



DEFLATION – A PROBLEM OF THE SOCIO-MARKET ECONOMY OR A NEW THREAT?

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In this article I am going to focus on a process opposite to that of inflation, namely deflation. This is no random choice, since the fears of deflation in the world economy over the past months have been evidently growing. Economic observers and analysts draw attention to the vulnerability of the world economy to deflation processes. Alan Greenspan, the Federal Reserve chairman, in a discussion presentation to the Economics Club in New York in December 2002 noted that it is necessary to solve the issue of hidden deflationary pressures before they become an acute, real problem. This is now the second time in five years that the deflation issue has become the subject of examination and adequate measures for it sought. The first time was in 1997 and 1998 in connection with the Asian financial crisis. Then, it was brought about by deflation in Japan, followed by deflation in continental China and in several Asian countries with newly-established market economies, and in the end by a significant fall in inflation in advanced economies, where inflation as measured by the consumer price index fell below 2%, representing a 50-year record; where newly-established market economies have experienced their lowest rates of inflation since the 1960's.

Low inflation – less than 2% – has great advantages, for example in seeking out substantially more efficient resources and reducing uncertainties and imbalances in the economic environment. In the present economic situation – weak economic efficiency and the effects of a long-term nature from the collapse of stock exchanges markets, combined with structural changes in the world economy – a low rate inflation can increase the risk of deflation.

Legitimately the question arises, why is deflation harmful? Deflation can be relatively benign when global price indices fall to 1%, or may be temporary, meaning that it lasts only several quarters or less than 1 year; it may be mild, but last for example several years, or may be long-term and concurrently sudden, causing stagnation in the economy, where high unemployment is accompanied by a fall in prices and a fall in costs, as happened in the Great Depression of the world economy in the Thirties, and which was the most serious deflation of the 20th century. For this reason it is clear that as regards any assessment of deflation need be made on a case-by-case basis, taking regard of its intensity and duration. The first type of deflation – mild deflation – was seen at the end of the Eighties in Canada, Sweden and Norway. It was caused by a falling demand ensuing from a fall in asset prices. In this case deflation is accompanied by a slowdown or evident decline in economic activity. This decline in prices and economic activity is

however temporary. It is necessary to note that also a large number of developing countries have in recent years seen a decline in prices. But these declines, often brought about by a strong disruption to trade relations, have afflicted primarily countries exporting basic products and goods. This disruption to trade relations has lasted a relatively short time and not been very widespread. In connection to this, it is necessary to emphasise that an adverse change in trade relations is in fact a serious economic disruption, to which, if it lasts a long time, the economy must adapt its internal economic links and relations. If this adaptation is not made, the economy will suffer relatively significant losses.

Deflation, mild and temporary, may sometimes be brought about by improvements on the supply side. Such a case can be seen in China or in a decline in import prices. In such conditions economic activity may remain relatively high and asset prices may sometimes rise. Nevertheless, in such situations, especially if they have not been forecast, deflation can lead to a distribution of debtors' revenues towards creditors (in other words incomes of subjects typified by a strong propensity to spend towards those typified by a relatively weak propensity to spend), which operates in a depressive manner on aggregate demand. In the case of rigid nominal wages and a fall in prices of goods and services deflation will also increase real labour costs, which in the final result will reduce competitiveness. Where the ceiling for nominal interest rates is set, real interest rates grow in the case of the decline in price growth, which causes a decline in the effectiveness of monetary policy as an organic part of national economic policy, something which is extraordinarily unsettling, if production continues to decline. This situation can adversely affect the financial sector, the increase in the real value of businesses' and households' bonds putting pressure on their solvency.

What is the present state of the world economy? Japan, for example, is presently recording permanent deflation and weak economic activity, weak economic growth, although continental China, Hong Kong, Singapore and Taiwan have registered a relatively sharp fall in prices. In advanced economies, as well as in newly-established market economies however a fall in consumer price indices has been recorded from 1% – 3% over the course of the first half of the Nineties to 10% – 15% over the course of 2000, 2001 and 2002, representing a further higher fall in consumer price indices, which is shown also by the data in Tables 1 to 3.

