Deflation

A derangement of money or credit, a symptom of which is falling prices. Not to be confused with a benign, i.e., downward shift in the composite supply curve, a symptom of which is also falling prices. In a genuine deflation, banks stop lending. Prices tumble because overextended businesses and consumers confront the necessity of selling assets in order to raise cash. When prices fall because efficient producers are competing to deliver lower-priced goods and services to the marketplace, that is called "progress."

An extreme example of a genuine deflation occurred after World War I. During the war, belligerent governments resorted to money printing to bridge the gap between income and outgo. In the United States, the Federal Reserve quashed interest rates and liberally extended credit to induce the public to buy war bonds. The result was soaring consumer prices—up 18% in 1918—and artificially low borrowing costs.

By late 1919, the inflated structure of wartime prices began to sag. In early 1920, a worldwide depression got under way. In the United States, the governor of the Federal Reserve Bank of New York, Benjamin Strong, confided that "[w]e must deflate." Up went interest rates and down plunged commodity prices. From May to December 1920, the Federal Reserve's index of 12 commodity prices fell by 40%. Between July and December 1921, a price index of 10 crops plunged by 57%. Wages and consumer prices registered substantial, though less dramatic, declines. By mid-1921, America's depression had bottomed and recovery begun. Prices stabilized, and deflation ended.

In 2013, central bankers the world over define deflation as a fall in prices, no matter what the cause. Many central banks, including the Federal Reserve, the Bank of Canada, the Reserve Bank of Australia and—as of January 2013, the Bank of Japan—"target" a rate of rise in prices of around 2%, and they fret that a rate of inflation of less than 2% will somehow lead to deflation. The merits of this approach to monetary policy can be endlessly argued, but the fact is that it's something new under the sun.

Prices fell persistently in the final quarter of the 19th century. A portion of the American electorate sent up a hue and cry against the decline and demanded that the government take inflationary countermeasures. But William Jennings Bryan, the political champion of the inflationists, was defeated for the presidency each of the three times he ran, starting in 1896. And when prices, on average, began to creep upward starting within a few years of Bryan's defeat, Americans began to complain about the high cost of living.

In 20th-century America, the CPI registered 12 consecutive months of year-over-year "deflation" in 1954-55 with few people seeming to notice, much less worry, to judge by coverage in the leading newspapers. In 1961-64, the CPI never showed an average annual increase of as much as 2% (the maximum was 1.65% in 1963), a record that, again, excited scant public or official concern. Consumer prices showed monthly year-over-year declines in nine of the 12 months in 2009, the year following a major credit crisis, but this bout of "deflation" reflected a run-up in prices in 2008 more than a run-down of prices in 2009; it was more optical than actual.

Nowadays, to forestall what is popularly called deflation, the world's monetary authorities are seemingly prepared to pull out every radical policy stop. Where it all ends is one of the great questions of contemporary finance.

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