

Deflation threat to world economy

Nick Beams
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As stock markets continue to fall and financial problems start to spread, a discussion has broken out in sections of the financial press over whether the global economy is entering an era of deflation of a kind not seen since the Great Depression.

An article in the *Economist* of October 10, for example, headlined “Of debt, deflation and denial” warned that the risk of falling prices was greater than at any time since the 1930s. Deflation could be a serious threat in America, Europe as well as Japan. This could prove “particularly awkward” given the increase in borrowing, especially in the United States. This is because while in an inflationary environment the borrower tends to benefit as loans are repaid in a devalued currency, under deflationary conditions debt burdens increase.

If prices continue to fall for any length of time this leads to major problems when the value of assets drops below the loans taken out to purchase them. This is the situation now facing many banks and financial institutions in Japan and is one of the main reasons why, despite bank bailout efforts, the mass of bad loans within the financial system keeps on rising. Now it seems that these problems may be starting to spread to the rest of the world.

In another article published in the same edition, the *Economist* drew attention to a remark by American economist J. K. Galbraith that “inflation rescues firms from the errors of optimism and stupidity” noting that over the past three decades “indebted companies and individuals have often been bailed out by inflation, which has eroded the real burden of their debt.”

But while in both America and Europe private sector debt in the late 1990s rose more sharply in relation to gross domestic product than at any time in the past, with much of this borrowing assuming unrealistic growth in incomes, profits and share prices, “inflation can no longer rescue bosses and consumers from their folly.”

The *Financial Times* has also taken up the deflation debate. On October 9 it published a comment by Glenn Hubbard, chairman of the US president’s council of economic advisers, denying that the US was in danger of deflation. According to Hubbard the “basic features of the

US economy look quite good” and data showing that increases in productivity which began in 1995 are continuing unabated. Consumers, he claimed, could look forward to real incomes that grow more quickly than they have in the past 30 years. All in all, Hubbard insisted, “the economic fundamentals are sound.”

This optimistic outlook was not shared by Morgan Stanley chief economist Stephen Roach who contributed a comment to the *Financial Times* four days later. He claimed that the view of most economists that, despite the build up of deflationary pressures there would not be an overall fall in prices, was mistaken as it was based on the assumption that services, unlike goods, would not experience deflation.

Roach noted that services inflation was running at an annual rate of 3 percent at the end of 2000, the last peak in the business cycle, but since then had fallen by 0.8 of a percentage point. This contrasted with the experience over six previous recessions when services inflation increased on average by 0.2 of a percentage point over the six quarters following the business cycle peak.

The figures for the goods sector showed even more clearly the deflationary pressures at work. Goods inflation which was running at an annual rate of 0.7 percent at the last business cycle peak slipped into outright deflation of 0.8 percent in the second quarter of this year. “This swing,” Roach noted, “is three times the average change that occurred over the same 18-month period in the previous six business cycles.” The deflationary pressures in the goods-producing sector of the economy have been more intense than in previous business cycles, but this time they have not been offset by price increases in the services sector.

An article by the *Guardian*’s economics correspondent Larry Elliott, published on Monday under the headline “Deflation is a bigger threat than Saddam”, reported that the financial firm Lehmann Brothers had encountered a “litany of worries” in its discussions with central banks, hedge funds and equity fund managers. These include: that the impact of last year’s interest rate cuts is fading, that the US and Europe are on course to emulate Japan’s “lost decade” and that shares on Wall Street still have another 40 percent to fall.

The significance of deflation lies not only in the fact that it indicates downward pressure on profit rates, forcing firms to continually cut costs if they are selling in a market where prices are falling, but also that there is significant excess capacity throughout the economy. Back in 1999, the *Economist* estimated that the output gap—the difference between potential GDP and actual GDP—was at its highest level since the 1930s. There seems to be little improvement since then, and the situation may even have got worse with the US economy, operating at near capacity three years ago, now estimated to be running at 1 percent below its potential.

Deflationary pressures, falling profits, and declining share prices are also playing havoc in financial markets, with pressures building up on major banks and insurance companies as investments turn sour. The plight of the Japanese banks has been widely reported but now, according to an article in the October 13 edition of the *Financial Times*, it appears that a major financial crisis is building up in Germany.

“It has become fashionable to argue,” the article began, “that the world economy will survive corporate scandal and market upheaval without the kind of systemic banking crisis typical of previous bear markets. Look at Germany, though, and you have to wonder.

“German banking is in turmoil. As the Dax index of leading shares slides remorselessly, credit rating agencies are issuing stark warnings about lenders’ financial health. Bank shares have tumbled and credit spreads [the difference between the most secure and the most risky investments] have ballooned. Rumours of liquidity problems swirl through the markets. Despite hot denials from regulators and banks, twitchy investors are beginning to fear the worst: that, somewhere, a big bank failure is waiting to happen.”

The article pointed out that in terms of share values in dollar terms, German banks in the past year have performed worse than those of any country except Argentina and Brazil. European Central Bank chief economist Otmar Issing has claimed that while the German banking system was not “in crisis” the situation was “dramatic”. In London, bankers believe that the Bank of England is becoming concerned about the state of German banks and the risks their weakness poses to the whole financial system.

Serious strains are already starting to appear. According to the *Economist*, pessimism in international credit markets is unsettling equity markets and vice versa. Last week, it noted, five-year bonds issued by the Ford Motor Company were quoted at just 89 percent of their face value—reducing them to “junk” status, despite assurances from both major credit rating agencies, Moody’s and Standard and Poor’s, that they had no plans to downgrade the company’s debt rating.

It seems that Ford bonds were overwhelmed by general

market trends. So far this year 50 companies have had their investment-graded bonds downgraded to “junk” status, only seven short of last year’s total and the level of defaults in the corporate bond market has reached \$140 billion, already more than the total for 2001. The *Economist* noted that according to Moody’s “the creditworthiness of American companies has now deteriorated for 18 consecutive quarters, one short of a record.”

Taken together these processes severely undermine the reassurances by Hubbard and the Bush administration in general that all will be well in the US, and, by implication in the global economy, because productivity is still rising.

Hubbard asserts that incomes will rise because workers are more productive. But this is a false analysis because the driving force of the capitalist economy is not productivity, as such, but the rate of profit. And here is to be found one of the peculiarities of the present situation.

In the past rising productivity did tend to indicate rising profits. But since 1995, when, according to Hubbard and others, US productivity started to sharply increase, the opposite has been the case. National accounts data for the US show that overall profit rates began to fall from 1997 onwards. Individual companies, however, still continued to report profit increases above the growth rate in the economy. These results were only achieved by the kind of “creative accounting” and outright fraud and swindling for which Enron and WorldCom have become by-words.

That increased productivity has been accompanied by falling, rather than rising, profit rates, leading to overcapacity and deflation and the attendant problems these processes create in financial markets, is of considerable significance. It shows that the global economy is being wracked by the emergence of contradictions located in the very heart of the capitalist profit system.



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