US Fed acknowledges deflation threat

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The statement from the Federal Reserve Board last Tuesday announcing its decision to keep its interest rate on hold at 1.25 percent Tuesday was just four paragraphs long but it attracted attention around the world. It wasn't the decision itself—that had been expected—but the accompanying statement on the economic outlook that sent a tremor through international financial markets.

According to the Fed, over the next few quarters the upside and downside risks to the attainment of economic growth were "roughly equal". But then an additional assessment was offered: "In contrast, over the same period, the probability of an unwelcome substantial fall in inflation, though minor, exceeds that of a pickup in inflation from its already low level." Consequently, the "balance of risks" was weighted to the "downside" for the foreseeable future.

What this rather convoluted phrasing added up to was that, after decades of trying to contain price increases, the Fed had offered an official assessment that too-low inflation represented a danger to the US economy. The signs that such a re-orientation in policy was about to be undertaken were clearly visible in the days leading up to the May 6 meeting of the Federal Open Market Committee (FOMC).

On April 30 Fed chairman Alan Greenspan, in testimony to the House of Representatives Financial Services Committee, warned that with price inflation already low, "substantial disinflation would be an unwelcome development, especially to the extent that it put pressure on profit margins and impeded the revival of business spending."

In March, senior Fed staff member Vincent Reinhart told the National Association of Business Economists that times had changed. "For the first time in 40 years," he said, "the Federal Open Market Committee is not in a position where it should obviously desire inflation to be lower than its current rate."

Minutes of the FOMC meeting of March 18, released last week, highlight the growing concern among Fed members over lower price levels. "Members saw further disinflation in core prices as a distinct possibility over the next several quarters," the minutes noted.

They were also pessimistic about the possibility of increased business investment, which is regarded as crucial for any sustained upturn in the US economy. There were a "variety of factors" likely to induce business firms to continue to hold back on investment decisions in the near term and there was "as yet not persuasive evidence that business fixed investment would provide the needed support for the strengthening in overall economic activity."

The immediate problem created by lower than normal price increases (disinflation) or outright price declines (deflation) is the setting up of a vicious economic circle. Stagnant or falling prices, reflecting lower profits, increase real interest rates and the debt burden on businesses, prompting them to cut back investment decisions. This leads in turn to a fall in economic growth, reduced profits, further price cutting and higher real interest rates and lower prices as firms try to maintain their share of the market.

Under these conditions, the ability of the Fed to stimulate the economy becomes increasingly restricted because interest rate cuts, aimed at trying to boost business investment, are overshadowed by the fall in prices. According to former Fed governor Laurence Myer, much of the benefit of the Fed's interest rate cut of half a percentage point last November has already been wiped out by the fall in the inflation rate since then. Real interest rates, he has concluded, after adjustment for inflation, are as high as they were six months ago.

The Fed's statement that it expected growth to recover, but was nevertheless worried by low inflation, has been interpreted as a commitment that it will not raise interest rates until the threat of deflation has passed. However, it remains to be seen whether the Fed can uphold such a commitment. This is because the sharp fall in the US dollar over the past few weeks is tending to increase American interest rates.

Following the Fed statement last week, the dollar fell to a four-year low of $1.15 against the euro. The euro has been steadily rising against the dollar for the past 10 months, after falling for the first three years of its existence, and on present trends may soon reach, or even exceed, its January 1999 issue level of $1.18.

The main factor in the fall of the dollar is the shift out of American financial markets by private foreign investors fearful that, with a record balance of payments gap of around $500 billion coupled with rising budget deficits, the value of the dollar is going to drop further, causing them significant losses.

While the general consensus among economists is that the US dollar should start to fall over the longer term, thereby boosting exports and easing deflationary pressures, there are concerns that serious financial consequences could follow if the decline is too rapid.

As the *Washington Post's* economic commentator Paul Blustein noted, "[A] tumble in the dollar risks getting out of hand by prompting foreign investors to dump their holdings of US stocks and bonds, which could drive interest rates up and choke off US economic growth."

According to International Monetary Fund chief economist, Kenneth Rogoff, while a moderate fall in the dollar would be a "welcome correction", a sudden decline "might lay bare weaknesses in the financial system" by causing huge losses for financial operators who had banked on the US dollar remaining stable or declining at a gradual rate.

The situation is further complicated by the contradictions besetting the world economy as a whole, some of which were elaborated by Morgan Stanley chief economist Stephen Roach in an article published in the Japanese newspaper *Nihon Keizai Shimbun* on May 1.

Roach began by pointing out that the threat of deflation reflects "the inherent tensions of an increasingly dysfunctional global economy." Since 1995, demand in the US has increased on average by 4 percent a year, double the 2 percent annual increase in the rest of the world. This has meant that the US accounted for 64 percent of the cumulative increase in world gross domestic product in the period 1994-2001—double its share of the world economy.

This imbalance has expressed itself in the growing US balance of payments gap which, if it continues, could reach the equivalent of 7 percent of gross domestic product (GDP), requiring a foreign capital inflow of $3 billion every business day. "The world," as Roach noted, "has never before faced an external financing burden of that magnitude."

The other major problem to which he pointed is the growth of excess capacity in key industries, a legacy of the collapse of the financial bubble of the late 1990s. In this respect "the American disease bears an eerie resemblance to the Japanese strain."

A so-called "rebalancing" of the world economy would require a fall in the value of the US dollar and a consequent appreciation of the yen and the euro. But this would lead in turn to cuts in demand for both eurozone and Japanese exports, under conditions where both these economic regions have relied on external demand to promote growth.

If rising currency values led to falling growth rates via a reduction in export demand, this could bring financial complications as well. The consequences of low growth and deflation are already visible in Japan, where the bad loan problems of the banks and major financial institutions have steadily worsened over the past decade. Now there is a danger that the same process could afflict the German financial system as well.

Examining each component of the world economy in this way reveals a series of interconnected contradictions.

The US economy needs a fall in the value of the dollar to increase exports and cut its balance of payments deficit but without too rapid a decline which would precipitate a capital outflow, interest rate hikes and recession. Europe and Japan, however, do not want to see appreciation of their currencies and a consequent reduction in markets. On the other hand, however, the process which has seen them finance the US deficit, thereby maintaining a "strong" dollar, cannot continue indefinitely.

While it is not possible to predict exactly how these contradictions will unfold, the fact that they have emerged with such sharpness points to the development of a major financial crisis of which deflation is a harbinger.