Since the consumer price index may sometimes be marked by an irregular movement upwards in the range of

Table 1 Inflation in advanced industrial economies

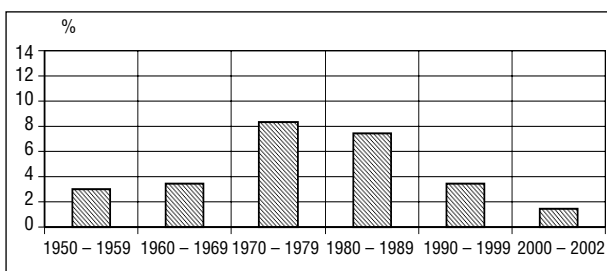


Table 2 Inflation in developing economies and newly-established socio-market economies

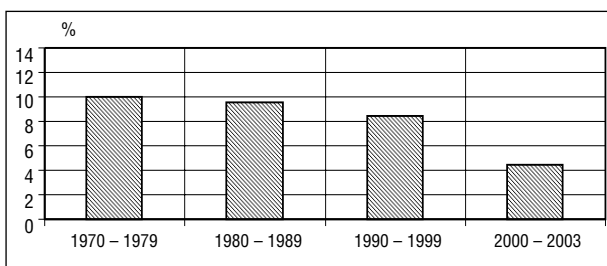
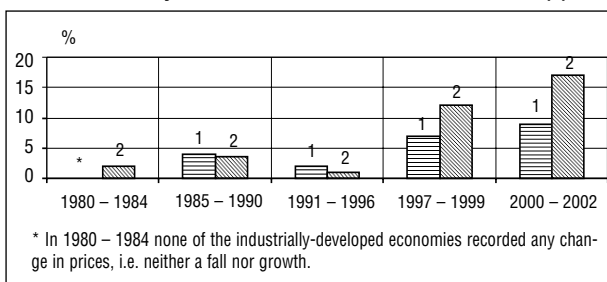


Table 3 Decline in industrially-developed economies (1) and in the newly-established socio-market economies (2)



Source: FMI, International Financial Statistics, podľa F a D, 2003.

0.5% – 1% (especially in situations where possibilities to substitute consumer goods as regards the existence of new products of higher quality are ignored), it may be said that inflation quantified at 1% should be closer to a stabilisation of prices or to deflation. In this case the economy falls within an area of slight deflation.

In the case of the existence of deflation there is the unsettling fact that incorrect consequences of deflation may begin to accumulate and deflation can become a permanent process, even though it is as yet only slight. This is the case of Japan, where the decline in prices over the years 1998 – 2002 reflects and spreads weak economic activity. Weak economic growth set off an adverse economic dynamic, business profits fall, the financial sector faces a growing proportion of non-performing loans, reducing financial intermediary processes, while consumption and productive capital expenditure are deferred.

What are the risks of deflationary processes and deflation as such? Mild, but persistent deflation was nothing extraordinary in the 19th century and earlier. It was characteristic that it always appeared, or came hand in hand with positive shocks, influencing the supply side of the econo-

my. Nonetheless, the general opinion prevails that deflation, even when it is still slight, has negative consequences on economic activity both at the macroeconomic as well as microeconomic level. Either is from the long-term point of view unsustainable. Deflation has another, no less significant, negative impact on the population's standard of living, which subsequently induces frequent social conflicts and political problems. Statistical polls made in employee and working-class households in the USA and United Kingdom have proven that the fall in nominal wages was not compensated by the (even) faster reduction in consumer prices. Economic growth is very slow, even slower than could be expected with regard to technological advances; the frequency of financial crises increases and crises of this sort become a very frequent phenomenon.

The risk exists that mild deflation will gradually develop into a very serious phenomenon in connection with the intensification of the decline in prices. Besides insufficient aggregate demand, problems of a structural nature may arise in the financial sector, rigidity in the labour market and goods market (capital, consumer and services), volumes of nominal state debt grow substantially. An inappropriate economic policy can also contribute to the increase in these risks. The economic policy is inappropriate in the sense that it does not correspond to the stage that the economy is at; in such a type of economic policy acute and anticipated anti-deflationary measures and objectives are absent. Deflation increases the real debt of the economy, aggregate demand is insufficient. All negative features of deflation lead to pressures on prices, worsen profits and in the end result also macroeconomic, national economic balances. A shortage of credit is seen and financial costs connected with obtaining credit are high. Wage rigidity may initially help in reducing the deflationary spiral, but can also cause a stronger fall in production, employment and business profits. An extreme consequence may be a loss of confidence in the national economy as a whole.

