inflationary episodes take the name "bull markets." They are always welcome. When, on the other hand, the surplus dollars chase skirts (or sweaters or automobiles or medical care), that phenomenon is called "inflation." It is usually unwelcome.

Deflation is not quite the opposite of inflation. We would define deflation as too few dollars chasing too much debt. Dollars extinguish debt; too few dollars in relation to the stock of debt is the precondition for what, these days, is euphemistically called a "credit event." A second-order effect of a credit event is falling prices. Prices fall because, in a big enough credit event, business activity stops cold. In the absence of liquid markets, cash is king. But we would not throw around the term "deflation" to describe every episode of weak or falling prices. If prices fall because the global supply curve has shifted downward and to the right, we would call that circumstance "falling prices." "Deflation," to us, means "debt deflation."

Pending the worldwide acceptance of these ideas (which we have borrowed from economists long dead), we will accommodate our views to the world's. This means we will not pedantically enclose the conventionally employed words inflation and deflation with quotation marks. But the world is doing itself no favors by so narrowly defining inflation and by so carelessly crying deflation.

The Fed is, of course, a prime perpetrator of sloppy thought, loath to acknowledge that inflation is anything other than an unacceptable rate of rise in its favored inflation index. This index is the personal consumption expenditure deflator, excluding such minor and discretionary items as food and energy. It is not that the Maestro has refused to acknowledge that the world's cup of goods and services runneth over. In so many words, he has conceded that the global supply curve has shifted in the direction of plenty. But, as far as we know, he has not followed this observation where it logically leads. If everything else were left the same, the measured inflation rate might, by now, be negative. We emphasize "might," as the cornucopia effect of greater, and cheaper, global supply is offset to a degree by the depreciating dollar exchange rate. However, we are certain that, except for heavy Fed intervention, the measured rate of inflation would be lower than it is now. So, too, the "unmeasured" rate of inflation, by which we mean house prices, credit spreads and other such markers of asset valuation.

We are prepared to wager that the Maestro knows more than he lets on about the true nature of inflation and deflation and about the tendency of the U.S. price level to subside in a world so generously supplied as this one. And we are equally prepared to wager that he has some appreciation of how highly leveraged are American families and businesses. In relation to income, the stock of debt has been rising for decades. If the price level reversed course and declined, uncounted net debtors would struggle to stay solvent. Falling prices, even if they were not caused by a credit event, could easily provoke one (in which, for example, trillion-dollar government-sponsored enterprises just might have to call in their chits to the Treasury).

Small wonder, then, that everything has not been left the same. The Fed, warning about the dire consequences of the "zero bound" (by which it means a federal funds rate stuck at zero percent) and invoking the specter of Japanese stagnation, or worse, assumed a radically easy monetary stance in 2001. It has taken five tightening moves to bring the funds rate back to $2\frac{1}{4}\%$, at which point it is still 75 basis points lower than what passed for an ultra-low funds rate during the 1992-93 easing cycle. The late Daniel Patrick Moynihan spoke of "defining deviancy down." The Fed has been redefining accommodation down. It has been pushing low interest rates lower and lower.

The interest-rate stimulus administered by the Fed in 2001-03 showered wealth on the homeowners who refinanced their mortgages not once but over and over, extracting equity as they went. But as interest rates have stopped falling, the shower is over. So it goes with monetary palliatives.

Friedrich von Hayek, winner of the Nobel Prize in economics, touched on the risks of credit creation in a speech as he accepted the prize 20 years ago. Beware the nostrum of printing money to boost aggregate demand, he warned. Such a policy is, of course, inflationary, but the problem goes deeper than that. Money printing distorts prices and wages, the traffic signals of a market economy. Responding to the wrong signals—spending on red and saving on green—people take the wrong jobs and capital flows into the wrong channels. All were misled by the wrong prices, or, in the past couple of years, by the wrong interest rates.

Said Hayek: "The continuous injection of additional amounts of money at points of the economic system where it creates a temporary demand which must cease when the increase of money stops or slows down, together with the expectation of a continuing rise in prices, draws labor and other resources into employments which can last only so long as the increase of the quantity of money continues at the same rate—or perhaps even only so long as it continues to accelerate at a given rate. What this policy has produced is not so much a level of employment that could not have been brought about in other ways, as a distribution of employment which cannot be indefinitely maintained and which after some time can be maintained only by a rate of inflation which would rapidly lead to a disorganization of all economic activity."

Hayek spoke of injecting money "at points of the economic system," and it is in these favored niches that prosperity temporarily smiles (until the money printing or the interest-rate slashing comes to a stop and throws the process into reverse). To an investor, still more to a speculator, "temporarily" is the magic word. Could the Nobel laureate not be a little more specific? We must try to fill in the blanks ourselves. One notes, for example, reading the January 5 *Wall Street Journal*, that "With Market Hot, More People Now Have Third Homes." Rising interest rates must sooner or later cause the marginal third-home owner to become a two-home, or a one-home or even a no-home owner. One would suppose that a similar chain reaction is going to take place in other highly leveraged sectors of the U.S. economy. Which might they be? The FOMC itself, in a much-quoted passage in the just-released minutes of the December 14 meeting, serves up a helpful list. "Some participants," the text relates, "believed that the prolonged period of policy accommodation had generated a significant degree of liquidity that might be contributing to signs of potentially excessive risk-taking in financial markets evidenced by quite narrow credit spreads, a pickup in initial public offerings, an upturn in mergers-and-acquisition activity and anecdotal reports that speculative demands were becoming apparent in the markets for single-family homes and condominiums."

In a provocative letter to the editor of the *Financial Times* last weekend, Ann E. Berg, a former director of the Chicago Board of Trade, offered a Hayekian coda to the discussion of the U.S. trade deficit. To correct the huge and growing gap between what this country consumes and what it produces, the market has focused almost entirely on the dollar exchange rate. "I have yet to see a single analyst suggest the trade imbalance could be solved by a general contraction of consumer credit—something that would surely correct the import/export imbalance," Berg writes. "For 25 years, U.S. consumers have enjoyed increasingly easy credit due primarily to a declining interest rate environment."

But, as Berg goes on, in addition to falling interest rates, the American shopper has gained from the growth and resourcefulness of Wall Street in processing, packaging and distributing debt. The advent of futures and options, of swaps and securitizations has facilitated American borrowing "and lined consumer pockets with several hundred billion dollars over the past few years, particularly with the turning of unsecured credit card debt into asset-backed security agreements (home equity loans)." Conveniently for the United States, the "emerging" economies are better at producing and saving than at banking and consuming. Rising U.S. interest rates will likely slow the pace of borrowing, therefore of consumption in this country. However, as Berg notes, for the time being, consumer debt continues to rise faster than consumer incomes. And it is this fact that "will cause some creditors to demand higher risk premiums due to the greater default probabilities of borrowers. Anecdotal evidence suggests that some credit card issuers are demanding significant increases in monthly minimum payments. Further dollar depreciation helping spur export growth is therefore only one solution to the current account deficit. A tighter credit environment forcing a leaner consumer might prove an equally likely resolution, however unwelcome." However un-American.

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