Conventional “economic wisdom” overturned

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29 April 2003

In a sign of very changed economic times, a comment published in the *Financial Times* last week called on the US Federal Reserve Board to abandon its policy of seeking to curb inflation and urged instead a program aimed at boosting prices.

For more than five decades, and particularly over the past three, the prevailing economic orthodoxy has been that rising prices are the chief danger to a sound economy and that central banks need to ensure price stability.

Now this conventional wisdom is being turned on its head. According to the authors of the FT comment—Bill Dudley, chief economist of Goldman Sachs, and Paul McCulley, the managing director of Pimco, an investment management firm—rising prices are exactly what is needed. Without price increases of at least 2 percent, they maintain, the Fed, which has already cut its base rate to a 40-year low of 1.25 percent, has little room to manoeuvre in using monetary policy to try to stimulate the economy.

The chief danger of deflation is that it undermines the credit structure on which the expansion of all capitalist economies depends. In conditions of falling prices, firms that have taken out investment loans find that their real interest payments increase while at the same time the assets used to back loans rapidly lose value. Consequently, as Dudley and McCulley point out, the costs of deflation could be “very high” in the post-bubble economy of the US “given the heavy debt burdens of business and households.”

While the US economy is not yet in a deflationary state, it is approaching it. Moreover there is nothing in the latest economic data to indicate it will turn around any time soon. US gross domestic product grew at an annual rate of only 1.6 percent in the first quarter, barely above the 1.4 percent rate of the previous quarter, and well below predictions of a 2.4 percent growth rate. Among the major factors contributing to the slow growth were falling business investment and cuts in spending by state governments. In a sign of worsening profitability, non-residential fixed investment fell at an annual rate of 4.2 percent, down from a gain of 2.3 percent in the fourth quarter of last year.

The lack of investment directly contributes to the creation of a deflationary environment. Facing stagnant or falling prices businesses reduce their profit expectations and cut back investment plans. This leads in turn to falling employment, reduced consumption demand and a further decline in profit expectations and investments.

The Japanese economy has been in the grip of this type of deflationary cycle for most of the past decade. Now there are indications that the problem is spreading to the rest of the world.

As the *Economist* noted in an article published on April 21 entitled “How big is the danger?” the days when the search for a counter-inflationary policy dominated the lives of finance ministers and their officials have long gone and deflation is high on the agenda.

Japan is experiencing its fourth successive year of falling prices and the problem seems to be spreading, it continued. “In the past few months ... the comfortable assumption that the world’s second-biggest economy had problems that were peculiar to itself has been challenged” and there is growing concern that “deflation might become a problem in Europe or America.”

The *Economist* claimed that while America was yet to see the collapse in demand which accompanies or precedes deflation, the same could not be said for some European countries, in particular Switzerland and Germany.

Switzerland’s GDP had been growing at below its long-term trend rate, implying weak demand and surplus capacity. Even more significant were the warning signs in Germany. “The euro area’s largest economy is in poor shape: at best, growth is going to below trend both this year and next; at worst, the economy could slip into another recession. Domestic demand is weak, and the recent appreciation of the euro against the dollar is curbing export demand as well.”

Germany’s growing problems are compounded by the fact that whereas its economic circumstances would indicate the need for a cut in interest rates and an increase in government spending, interest rates are set by the European Central Bank for the eurozone as a whole and fiscal policy is constrained by the European stability and growth pact which sets budget deficit limits.

The growing dangers of German deflation were the subject of a recent paper by Adam Posen, a senior fellow at the Institute for International Economics. Entitled “Is Germany Turning Japanese?” Posen’s paper began by pointing out that since the end of the “reunification boom” the German economy—the world’s third largest—has lagged behind the rest of the eurozone with the gap widening “significantly” in the current downturn.

“Germany’s stock markets have suffered the largest losses of those in any major economy from the bursting of the IT/telecom bubble, and German real estate prices have been falling for nearly a decade,” he noted. By October last year the German DAX index was 68 percent below its March 2000 peak as opposed to a 49 percent drop over the US S&P index for the same period.

But, as Posen noted, the problems in the German economy precede the bursting of the financial bubble. Since 1992, its economy has grown at an average rate of just 1.3 percent per year. In 2002, the economy expanded by only 0.2 percent and the government’s forecast for 2003 is just 1.0 percent, which is “insufficient to keep public deficits and unemployment from rising further.”

Posen drew attention to the growing problems of the German banks and the similarities to the Japanese experience. Increasingly they are lending to “less productive small and medium enterprises” with these loans “secured mainly by real estate collateral of declining worth.” Like Japan, the more stable export-oriented manufacturing industries have raised a greater share of funds by going to foreign markets. As a result, the profitability of the loan portfolios of German banks has decreased.

Posen noted that while it was accurate to say that the “risk of financial breakdown or even abnormal interbank liquidity problems in German is negligible in 2003 ... the same thing could have been said of Japan’s banks at the start of the post-bubble years. A few consecutive years of low profitability creates a lack of capital, ultimately leading to distorted credit decisions and the accumulation of bad loans.”

Posen concluded by warning that the problems of the German economy had global implications. “The US economy is no longer growing at the same speed as it was during the Asian financial crisis, and cannot afford to take in a growing amount of imports indefinitely, let along increase its current account deficit by importing more from emerging markets, especially while cutting public savings by undertaking a war budget.”

Consequently, he continued, “preventing Germany from going further down Japan’s path” should be the “primary foreign economic policy priority” of the US and one of its “main security priorities overall.” However, the situation had not been helped by the “hectoring rhetoric of the Bush administration”, its emphasis on transatlantic differences and the claims that Germany’s problems result from its being part of “Old Europe.”

But there is little chance that calls for the US to take action to help boost the German economy will be heeded. In the first place, the mounting balance of payments and now budget deficits mean that the US is in no position to do so. Secondly, the very emergence of deflationary tendencies on a global scale points to the fact that profits are declining, overcapacity is increasing and the struggle for markets is growing more intense. This means that rather than increased collaboration, the economic relations between the major capitalist powers will be marked by deepening conflicts.