The macroeconomic data from Japan show how difficult it is to predict the occurrence, or emergence of deflation and deflationary processes. According to a detailed study on the beginnings of deflation in Japan, published by the Federal Reserve Board in 2002, polls conducted in households as consumer units and in businesses as production units, as well as yields on state and business bonds showed as early as the first half of the 90's that the persistence of slight inflation anticipated the initiation of deflation. From this it results that for correctly judging conjunctive risks it is not enough simply to focus on price indicators, or simply on financial indicators including price expectations and forecast bond yields, rather it is necessary to consider various indicators so that it is possible to identify factors that could induce deflationary processes in the economy. Such indicators include, for example, the rate of employment, the existence of a degree of surplus economic capacity or production potential, financial intermediary pro-



cesses, credit markets, etc. Through this statement we wish to draw attention to the important fact that the occurrence of a deflationary situation cannot be deduced simply from price movements, rather it is necessary to take account of and analyse other indicators, of which we draw particular attention to surplus economic capacities and potentials. Factographic indicators in this field have proven that surplus potentials in for example the G7 states have been on the increase and especially the largest rise in this direction has been recorded in Japan. According to projections of the World Economic Outlook, published in April and prepared by the International Monetary Fund, the deviation of production from economic production potentials in advanced economies is set to grow even more in a short-term outlook.

Over the course of the past three years share prices in advanced economies, as well as in other economies have fallen significantly. It is clear that these declines in prices adversely affect economic activity. They limit consumption (including individual consumption), act to reduce household assets and cause a decline in capital expenditure. It may seem that these impacts are not yet quite discernable, in particular as regards business balance sheets and those of financial institutions. House prices, which grew substantially in advanced economies - particularly in the United States and the United Kingdom – following a certain decline in mortgage lending have helped to ameliorate the effects of the decline in share prices on consumption.

What can be done to prevent deflationary effects? If deflation has occurred and is spreading further, this is a reason for appropriate measures. The competent financial bodies in advanced socio-market economies have available economic instruments for solving the problem arisen, they can even also take certain preventive measures. Monetary policy plays a key role in anticipating deflation. Still, as notes Paul Krugman [4], central banks underestimate either the risks of deflation or are unable for a variety of reasons – political and economic – to take the necessary measures to prevent deflation. If monetary policy does not deliver the expected results in solving deflation it is necessary to use budgetary policy and realise the respective structural measures.

The example of Japan's economy illustrates the use of monetary policy instruments. Before deflation monetary policy was seen as a policy corresponding to the current situation, it was assessed as loose. Stepping back and looking at the broader picture it may be said that it was manifested as too restrictive, since in the final result lower inflation was reported than was originally projected. With regard to this anticipation, monetary policy may play a key role. For example through an explicit inflation-targeting strategy a buffer zone may be created. The aim is essentially to reduce the risk of inflation closer to zero, which could harm the economy through deflation in the case of falling aggregate demand. The buffer zone interval in individual countries will differ depending on the severity and variety of

potential economic shocks and the economy's flexibility.

Besides this, a looser monetary policy is sometimes a desirable phenomenon when aggregate demand and the rate of economic activity notify of the risks of a decline. In this case it will be necessary to supplement the loose monetary policy by a more expansionary budgetary policy. It is possible that on the other hand through the action of automatic stabilisers a budgetary revival could turn out to be as counterproductive or pro-cyclical.

Institutions responsible for realising monetary policy are confronted with further problems from the aspect of deflation, specifically when nominal interest rates reach their ceilings. When the nominal interest rate is insignificant, it is, understandably, not possible to reduce interest rates in the conventional manner. The problem may further be complicated, for example, following a collapse in asset prices, the result of which as a rule is the need to make structural reforms. In a deflationary situation irrevocable receivables of the central bank grow and probably strengthen their aversion to take risks. Central banks can then influence the economy in other ways that may be used when central banks have been lowering interest rates for a long time – for example they may promise that during a certain period they will maintain interest rates from the short-term aspect at a low (insignificant) level, or that they will buy bonds with a longer maturity. The government moreover may support purchases of bonds through notifications of the yields that may be achieved on them.

From the above it can be seen that in many countries the threat of deflation is growing, while in other countries mild deflation is persisting. This vulnerability of economies is explained by the very low, or weak economic growth, the collapse of share prices, structural factors and in certain cases by political and economic pressures. The risks of general world deflation seem to be relatively weak. With regard to the problems that deflation may bring about and accumulate, it is however necessary and important to adopt preventive measures, so as to prevent the emergence of deflation and deflationary processes, and when the phenomenon of deflation and deflationary processes have become a fact, to seek vigorous measures for halting this process by means of effective and prompt anti-deflationary interventions.

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