Is the US economy heading into deflation?

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When the US economy went into recession last year, the initial concern among those economists who disagreed with the scenario of a rapid V-shaped recovery was that the recession would be somewhat prolonged, or that, even if a recovery did occur, the economy would quickly slide back again—giving rise to a so-called "double dip."

In the recent period, these predictions have given way to an even more serious concern: that the US economy has already entered a period of deflation not unlike that experienced by Japan following the collapse of its stock market and real estate bubble at the beginning of the 1990s.

These fears are being fuelled by the nature of the recession, which differs substantially from all others in the post war period. Previous recessions were set off by cutbacks in consumer spending, generally initiated by tighter monetary policies imposed by the Federal Reserve Board, followed by cuts in business investment. Economic revival from such recessions was generated by increased consumption spending, which eventually stimulated production and investment.

In sharp contrast to this scenario, during the recession of 2001, which extended over three quarters, not one as previously thought, consumer spending did not fall and has continued to remain high. The key factor was the drop in business investment.

The decline in real business capital spending for the first three quarters of 2001 has been estimated at $88.2 billion as compared to a fall in real gross domestic product of $57.2 billion over the same period.

What these figures make clear is that the economy as a whole was only sustained by consumption spending. However, this has created problems for the future. If consumption levels are already high—sustained by increased levels of debt—they cannot rise still further and provide a source of increased profits and a stimulus for investment.

This means that under conditions where sales remain relatively flat, the only road to increased profits is to cut costs. But while cost cutting, particularly the axeing of jobs, may increase profits for the individual company in the short-term, it exacerbates the problems of the economy as a whole. This is because increased unemployment leads to reduced consumption spending, adding to the pressure on profits and necessitating further cost cuts. The danger is that a vicious circle sets in.

Consideration of these processes was the subject of an article in the *New York Times* last Monday which claimed that the US was "caught in the strangest and perhaps most perilous recovery since the Depression."

An article in the *Washington Post* on the same day took up similar themes and pointed to the growing problem of overcapacity in all sections of the economy—from agriculture and steel to computers, software and financial services. In the manufacturing industry, where figures are available, the Federal Reserve estimates that factories were operating at 74.4 percent capacity last month compared to the average historical average of 81 percent over recent decades.

Overcapacity means a widening gap between the "potential output" of the economy and actual production. According to an article by University of California economist Bradford DeLong, published in the *Financial Times* on August 20, the American economy as a whole is operating 3-4 percent below potential. And while the forecast growth rate of 3.5 percent, if it is met, will prevent the output gap from widening it will do nothing to close it.

The existence of an output gap applies great pressure to profit rates via stagnant or falling prices.

"With production substantially below potential output," DeLong writes, "there is downward pressure on US inflation. We have already seen US inflation drop nearly in half over the past two years. The

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downward pressure is not expected to lessen for at least the next year and a half. This means that by the summer of 2004 the US will have an inflation rate—at least as measured by the GDP deflator—that is less than zero. The US will, if these forecasts come true, have joined Japan in deflation."

In a comment published on August 5, Morgan Stanley chief economist Stephen Roach noted that "like Japan, recovery in the post-bubble US economy is turning out to be fragile, at best."

"The politically correct spin coming out of Washington," he continued, "always ends up with the vacuous claim that the 'fundamentals of the US economy have never been sounder.' Sadly, in a post-bubble era—replete with excess capacity, low national saving, a huge overhang of debt, and a massive current account deficit—nothing could be further from the truth."

According to Roach's estimates, while the overall inflation rate remains positive at 2.2 percent, largely due to the rising price of services, there are significant deflationary pressures in the rest of the economy. In July the Producer Price Index for finished goods was down 1.1 percent in the year to July, prices of intermediate goods were down 1.5 percent over the same period, while the prices of crude materials goods were down by 6.2 percent. These price falls mean that "a little less than half the US economy is now in the throes of outright deflation."

The emergence of deflation in the US economy has far-reaching consequences. In the first place it means that the ability of the central bank to stimulate the economy through interest rate cuts is severely limited. If inflation is running at say 4 or 5 percent then a cut in interest rates provides businesses with an incentive to invest their cash surpluses because simply holding on to these surpluses will see their real value diminish.

But falling prices are a disincentive to investment because businesses with large cash balances find that the real value of their cash assets will increase over time.

This is not the only consequence of deflation. According to DeLong, even more important is the fact that "deflation exposes weaknesses in businesses' and banks' capital structures. If there is the potential for a chain of bankruptcies that will disrupt the flow of funds through financial markets, cripple investment spending and bring on a deep recession, deflation is the best way to turn that potential into an unpleasant reality."

New York Times economics columnist Paul Krugman is another to point to the parallels between the US and Japanese economies. In an August 16 article he noted that he used to have a list of four reasons why the US could not follow Japan into a decade of stagnation.

These were: the Fed had plenty of room to cut interest rates, the long-term budget position of the government was very strong, creating plenty of room for fiscal stimulus, there was no need to worry about Asian-style loss of confidence in the business section because of "excellent corporate governance" and while there was a stock bubble there was no real estate bubble.

The first three items had now been struck off the list, he wrote, and there was growing evidence that the rising US housing market was turning into a bubble. If that were the case, Krugman concluded, and the bubble burst, the US economy would start to look like Japan.

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