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U.S. MARKET COMMENT: DEFLATION IN JAPAN—COULD IT HAPPEN IN THE UNITED STATES?

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The Federal Reserve's Rx to Avert Deflation

Japan could have averted deflation if it had applied more aggressive monetary and fiscal stimulus during the first half of the 1990s. This position was recently articulated in a Federal Reserve paper,[1] which prompted a flurry of opinion and observations among financial circles. This Comment provides highlights of a more in-depth piece that we will soon publish concerning the paper's policy recommendations and the host of commentary it elicited.

According to the Fed's paper, no one saw deflation coming in Japan: neither Japanese firms, financial markets, the Bank of Japan (BOJ), the Federal Reserve, Consensus Economics surveys, nor private sector forecasters. Deflation is not only extremely difficult to predict, but it also carries asymmetric risks. While too much stimulus can be taken back at a later stage by raising interest rates, providing too little stimulus could allow the economy to fall into deflation. From a policy standpoint, therefore, when interest rates and inflation approach their zero-bound limit, authorities should accelerate fiscal and monetary stimulus. Once inflation drops into negative territory and short-term interest rates approach zero, monetary policy runs into extreme difficulty in stimulating the economy.

The authors came to this policy recommendation by modeling Japan's economic activity, monetary policy, interest rates, and price levels. They found that the BOJ had a narrow window of opportunity to act before deflation extended its tenacious grasp over the economy. Between 1991 and early 1995, the central bank should have lowered policy interest rates by an additional 200 basis points, the Fed paper argues. The 1993-94 period was especially crucial for monetary policy because it was the last time inflation exceeded zero by a reasonable margin, so a sufficiently large drop in rates could have generated very low or negative short rates. After the second quarter 1995, lowering rates would have been ineffective.

By concluding that the best preventative against deflation would have been early and aggressive monetary policy, the paper dismisses accounts that blame the ineffectiveness of monetary and fiscal policy, or the deterioration of the banking sector. It contends that monetary policy in the early 1990s *did* function according to expectations by increasing asset prices, although several factors probably diminished its overall success. Similarly, fiscal policy in the early 1990s *did* affect economic activity, though more aggressiveness would have increased its efficacy. The banking sector played a relatively small role in precipitating the investment slowdown because demand for loans fell more sharply than supply.

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[1] "Preventing Deflation: Lessons from Japan's Experience in the 1990s," by Alan Ahearne, Joseph Gagnon, Jane Haltmaier, and Steve Kamin, *International Finance Discussion Papers*, No. 729, The Federal Reserve Board, June 2002. http://www.federalreserve.gov/pubs/ifdp/2002/729/ifdp729.pdf

The Fed's prescription of aggressively applying conventional macroeconomic tools to stimulate the economy applies to the United States and other industrialized economies as well. If interest rates and inflation began to approach their zero-bound limit in the United States, it is quite reasonable to assume that the central bank would aggressively lower policy interest rates and crank up the money supply tools (in fact, the Fed has been doing this).

Commentary: Secular Deflation Couldn't Happen Here

Most of the subsequent commentary among economists and financial pundits has not directly addressed the paper's policy recommendations. Instead, they have argued that the United States is extremely unlikely to suffer Japanese-style deflation because its economic institutions are quite different than those of Japan. Many analysts point out that, unlike the managed and intertwined economic system in Japan, the openness and competitiveness of the U.S. economy have enabled it to adjust quickly to the repercussions of the bubble fallout. Many have also expressed faith in U.S. and Federal Reserve officials to aggressively apply heavy doses of fiscal and monetary stimulus in order to avert deflation.

Many commentators believe that potential deflationary triggers in the United States are qualitatively different than those that existed in Japan. First, not only is America's financial system fundamentally healthier than Japan's, but their banking systems play disparate financial roles. In Japan, bank loans account for more than half of the total amount of corporate debt, while in the United States most corporate debt is in the form of capital market debt. This is a crucial distinction because capital markets tend to immediately mark tradable debt prices to market, while a bank-based system can defer that pain. Second, commentators often point to the bursting of the real estate bubble as a key contributor to Japan's deflationary pressures. Some, however, argue that the United States has not built up speculative excesses in real estate to the extent witnessed in Japan during the late 1980s.

While other pundits do not dismiss out of hand the possibility that the United States could move into deflation, they are not particularly worried about it at this time. As they see it, the current business cycle is playing out in a dynamic typical of other postwar slowdowns: inflation is decelerating but not yet at risk of falling into negative territory; prices have yet not dropped to the extent that they have added to the real burden of debtors; and consumer disposable personal income continues to look healthy. These conditions have held up relatively well in the current slowdown thus far, but they bear close monitoring to determine whether or not conditions are worsening.

Chances of Deflation Are Low, But Rising

We also believe that it is highly unlikely the United States will fall into a secular period of deflation. The deflation naysayers construct a reasonable case by underscoring the fundamental disparities between the two economies, as well as the qualitative differences between the catalysts for Japan's deflation and the current imbalances in the U.S. economy. That said, however, investors should not become too complacent, because the risks of deflation continue to rise, and they are currently higher than at any time since the Depression. Furthermore, while America's imbalances may be different than those of Japan, they could still unleash deflationary forces.

The Fed paper's remedy is to avert deflation by accelerating economic stimulus, while the central bank has aggressively lowered policy interest rates over the last two years. However, there is the possibility that monetary policy will *not* be able to resuscitate the economy in the future. It is also possible that the cure may be worse than the disease, in that low interest rates and easy money could generate other bubbles in the economy; the current housing market may be a prime example. By artificially reducing the cost of capital, creating money on a large-scale increases the incentive to borrow, which could lead to an investment bust, begetting deflation and increasing the real debt burden of borrowers. [2] The proposals articulated in this paper, as well as the Fed's actions to date and more aggressive policies discussed in other recent Fed papers, such as central bank purchases of stocks and corporate bonds, suggest that the central bank may be prepared to provide an unprecedented degree of monetary expansion if inflation and short-term interest rates move closer to zero. Of course, the exact course of its prospective actions cannot be known.

The Fed's paper emphasized that Japan's deflation arrived quickly and with little forewarning. The very unexpected nature of deflation, coupled with the current consensus of confident denial, may compel the contrarian to conclude that the future may in fact be more perilous than the deflation naysayers appreciate.

[2] This view was discussed in our recently published paper, "Austrian Economics and the Case for Shorter Government Bonds and Gold," *Selected Investment Perspectives*, Issue No. 12, September 10, 2002.